Financial System Stability Review

2012

Central Bank of Sri Lanka

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Governor's Message

Sri Lanka's financial system remained stable and resilient despite the challenges in the global and domestic environment in 2012. Subsequent to the recent global financial crisis, the recovery of the world economy remained sluggish and the international financial markets were fragile and uncertain.

Despite these challenges, the financial sector expanded steadily during the year 2012. In recording sustained growth in the asset base, the financial institutions have demonstrated their resilience to market pressures that manifested through global as well as domestic sources. The overall soundness of the financial institutions of the country improved with more than adequate capital and liquidity buffers, healthy earnings and strengthened corporate governance and risk management practices. The regulatory and macro prudential policies implemented by the Central Bank to further strengthen risk management frameworks of banks and non-bank financial institutions have enhanced the capacity for risk absorbency in the financial sector. Encouraged by the Central Bank, several banks were successful in securing foreign funding sources to further facilitate domestic economic activities. Safety net mechanisms and consumer protection were further strengthened and developed enhancing public confidence in the sector.

A strong financial intermediation function, that supplies adequate funding and a reliable and smooth payments system, is necessary to facilitate robust economic growth. The challenging task ahead for the financial sector will be to reposition itself to meet the demands of the fast growing economy and to strengthen its resilience to potentially severe risks from external as well as internal sources. In this regard, institutional capacity building along with financial innovation and financial infrastructure development would be vital. The deepening of the financial markets too would be necessary to supplement the financial institutions in catering to the growing financial needs. The strength, efficacy and stability of the financial system would be the foundation for robust economic growth which is vital in achieving the country's goal of becoming an economic hub in South Asia with a US dollar 100 billion economy and per capita income of US dollars 4,000 by 2016.

The Central Bank will continue to regularly and closely monitor the financial system, for the purpose of assessing stability and detecting any vulnerabilities or risks that may render the system less efficient or weak. By publication of this review of financial system stability, it is intended to create awareness of possible risks and vulnerabilities to financial stability, among the financial market participants, stakeholders and other regulatory authorities. A coordinated effort is required by all stakeholders of the financial system to ensure that the system is geared to successfully face the challenges in meeting the demands of a burgeoning economy.

Ajith Nivard Cabraal

Governor

Central Bank of Sri Lanka

1. Overall Stability Assessment

The financial system remained stable…

Sri Lanka's financial sector expanded and strengthened playing a key role in supporting the growth momentum of the economy despite challenging global as well as domestic market conditions. The overall soundness of the financial sector improved with adequate capital and liquidity levels, improved profitability, enhanced regulatory and risk management frameworks and confidence building through financial safety nets. The multi-pronged monetary, fiscal and macro prudential policy measures taken during the year to contain high credit and monetary expansion and to reduce the widening trade deficit have resulted in expected outcomes. Although some volatility was seen in the financial markets during early 2012, policy measures taken to contain excessive volatility have been effective.

…notwithstanding the global economic uncertainties.

The world economic growth forecast for 2012 has been revised down to 3.3 per cent from 3.8 per cent in 2011 largely due to the slow recovery in the advanced economies. With the slowdown in demand and fiscal cutbacks in advanced economies, global inflation has decelerated in both emerging markets and advanced countries. However, inflation has remained high in certain Asian countries, including India, due to elevated costs of food and housing. Monetary policy remained accommodative in most economies, while real interest rates in many emerging and developing economies were relatively low and credit growth remained high. The global financial markets, which have been affected by the Euro area crisis and the imbalances in other advanced economies, have remained fragile and uncertain during the year.

Several policy measures were taken to ensure stability in the domestic macroeconomic environment.

As the emerging markets and developing economies were affected by both low growth and uncertainty in advanced economies, the growth forecast for the Sri Lankan economy for 2012 is expected to moderate to 6.5 per cent after recording robust growth rates of above 8 per cent in 2010 and 2011. While the impact of global developments spilled over to the Sri Lankan economy through trade and financial channels, the multi-pronged policy measures implemented during 2012 have been successful in minimizing adverse effects. To counter the pressures on the external sector in the face of global uncertainty and to reign in possible demand side inflationary pressures from high credit and monetary expansion, greater flexibility in the exchange rate was allowed, policy interest rates were increased, a ceiling was imposed on private sector credit growth and duties on non-essential imports were increased.

The external sector imbalances were contained…

As a consequence of the policy measures implemented, the expenditure on imports decelerated significantly. However, export earnings have not increased as expected. Nevertheless, as the drop in expenditure on imports has been greater than the decline in earnings from exports, the trade deficit has contracted diffusing the pressure on the exchange rate. This improved performance in the trade account together with inflows to capital and financial accounts are expected to result in a BOP surplus in 2012. As at end November 2012, the gross official reserves stood at US$ 6.5 billion, which was equivalent to 4.1 months of imports.

...and demand side inflationary pressures were reined in by moderating monetary and credit expansion…

In response to the Central Bank tightening its monetary policy stance during the early part of the year, growth of money supply as well as credit to the private sector decelerated. Although inflation edged up during the year to reach 9.8 percent in July 2012, it has moderated to 9.2 per cent by December 2012 continuing to remain at single digit levels for the past 47 months. With expectations of further slowdown in credit utilisation and moderation of inflation towards mid-2013, monetary policy was eased with a view to induce a downward adjustment in market interest rates and the credit ceiling was allowed to expire at end 2012 to support the growth potential of the economy. However, overall fiscal management has been a challenging task during the year in the face of lower than expected revenue collection, recurrent expenditure overruns and frontloading of capital expenditure.

… enabling a conducive environment for financial sector expansion.

The domestic macroeconomic conditions were conducive for the financial sector to expand and remain resilient notwithstanding the challenging global and domestic market conditions. Single digit inflation and moderated inflation expectations, along with the improved external sector performance have buoyed investor confidence. Continued foreign investments were seen in both equity and government debt securities markets. However, the high interest rates have raised concern on the possible deterioration of asset quality of the banking and non-banking sectors.

Volatility seen in the financial markets during the early part of the year has stabilized with effective policy measures taken.

With the tightening of monetary policy amidst inflationary pressures and the liquidity constraints that prevailed intermittently in the market, there was upward pressure on the deposit and lending rates during most part of the year. The interbank call money rates have remained within the policy corridor. The yield rates in the government securities market also increased responding to the increase in policy interest rates, the increased borrowing requirement of the government and rising inflation until easing of monetary policy in December 2012, after which the yield rates have been decreasing steadily.

Among the policy measures that were introduced to curb excessive volatility in the foreign exchange market was the free floating of the exchange rate in February 2012 allowing the market to determine exchange rates. The rupee has thereafter depreciated by about 10.6 per cent against the US dollar as at end December 2012. The measures taken to decelerate import growth, the easing of exchange control regulations, the foreign currency inflows such as proceeds of the sovereign bond and the receipt of the last tranche of the IMF SBA program etc. have contributed towards stabilizing the exchange rate and raising the international reserves.

The stock market continued its downward trend during the year although a limited turnaround was seen during the month of September 2012. The decline in market liquidity, a rise in interest rates and restrictions imposed on broker credit contributed to the decline in stock prices. However, there has been continued foreign interest in the fundamentally sound blue-chip stocks due to the attractive price earnings ratios resulting in a total net inflow of foreign funds amounting to US$ 304 million during the 2012.

The banking sector remained stable and its expansion contributed to continued economic growth.

The banking sector has expanded in terms of the asset base, despite the increase in domestic interest rates. The stability of the banking system was maintained by way of strengthened supervisory and regulatory frameworks, improved risk management, enhanced legal frameworks, and confidence building through financial safety nets. The risk absorbency capacity of the banking sector improved with strengthened capital levels, adequate liquidity buffers and healthy earnings. With the banks raising capital funds from overseas, the sources of funding have diversified and the balance sheets have been strengthened. The capital adequacy and liquidity of the sector were maintained at healthy levels with a capital adequacy ratio of 15 per cent and the liquid assets ratio of 31 per cent, both well above the minimum regulatory requirements.

Deposits continued to be the main funding source, but the share of borrowings in the funding sources increased with the higher foreign currency borrowings. Profitability of the sector too has improved. Although the higher interest rates have marginally contracted the net interest margins, earnings have been buoyed by non-interest income attributed to foreign exchange revaluation gains as a result of the depreciation of the rupee during the year. The credit ceiling imposed to curb the excessive credit growth seen during 2011 and early 2012, has shown desired results. Hence, with expectations that the credit growth in 2013 will remain at desired levels, the credit ceiling has been allowed to expire at end 2012. However, the asset quality has deteriorated marginally in a high interest rate environment. The banking sector continued to be resilient to foreign exchange risk as well as operational risk and has undergone several regulatory reforms in line with developments in the international regulatory framework. Hence, with improved profitability, increased resilience to market and liquidity risks and enhanced corporate governance, the soundness of the banking sector has improved over the year.

Growth was also evident in non-bank financial institutions.

The significant expansion seen in the total asset base of the Licensed Finance Companies (LFC) and Specialized Leasing

Companies (SLC) was mainly attributable to the credit growth in the sector. The overall liquidity levels were in excess of the statutory minimum requirement while the non-performing loans ratio has improved marginally but remain challenged by the increased interest rates. Profitability has been maintained, supervisory, regulatory and legal frameworks have been strengthened and capital and liquidity buffers have been enhanced. However, several prudential requirements remain to be achieved in respect of the restructured companies in order to improve soundness of the overall sector.

The insurance sector soundness was maintained while it recorded growth in total assets, premium income and profitability, despite a decline in total investment income. The recent regulatory reforms, which include enhancement of capital based on risk weighted assets, segregation of life and general insurance businesses and listing on the Colombo Stock Exchange, are expected to further improve the soundness of the sector.

Although the primary dealers and stock brokers experienced a contraction in their assets bases due to the marked to market losses in investments in the government securities and stock market during the first half of 2012, recovery was seen thereafter. The primary dealers have recorded an overall profit for the year so far but the stock brokers and other market intermediaries remain in an overall loss territory. The value of the Unit Trusts sector too declined due to the downturn in the equity market.

The aggregate performance of the superannuation funds improved in terms of assets, investments and contributions, while risks have been adequately managed.

The systemically important financial infrastructure operated without any disruptions.

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

Table 1 **Total Assets and Deposit Liabilities of the Financial System**

Financial Institution	Assets				Deposits			
	2011 (a)		2012 September (b)		2011 (a)		2012 September (b)	
	Rs. billion	Share (%)	Rs. billion	Share (%)	Rs. billion	Share (%)	Rs. billion	Share (%)
Central Bank of Sri Lanka (CBSL)	**1,123.4**	**14.6**	**1,356.6**	**15.4**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Institutions Regulated by the CBSL	**4,877.3**	**63.3**	**5,608.7**	**63.7**	**3,258.5**	**98.3**	**3,698.8**	**98.0**
Deposit Taking Institutions	**4,604.3**	**59.7**	**5,344.6**	**60.7**	**3,258.5**	**98.3**	**3,698.8**	**98.0**
Licensed Commercial Banks	3,578.5	46.4	4,207.4	47.8	2,558.7	77.2	2,927.2	77.6
Licensed Specialised Banks	673.7	8.7	708.8	8.0	513.8	15.5	539.2	14.3
Licensed Finance Companies	352.1	4.6	428.4	4.9	186.0	5.6	232.4	6.2
Other Financial Institutions	**273.0**	**3.5**	**264.1**	**3.0**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Primary Dealers	132.7	1.8	128.5	1.5	n.a.	n.a.	n.a.	n.a.
Specialised Leasing Companies	137.7	1.8	135.6	1.5	n.a.	n.a.	n.a.	n.a.
Institutions not Regulated by the CBSL	**1,716.4**	**22.2**	**1,842.4**	**20.9**	**56.4**	**1.7**	**74.2**	**2.0**
Deposit Taking Institutions	**75.0**	**1.0**	**84.2**	**1.0**	**56.4**	**1.7**	**74.2**	**2.0**
Rural Banks (c)	67.6	0.9	76.9	0.9	51.4	1.6	67.9	1.8
Thrift and Credit Co-operative Societies (c)	7.4	0.1	7.3	0.1	5.0	0.2	6.3	0.2
Contractual Savings Institutions	**1,570.8**	**20.3**	**1,695.5**	**19.2**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Employees' Provident Fund	1,018.0	13.2	1,113.0	12.6	n.a.	n.a.	n.a.	n.a.
Employees' Trust Fund	142.4	1.8	154.3	1.8	n.a.	n.a.	n.a.	n.a.
Approved Private Provident Funds (d)	115.1	1.5	110.3	1.3	n.a.	n.a.	n.a.	n.a.
Public Service Provident Fund	29.9	0.4	31.3	0.4	n.a.	n.a.	n.a.	n.a.
Insurance Companies (e)	265.4	3.4	286.6	3.3	n.a.	n.a.	n.a.	n.a.
Other Financial Institutions	**68.5**	**0.8**	**67.7**	**0.8**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Stock Broking Companies (f)	11.3	0.1	18.2	0.2	n.a.	n.a.	n.a.	n.a.
Unit Trusts / Unit Trust Management Companies (f)	23.7	0.3	24.4	0.3	n.a.	n.a.	n.a.	n.a.
Market Intermediaries (f) (g)	31.2	0.3	22.8	0.3	n.a.	n.a.	n.a.	n.a.
Credit Rating Agencies (f)	0.2	0.0	0.2	0.0	n.a.	n.a.	n.a.	n.a.
Venture Capital Companies	2.1	0.0	2.1	0.0	n.a.	n.a.	n.a.	n.a.
Total Assets	**7,712.3**	**100.0**	**8,812.8**	**100.0**	**3,314.9**	**100.0**	**3,773.0**	**100.0**

(a) Revised.
(b) Provisional.
(c) Registered with the Department of Co-operative Development.
(d) Registered with the Department of Labour.
(e) Regulated by the Insurance Board of Sri Lanka.
(f) Regulated by the Securities and Exchange Commission of Sri Lanka.
(g) Market Intermediaries include Underwriters, Margin Providers and Investment Managers.
These assets of Licensed Banks, Licensed Finance Companies and Specialised Leasing Companies which are registered as Market Intermediaries has been excluded.

n.a. – Not applicable

Source : Central Bank of Sri Lanka

2. Global Developments

- *Advanced economies were weighed down by fiscal cutbacks and decline in economic activities in major economies such as the Euro area, Japan, United States and United Kingdom. The spill over effects from advanced economies have adversely affected the emerging market and developing economies, slowing down the growth of these economies.*

- *The projections for global output have been revised downwards for 2012, reflecting further delay in the global economic recovery.*

- *The global inflation has decelerated due to slowdown in global demand and easing of non-food commodity prices in both advanced economies and emerging market economies. However, inflation remained high in some Asian countries due to elevated cost of food commodities and housing.*

- *Most economies adopted accommodative monetary policies during 2012. While some advanced economies such as USA and UK resorted to quantitative easing, most economies reduced policy rates or postponed rate hikes amidst the decelerating global inflation.*

- *Effects of global developments which propagate to the Sri Lankan economy through external trade, worker remittances, tourism, portfolio and project investments, foreign direct investments, etc., have impacted the external sector. However, the policy measures taken have enabled the country to remain reasonably resilient to the external shocks.*

- *Although the global financial markets experienced favourable developments during 2012, they remained fragile and uncertain mainly due to the Euro area crisis and the imbalances in Japan and USA.*

Global Economic Growth

Projections of global output for 2012 have been lowered due to higher downside risks. As per the World Economic Outlook (WEO) published by the International Monetary Fund (IMF) in October 2012, projections for global output have been marginally lowered from its projections in April 2012. Advanced economies are expected to expand by around 1.3 per cent during the year 2012, down from 1.4 per cent as previously projected with the fiscal cutbacks, sharp slowing down in global manufacturing and decline in activities in major economies such as the Euro area, Japan, United States and United Kingdom. Spill over effects from advanced economies both through trade and financial channels, and domestically grown problems in the emerging market and developing economies have decelerated the activities in emerging market and developing economies as well. As a result, economic growth for 2012 in emerging market and developing economies is expected to slow down to 5.3 per cent from the previous projection of 5.7 per cent. As provided for in the latest WEO, relative to April 2012 forecasts, GDP growth forecast for 2013 has been revised downwards from 2.0 per cent to 1.5 per cent for advanced economies and from 6.0 per cent to 5.6 per cent for emerging market and developing economies, reflecting weakening nature of the global economy. In particular, the growth prospects of Euro area have slowed down sharply (Table 2.1).

Inflation

Global consumer price inflation is expected to ease as global demand slows and non-food commodity prices ease. However, sharply rising food prices remain a concern. Overall, headline inflation in 2012 in advanced economies is expected to reduce to 1.9 per cent, down from 2.7 per cent in 2011 due to lower commodity prices. The forecast is for further easing of inflation pressure in the advanced economies, with headline inflation to be about 1.6 per cent in 2013. Headline inflation in emerging market economies is expected to be around 6.1 per cent in 2012 while in 2013 it is projected to reduce further to 5.8 per cent (Table 2.2). Nevertheless, inflation remained high in a few economies in Asia, particularly India, Hong Kong, and Singapore due to elevated cost of food commodities and housing. Following the trend observed in headline inflation, core inflation has also decelerated both in emerging economies and advanced economies.

Table 2.1 **Economic Growth Prospects**

(per cent)

Region / Country	2008	2009	2010	2011	2012 (Proj.)	2013 (Proj.)	2017 (Proj.)
World	**2.8**	**-0.6**	**5.1**	**3.8**	**3.3**	**3.6**	**4.6**
Advanced Economies	**0.1**	**-3.5**	**3.0**	**1.6**	**1.3**	**1.5**	**2.6**
USA	-0.3	-3.1	2.4	1.8	2.2	2.1	3.3
Euro Area	0.4	-4.4	2.0	1.4	-0.4	0.2	1.7
UK	-0.1	-4.0	1.8	0.8	-0.4	1.1	2.7
Japan	-1.0	-5.5	4.5	-0.8	2.2	1.2	1.1
Emerging and Developing Economies	**6.1**	**2.7**	**7.4**	**6.2**	**5.3**	**5.6**	**6.2**
Developing Asia	7.9	7.0	9.5	7.8	6.7	7.2	7.7
China	9.6	9.2	10.4	9.2	7.8	8.2	8.5
India	6.9	5.9	10.1	6.8	4.9	6.0	6.9

Source : World Economic Outlook – October 2012

Table 2.2 **Inflation Prospects**

(per cent)

Region / Country	2008	2009	2010	2011	2012 (Proj.)	2013 (Proj.)	2017 (Proj.)
Advanced Economies	**3.4**	**0.1**	**1.5**	**2.7**	**1.9**	**1.6**	**1.9**
USA	3.8	-0.3	1.6	3.1	2.0	1.8	2.1
Euro Area	3.3	0.3	1.6	2.7	2.3	1.6	1.7
UK	3.6	2.1	3.3	4.5	2.7	1.9	1.9
Japan	1.4	-1.3	-0.7	-0.3	0.0	-0.2	1.0
Emerging and Developing Economies	**9.3**	**5.1**	**6.1**	**7.2**	**6.1**	**5.8**	**4.6**
Developing Asia	7.4	3.0	5.7	6.5	5.0	4.9	3.8
China	5.9	-0.7	3.3	5.4	3.0	3.0	3.0
India	8.3	10.9	12.0	8.9	10.2	9.6	5.0

Source : World Economic Outlook – October 2012

Monetary Conditions

In the major advanced economies, monetary policy is expected to remain very accommodative. Several economies have reduced policy rates in the past six months with some central banks implementing substantial cuts, while quantitative easing policies continued. For instance, the Federal Reserve recently announced that until economic conditions improve it would purchase Mortgage-backed securities at a pace of US $ 40 billion a month. Meanwhile, the Bank of England expanded its quantitative easing programme while other economies including Australia, Czech Republic, Israel and the Republic of Korea recently cut policy rates or postponed rate hikes. Over the medium term, policy rates may need to be adjusted upward, yet considering the downside risks to the economic outlook, many central banks may opt to hold steady or ease further.

Emerging market and developing economies launched a variety of easing measures in response to softening activity and inflation. Many postponed anticipated tightening, and some reduced policy rates, including Brazil, China, Colombia, Hungary, the Philippines and South Africa. Overall, real interest rates in many emerging market and developing economies are still relatively low and credit growth remains high.

Global Financial Markets

Even though, the global financial markets have experienced favourable developments in recent months, financial stability is prone to increased risks due to the fragile nature of confidence in the global financial system. As pointed out in the October 2012 issue of the Global Financial Stability Report (GFSR) published by the IMF, Euro area crisis remains the main concern despite efforts of European policymakers to restore eroding investor-confidence, reverse capital flight and restructure the affected countries in the Euro zone. Imbalances in both Japan and United States warrant policy action to carry-out medium-term adjustments in order to sustain confidence and arrest probable future market pressures. Although, uncertainty as measured by the Chicago Board Options Exchange Market Volatility Index in the United States and Bloomberg's Euro Stoxx 50 Volatility Index in Europe remained at fairly low levels, the worries whether the European policy makers are able to resist the Euro crisis and the inability of United States policymakers to agree on a fiscal plan contribute to enhance uncertainty.

The World Economic Outlook (WEO), October 2012, of the IMF sets out that many emerging market and developing economies have performed well over the past decade and through the global financial crisis. For the first time, they spent more time in expansion and had smaller and less frequent downturns compared to advanced economies mainly as a result of their improved policy arena. Nevertheless, since their resilience over time is questionable in the face of a worsening external environment and home-grown vulnerabilities, it is necessary for them to rebuild their buffers to absorb any potential shocks and mitigate the impact of such shocks.

Regulatory reforms with strengthened supervision and increased risk absorbency capacity is vital for speeding up the recovery process. GFSR's exploration as to whether the current regulatory reforms are proper and adequate to move the financial system in the correct path at the right pace, has found that progress has been restrictive due to reasons inter-alia that reforms are still in initial implementation stages and crisis intervention measures employed by some economies indeed delay their journey to a safer path rather than inducing the same. Furthermore, the GFSR reiterates the necessity of having effective implementation of reforms and strong supervision to secure greater financial stability. Policy measures such as bringing all the banks operating in the Euro area under the supervision of the European Central Bank, aimed at reversing the fragmentation of the Euro area and a movement towards complete integration, will contribute immensely to achieving strong financial stability. The GFSR also attempts to ascertain how certain features of the financial structure are related to economic outcomes, and the findings establish positive correlation between financial buffers made up of high-quality capital and truly liquid assets and better economic performance.

Effects of Global Developments on Sri Lanka's Economy and Financial Sector

Emerging market and developing economies are affected by both low growth and uncertainty in advanced economies, through trade and financial channels. Accordingly, effects of global developments may be propagated to the Sri Lankan economy through external trade and financial flows. The extent of the impact depends on Sri Lanka's exposure to crisis hit economies in the areas of trade, remittances, tourism, portfolio investments and foreign direct investments (FDIs).

Sri Lanka has performed reasonably well in the midst of unfavourable conditions prevailing in the global economy, particularly, in advanced economies. Inward workers' remittances increased by 17.1 per cent whilst tourist arrivals increased by 16.5 per cent during the first eleven months of 2012, year-on-year basis. Portfolio investments recorded a net inflow of US dollars 305 million in 2012, compared to a net outflow of US dollars 171 million recorded in 2011. Realized FDIs including foreign loans increased to US dollars 615 million during the first nine months of 2012 compared to US dollars 679 million during the corresponding period of 2011. However, during the first eleven months of 2012, export earnings of Sri Lanka dropped by 6.6 per cent compared to 21.9 per cent increase in the corresponding period of the previous year due to sluggish global demand and declining international commodity prices. As a result of the multi-pronged policy measures implemented to narrow the trade deficit, expenditure on imports declined by 4.5 per cent in the same period against a 53.0 per cent growth recorded in the relevant period in 2011. The trade deficit for the first eleven months of 2012 decreased by 2.1 per cent, compared to the increase of 112.4 per cent recorded for the first eleven months of 2011.

Despite the Euro area's severe economic downturn aggravated by the prolonged sovereign debt crisis, Sri Lanka's exports to the Euro area remained buoyant in 2011 and 2012. The share of exports to the Euro zone increased to 21 per cent in 2011 from 20 per cent in 2010. Sri Lanka's exports to the European Union and Euro zone accounted for about 34 per cent and 21 per cent of total exports respectively in 2011. Data for the first eleven months of 2012 reflects an export share of 32 per cent to the European Union and 20 per cent to the Euro zone. Meanwhile, the European Union contributed 9 per cent to Sri Lanka's total imports, while Euro zone accounted for 7 per cent of imports in 2011 and the same holds for the first eleven months of 2012.

Sri Lanka's exposure to crisis-hit countries in the Euro area appears to be insubstantial. Whole of Europe contributes to around 20 per cent of the total FDI flows to Sri Lanka. Out of the total Euro area investments in the first nine months of 2012, only a small share of 1.4 per cent was received from PIIGS countries (Portugal, Ireland, Italy, Greece and Spain). During the same period, major FDI contributors from the Euro area were Luxemburg (43 per cent) and Netherlands (20 per cent). In the first eleven months in 2012, tourism earnings from the Euro zone accounted for about 24 per cent of the total share of tourist earnings, with Germany, France and Netherlands contributing the major share of this portion at 76 per cent. Remittances from European countries generally accounts for 22 per cent of the total remittances to the country. In addition, the United States remained Sri Lanka's largest export destination, maintaining a share of 20 per cent in 2010 and 2011, despite its economic slowdown from 3 per cent in 2010 to 1.7 per cent in 2011.

In terms of projections for 2013, it is expected that exports earnings will improve in-line with the gradual recovery of global economic conditions and stabilizing international commodity prices. Nevertheless, the trade balance can be expected to widen given the anticipated increase in imports of intermediate and investment goods to facilitate a prospective higher rate of growth. Inward worker remittances, number of tourist arrivals, portfolio investments and FDIs are also expected to increase to mitigate part of the adverse impacts emanating from the uncertain global economy.

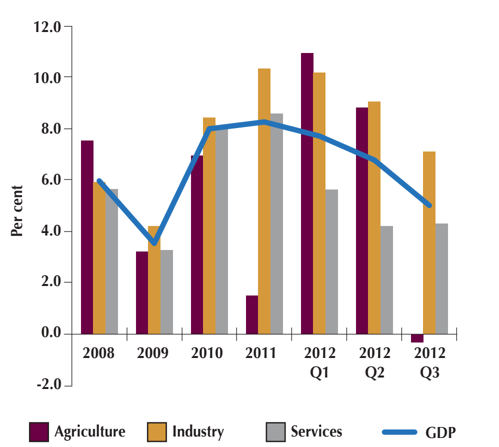
3. Domestic Macroeconomic Developments

- *During the first three quarters of 2012, the economy expanded by 6.3 per cent and is projected to record a growth of 6.5 per cent for the year, following two consecutive years of robust growth over 8 per cent in 2011 and 2010, despite the spill over effects of the global environment.*
- *Both agriculture and industry sectors grew by over 10 per cent during the first half of 2012. However, due to adverse weather conditions the agriculture sector recorded a negative growth in the third quarter. The slowdown in factory industry output and construction activities resulted in a slower growth in industry sector in the third quarter.*
- *The services sector also decelerated as a result of the dampening effect of weak global trade on exports and the reduction of imports in response to policy measures implemented.*
- *The external sector faced numerous challenges amidst threats emanating from the global and domestic economy. The multi-pronged policy measures taken by the Central Bank in the first quarter of 2012 were effective in containing the external sector imbalances.*
- *Maintaining the fiscal deficit within the budgetary target of 6.2 per cent of GDP was a challenging task due to lower than expected revenue collection and overruns in recurrent expenditure.*
- *Inflation which remained at single digit levels for the past 47 months edged up to 9.8 per cent in July 2012, due to demand side pressures and high monetary expansion, before moderating to 9.2 per cent by end 2012.*
- *In early 2012, the Central Bank tightened monetary policy to reign in possible demand side inflationary pressures arising from high credit and monetary expansion. However, with possible signs of weakening demand, monetary policy was loosened in December 2012 to support the growth potential of the economy.*

Economic Growth

The economy recorded a robust growth of 7.2 per cent during the first half of 2012 over an 8.1 per cent growth recorded in the corresponding period of the previous year. However, adverse weather patterns together with the slowing of global economic conditions, resulted in economic growth slowing to 4.8 per cent during the third quarter of 2012. The Agriculture sector recorded a negative growth of 0.5 per cent during the third quarter of 2012 as a result of a decline in paddy production due to severe drought conditions and a drop in rubber production due to price volatilities and replanting activity. However, tea and coconut production along with fisheries activities increased during this period. The Industry sector, which recorded a growth of 10.2 per cent during the first half of 2012, slowed during the third quarter recording a growth of 7.3 per cent on account of the slowdown in the factory industry output and construction activities. The Services sector recorded a growth of 5.1 per cent during the first half 2012, but slowed during the third quarter to 4.6 per cent largely due to the contraction in international trade on account of the policy measures taken to slowdown imports and the slow pace of the global economic recovery, which had an adverse impact on exports (Chart 3.1). Growth of activity in the sub-sectors of hotels and restaurants, transport and communication and banking, insurance and real estate also slowed during the third quarter of 2012.

Chart 3.1 GDP and Sectoral Performance (Growth Rate)



Growth of the Sri Lankan economy is expected to slow down to about 6.5 per cent in 2012 from 8.3 per cent in 2011 on account of the underperformance observed in some sectors of the economy and the sluggish recovery of the global economy. The Agriculture sector is expected to recover from its low growth recorded in the previous year with significant growth expected in coconut, livestock and fishing sub-sectors during the latter part of the year. However, a poor paddy harvest in the Yala season owing to the drought, followed by heavy rain and floods during December is expected to adversely affect growth projections. Furthermore, the contribution of the Industry and Services sectors to economic growth is expected to increase with some improvement in factory industry output along with trade, transport and tourism during the last quarter of 2012.

The expected slow performance in the Agriculture and Services sectors of the economy along with the slow pace of global economic recovery would pose downside risks towards sustaining the expected growth momentum during 2012. However, growth is expected to bounce back and be broad-based in 2013 with the expected improvement in performance in all major sectors alongside the slow but gradual recovery expected in the global economy.

The domestic financial sector has remained resilient despite the uncertainty in global financial markets. The relaxation of several rules by the Securities and Exchange Commission (SEC) is expected to improve investor confidence and increase stock market activity, thereby providing greater impetus towards economic expansion. Equally, the easing of exchange control regulations is expected to increase Foreign Direct Investments (FDI) thereby improving inflows to the capital and financial account. The financial sector will also have to play an important role in relation to financial intermediation and promoting financial inclusiveness in the economy, which would ensure high, sustained and inclusive growth.

Developments in the External Sector

Multi-pronged policy measures were implemented to arrest the numerous challenges faced by the external sector from threats emanating from the global economy during the first few months of 2012. Weakening of global demand as a result of the sluggish recovery of the global economy was the key challenge that authorities had to deal with earlier this year. Several steps were taken by the Central Bank and the Government to address these issues in the external sector ranging from allowing greater flexibility to the movement in the exchange rate, raising policy rates and imposing a ceiling on growth of private sector credit and increasing duties on non-essential imports. Furthermore, measures such as relaxing exchange control regulations, raising the threshold for foreign investment in government securities, and promoting and encouraging the raising of funds from international markets among banks and local corporates were also taken to strengthen the capital and financial accounts of the balance of payments (BOP).

Consequently, imports have decelerated since April, 2012. The trade deficit has narrowed by 0.3 per cent in the first nine months of 2012. The current account deficit also decelerated to US dollars 2,723 million in the first nine months of 2012, from US dollars 2,920 million recorded in the corresponding period of 2011, reflecting the improvements in workers' remittances and earnings from tourism and transportation.

Inflows to the capital and financial accounts increased significantly. Inflows to the government were in the form of receipts of project financing, foreign investments in Treasury bills and Treasury bonds and the proceeds of the fifth international sovereign bond. In addition, higher inflows were recorded to the private sector from foreign direct investments, net foreign inflows on account of portfolio investments and the mobilisation of funds from abroad by commercial banks.

The improved performance in the trade account as well as inflows to the capital and financial account are expected to have resulted in a BOP surplus in 2012. As of end November 2012, the gross official reserves stood at US dollars 6.5 billion, which was equivalent to 4.1 months of imports.

The Central Bank allowed more flexibility in the exchange rate and limited its intervention substantially since February 2012. During 2012 the rupee depreciated by 10.43 per cent, reflecting the flexible exchange rate policy announced at the beginning of the year. However, since end of June 2012, the rupee has appreciated by 5.3 per cent as at end December 2012. This can be mainly attributed to the gradual deceleration of import expenditure and increase of foreign exchange inflows owing to tourism and workers' remittances and conversion of exports proceeds towards the end of the year. The rupee depreciated against most other major currencies reflecting cross currency exchange rate movements. Accordingly, the rupee depreciated against the euro (12.31

per cent), the Pound sterling (14.61 per cent), Indian rupee (7.45 per cent) and Japanese yen (0.88per cent), during the year 2012.

Despite the challenging global environment, the external sector is expected to have recorded a substantial improvement during 2012. The policy measures adopted by the authorities earlier this year are expected to significantly reduce expenditure on imports although export earnings have been adversely affected by fluctuations in commodity prices in international markets along with the slowing down of global demand. The current account deficit is expected to decline to around 5.5 per cent of GDP in 2012 from 7.8 per cent of GDP in the previous year on account of expected improvement in the trade deficit and from services and workers' remittances. Accordingly, along with expected inflows to capital and financial accounts, the overall BOP is expected to record a surplus in 2012.

Developments in the Fiscal Sector and Government Debt

Strengthening the fiscal consolidation process by improving revenue while rationalising recurrent expenditure and maintaining capital expenditure at a desired level to support the expected higher economic growth was the main focus of the budget for 2012. Provisional data for the first eight months of 2012 along with the projections for the rest of the year indicate that overall fiscal management has become challenging owing to lower than expected revenue collection, recurrent expenditure overruns and the front loading of capital expenditure. In nominal terms, total revenue collection increased by 10.0 per cent to Rs.632 billion during the first eight months of 2012 from Rs.575 billion recorded during the same period of 2011. However, total government revenue as a percentage of estimated GDP during the first eight months of 2012 declined to 8.4 per cent compared to 8.8 per cent in the corresponding period of 2011 mainly on account of the lower than expected revenue collection caused by the slowing down of imports and economic activity and the downward revision of VAT rates in 2011. Foreign grant disbursements in nominal terms increased by 44.3 per cent during the first seven months of 2012 although it is expected to decline gradually over the years with the improvement of the country's per capita income and its status as a 'middle income – emerging market country'.

Government expenditure and net lending during the first eight months of 2012 increased. This was mainly as a result of higher interest expenditure due to greater reliance on short-term domestic financing in early 2012, and the depreciation of the Sri Lanka rupee against major currencies, along with the front-loading of capital expenditure. Accordingly, total expenditure and net lending as a percentage of estimated GDP increased to 14.5 per cent during the first eight months of 2012, from 14.2 per cent in the corresponding period in 2011. Government expenditure and net lending increased by 18.2 per cent to Rs.1,100.0 billion in nominal terms during this period, compared to Rs.930.3 billion in the corresponding period in the previous year. During the first eight months of 2012, recurrent expenditure in nominal terms is estimated to have increased by 13.2 per cent to Rs.781.0 billion from Rs.690.0 billion in the corresponding period of 2011, mainly owing to increases in interest payments, fertiliser subsidy, pension payments and salaries and wages. However, recurrent expenditure as a percentage of estimated GDP declined to 10.3 per cent during the first eight months of 2012 compared to 10.6 per cent in the corresponding period of 2011. Further, capital expenditure and net lending is also estimated to have increased significantly by 32.8 per

Box 1

The Credit Growth and Financial System Stability

A healthy, sustainable rate of credit growth is paramount for the growth of an economy as well as for the development of the financial sector. However, excessive credit growth could threaten a country's macroeconomic stability through economic overheating if it causes the economy to grow above its potential. Excessive credit growth may lead to future inflationary pressures while impacting adversely inflation, interest rates and the external current account balance. It can also result in the destabilization of the financial system through the rise of non performing advances and balance sheet mismatches. Moreover, excessive credit growth, if unchecked, could lead to the buildup of a credit bubble. A possible burst of the bubble could lead to negative macroeconomic outcomes and financial system instability.

A "credit boom" is an expansion in credit to private sector, where the rate of credit expansion is significantly higher than nominal GDP growth (Ottens et.al., 2005). A credit boom can also be seen as an episode of excessive credit expansion that is unsustainable and will eventually collapse of its own accord (IMF, 2004). More prolonged the credit boom, higher the tendency of the "boom" to precipitate in a crisis. Out of credit boom cases, about one out of every three ends up in financial crises (IMF, 2004). However, excessive credit growth does not always result in a "credit boom." Credit growth may exceed nominal GDP growth for some period of time due to financial deepening. Rapid credit growth in a developing country may also simply be a manifestation of convergence to the average credit levels in advanced economies. Credit can also grow in tandem with increases in income whereby the financial accelerator mechanism comes in to play in accordance to the theory of business cycles. During a period of economic expansion, increased economic activity push asset prices up, which in turn enhances the credit worthiness of borrowers, enabling borrowers to borrow more against higher collateral values, thus generating procyclical credit cycles. Procyclicality of the financial system can lead to systemic risk amplifying the stresses in the financial system. The difficulty remains in identifying a good "boom" from a bad one in real time.

Credit growth is closely linked to financial system stability. During a high growth-low interest rate period, banks and other lending institutions expand the size of their loan portfolio in response to high credit demand. Such expansion could result in the worsening of maturity mismatches in the financial intermediation process of banks and other financial institutions by borrowing short term and lending longer term. Moreover, with increased expectation of economic prosperity, lending institutions may extend loans to high-risk borrowers with an overoptimistic expectation of recovering the dues, leading to increased risk of non-performing loans (NPLs) in future. The increased competition among the financial sector may also lead to higher credit risk where institutions accept lower credit quality, high risk borrowers that may result in an increase in defaults in future. Increased defaults may trigger the burst of the credit "bubble," and may lead to a situation, which, if not checked in time, results in a banking and financial crisis in the medium to long term. Moreover, when credit growth arises from foreign currency borrowings sourced through the domestic financial sector in a situation where foreign interest rates are low, this may enhance the domestic banking sector exposure to foreign exchange risk.

Depending on criteria such as expediency, effectiveness and simplicity of use, central banks and supervisory authorities of lending institutions have resorted to use several tools to limit credit growth (Dragulin 2008, Herzberg 2008). Monetary policy, fiscal policy and macroprudential tools[1/] are used in dealing with high credit growth or

1/ Macroprudential tools are designed to address risks to the financial system arising from common exposures and interlinkages between financial institutions (cross section dimension of macroprudential analysis) and aggregate risks that build up over time (time dimension of macroprudential analysis) such as those emanating from the procyclicality of the financial system.

Box 1 (*Contd.*)

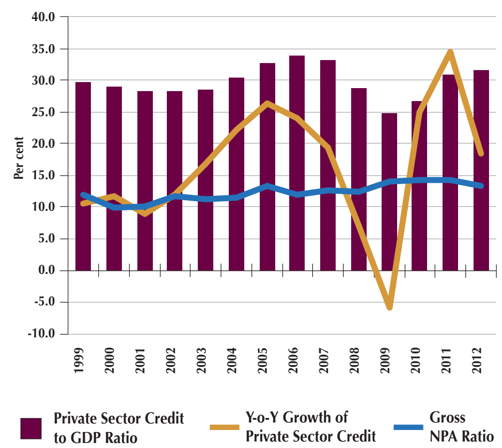
credit booms. By controlling monetary expansion through tight liquidity conditions and higher interest rates, credit growth could be dampened. This may have adverse effects such as limiting economic growth and increasing the debt burden of the private sector due to increased interest rates in a tight monetary environment. The hike in interest rates may also expose the financial sector to higher credit risk as borrowers face difficulties in servicing their debt. Due to high cost of domestic borrowing, the private sector may seek to continue borrowing from external sources resulting in increased exposure to foreign exchange risk. Fiscal policy measures could be used to discharge credit disbursement to more productive sectors through the tax structure. Macroprudential tools in the form of credit ceilings, loan-to-value (LTV) ratios, countercyclical capital buffers and countercyclical provisioning can minimize systemic risk arising from excessive credit growth. Basel III reforms, agreed in 2010, have provided banks and other lending institutions with provisions for the creation of a "countercyclical capital buffer" (Basel Committee on Bank Supervision, 2010). Such capital buffer, expressed as a percentage of risk weighted assets (RWA) of a bank, and covered by high quality Tier 1 capital, would enable banks to see through any systemic risk that may arise during a credit boom.

Taming Credit Growth in Sri Lanka

The Sri Lankan banking sector witnessed an expansion of credit to the private sector from a negative 5.8 per cent growth at end 2009 to 24.9 per cent at end 2010 and further to 34.5 per cent at end 2011 on a year-on-year basis. A high growth was also witnessed in credit granted by the non-bank financial sector as well.

Sri Lanka has on average maintained a private sector credit to GDP ratio of around 30 per cent during the past decade. While this ratio declined to below 25 per cent in 2009, with the ending of the ethnic conflict, demand for credit rose due to enhanced investor confidence and increased domestic economic activity. At the end of 2010, Sri Lanka recorded a high growth rate of 8 per cent which was sustained for two consecutive years. The conducive macroeconomic environment

Chart B3.1 **Credit Granted by LCBs and Related Ratios**



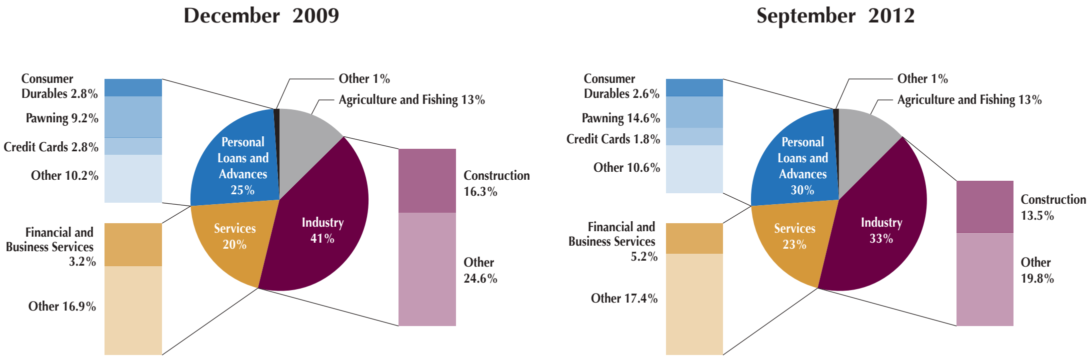
Source : Central Bank of Sri Lanka

with low interest rates and inflation, and stable exchange rates spurred demand for credit further, and the high credit growth raised the private sector credit to GDP ratio to over 30 per cent again in 2011. However, the credit expansion in Sri Lanka was broad based. In terms of sector-wise credit growth, the outstanding credit to private sector by commercial banks was spread out among all sectors, which prevented bubble formation in a specific sector (See Chart B3.2). In terms of maturity, higher growth was seen in medium and long term credit in 2011, compared to the previous year especially in housing and construction sectors and consumer durables such as motor vehicles. As such, the high rate of credit expansion that occurred during the period from 2010 to the first quarter of 2012 can be seen as a correction of the decline in the private sector credit to GDP ratio observed in the three-year period prior to 2010.

However, high credit growth also resulted in an expanded trade and current account deficit with demand for imports sustained at high levels, threatening the country's macroeconomic stability. Increased lending by commercial banks also contributed to the growth of broad money. Broad money, which grew at a rapid pace in 2011, continued to grow unabated in early 2012, warranting policy action to mitigate inflationary pressures that could have arisen from excessive credit and monetary expansion.

Box 1 (*Contd.*)

Chart B3.2 **Commercial Banks Loans and Advances to the Private Sector**



The Central Bank of Sri Lanka resorted to several policy measures to curb credit growth. The statutory reserve ratio was increased in April 2011 to absorb part of excess market liquidity, thus signaling the beginning of policy tightening. In February 2012, the Central Bank raised its policy rates by increasing the Repurchase rate and the Reverse Repurchase rate by 50 basis points each and again in April 2012 by raising the Repurchase rate by 25 basis points and the Reverse Repurchase rate by 75 basis points respectively. However, in order to bring about a more rapid curtailment of credit, and arrest possible buildup of a credit bubble, the Central Bank employed a "hard tool," *i.e.*, the credit ceiling. The Central Bank issued a direction in March 2012 to all licensed banks under Section 101(1) of the Monetary Law Act, No. 58 of 1949, imposing a ceiling on rupee lending during the year. Accordingly, credit growth was to be restricted to 18 per cent or Rs. 800 million, whichever was higher, while 23 per cent or Rs. 1 billion was allowed for banks that mobilised funds from abroad. The credit ceiling and the contractionary monetary policy measures of the Central Bank, *i.e.*, policy rate increases, resulted in a gradual decline in credit growth from April 2012. Thus, by swiftly engaging the credit ceiling, a possible building of a credit bubble was averted, possible inflationary pressures minimized, and the stability of the financial system strengthened.

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cent to Rs.319.1 billion during this period, of which foreign funded capital expenditure increased significantly by 59.1 per cent mainly for infrastructure development, while rupee funded capital expenditure increased by 10.7 per cent.

With these developments, maintaining the overall deficit within the annual budgetary target of 6.2 per cent of GDP will be a challenging task. The overall fiscal deficit as a percentage of estimated GDP increased to 6.0 per cent (Rs.454.6 billion) during the first eight months of 2012, from 5.3 per cent (Rs.349.6 billion) in the corresponding period of 2011. In financing the overall budget deficit during the first eight months of 2012, the major share of funding came from foreign sources mainly due to the substantial increase in foreign investment in rupee denominated government securities with the relaxation of eligible borrowing limit for foreign investors, and the successful issue of the fifth international sovereign bond amounting to US dollars 1 billion in July 2012. During the period under review, foreign sources contributed Rs.247.2 billion (54.4 per cent of total financing), compared to Rs.120.1 billion (34.4 per cent of total financing) in the corresponding period of 2011, whilst domestic sources contributed the balance Rs.207.4 billion (45.6 per cent of total financing), compared to Rs.229.5 billion (65.6 per cent of total financing) in the same period of the previous year.

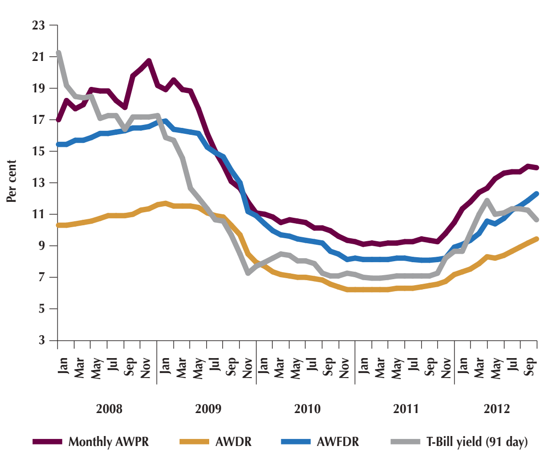
Accordingly, total outstanding government debt increased by Rs.1,115.6 billion to Rs.6,249.0 billion as at end August 2012 from Rs.5,133.4 billion as at end 2011. Foreign debt increased by Rs.666.5 billion to Rs.2,995.8 billion, thereby accounting for 48 per cent of the total debt stock, while domestic debt increased by Rs.449.1 billion to Rs.3,253.2 billion during the period under review. The increase in foreign debt during the year was mainly on account of receipts from the issue of the US dollar 1 billion international sovereign bond in July 2012 and the increase in bilateral loans during the period, whilst increase in borrowings through Treasury bonds caused domestic debt to increase. Of the total domestic debt, short term debt increased by only 15.0 per cent from end December 2011 to end August 2012. However, medium and long term domestic debt increased by 16.4 per cent during this period mainly due to an increase in borrowings through Treasury bonds. The depreciation of the Sri Lanka rupee against major foreign currencies during the first eight months of 2012 contributed by Rs.365.4 billion to the increase in the total debt stock.

Developments in the Monetary Sector

In 2012, the Central Bank tightened monetary policy substantially considering the risks posed by high credit growth to demand driven inflation and external sector stability. As a result, the Central Bank raised its policy rates twice during the year: the Repurchase rate and the Reverse Repurchase rate were raised by 50 basis points each in February 2012, and in April 2012, the Repurchase rate and the Reverse Repurchase rate were raised by 25 basis points and 75 basis points, respectively. The Central Bank also took measures to curtail domestic credit by issuing a direction in March to all licensed banks under Section 101(1) of the Monetary Law Act, imposing a ceiling on their rupee lending during the year. Accordingly, credit growth was to be restricted to 18 per cent of the total outstanding of rupee credit as at end 2011 or Rs.800 million, whichever is higher. Banks were allowed to grant rupee credit in 2012 in excess of the above limit up to 23 per cent of the total outstanding of rupee credit as at end 2011 or Rs.1,000 million, whichever is higher, provided the corresponding funds were raised from overseas sources. However, with the expectation of further slowdown in credit growth and monetary expansion, monetary policy was eased in December 2012, with a view to inducing downward adjustment in market interest rates and to support the growth potential of the economy.

Money market liquidity during the first nine months of 2012 was in excess albeit displaying considerable volatility. The Central Bank's purchases of Treasury bills from the primary market, profit transfers and provisional advances to the government and the Central Bank entering into foreign exchange swap arrangements with commercial banks contributed to the overnight excess liquidity, which averaged around Rs.11 billion in the first nine months of 2012. The tax adjusted average weighted call money rate (AWCMR) increased by 143 basis points to 9.50 per cent by end September 2012 from end 2011, whilst the AWCMR including tax increased by 158 basis points to 10.55 per cent during the first nine months of the year thereby reflecting the policy rate adjustments and volatility in the market liquidity. In line with the increase in policy rates and tight

Chart 3.2 **Deposit Rates of Commercial Banks, Treasury Bill Yield and Monthly AWPR**



monetary conditions, market interest rates rose, with both lending and deposit rates rising substantially thus far during this year (Chart 3.2). Likewise, yield rates on government securities moved upwards in both primary and secondary markets due to the higher borrowing requirement of the government and policy actions taken earlier this year. However, some decline in yield rates has been observed since September 2012.

The Central Bank implemented a series of policy measures during the first quarter of 2012 to arrest further expansion of credit and money supply. Supported by improved macroeconomic conditions, heightened investor confidence and enhanced prospects for economic growth, credit obtained by the private sector continued to increase during the first quarter of 2012, thereby fuelling monetary expansion and the growth of imports leading to a widening of the trade deficit. In response to the policy actions implemented, the quarterly growth of broad money (M_{2b}) decelerated to 2.4 per cent in the second quarter of 2012 from 7.3 per cent in the first quarter of 2012. Growth of broad money during the first eight months of the year moderated to 12.9 per cent although year-on-year growth of broad money increased to 20.2 per cent by August 2012 compared to 19.1 per cent recorded in December 2011. Similarly, quarter-on-quarter growth of credit extended to the private sector by commercial banks decelerated to 3.4 per cent in the second quarter from 7.7 per cent in the first quarter of 2012 following the significant tightening of monetary policy. Year-on-year growth of credit to the private sector decelerated to 28.7 per cent in August 2012 from 34.5 per cent at end 2011 (Chart 3.3). However, credit obtained by the government increased by Rs.198 billion during the first eight months of the year.

Chart 3.3 Credit Granted by Commercial Banks to the Private Sector

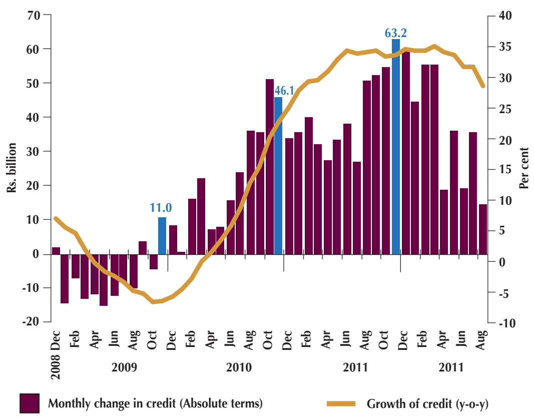
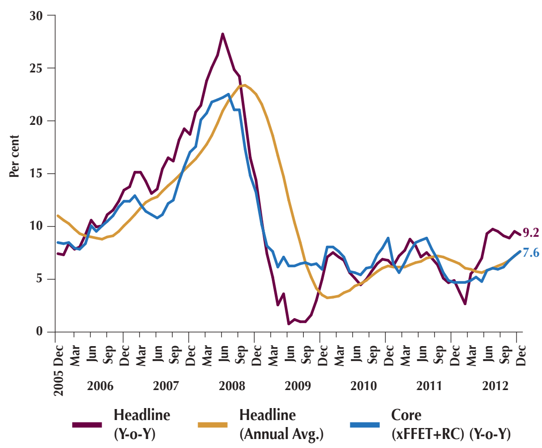


Chart 3.4 Movements of Headline and Core Inflation



Credit extended to the private sector by commercial banks is expected to moderate further during the remainder of the year as banks have expressed their commitment to meet the credit ceiling by year end. The deceleration of credit growth to the private sector along with a reduction in public sector borrowings from the domestic banking sector is necessary to ensure that growth of broad money supply is maintained at the targeted level.

Inflation

Inflation moderated to 9.2 by year end supported by demand management policies adopted earlier this year and with domestic food supplies returning to normalcy. Inflation, which has remained at single digit levels for 47 months declined to 2.7 per cent in February 2012 supported by improved domestic supply of agricultural commodities and relatively low international commodity prices. However, year on year inflation increased thereafter due to the upward adjustment of several administratively determined prices to reflect developments in international commodity markets, the pass-through of the depreciation of the rupee, supply disruptions on account of drought conditions in major cultivation areas and the high monetary expansion in 2011. Accordingly, year on year inflation edged up to 9.8 per cent in July 2012 before moderating to 9.2 by end 2012 (Chart 3.4).

Effects of Macroeconomic Developments on the Financial Sector

Conducive domestic macroeconomic conditions and the high growth momentum of the economy helped the financial sector expand and remain resilient notwithstanding the uncertain global and domestic market conditions. This has enabled both banking and the non-banking sectors to expand thus far during 2012. Profitability of banks and other financial institutions is expected to increase with the increase in provision of financial services arising from the rapid development taking place in the Northern and the Eastern provinces.

Single digit inflation and moderated inflation expectations, along with the easing of exchange control and capital market

regulations are expected to improve business and investor confidence, and increase economic activity thereby improving the resilience and profitability of the financial sector. However, with the raising of policy rates during the early part of 2012 and constricted liquidity in the domestic money market, both deposit and lending rates increased during the year. Banks and other financial institutions were forced to offer high rates of interest to mobilise deposits for lending purposes, while lending rates were adjusted upwards in order to account for the increase in cost of funds. The banking industry led by Licensed Commercial Banks (LCBs) remained stable and maintained profitability in spite of the slight contraction in interest margins and moderation in lending activities in the second quarter of 2012. The imposition of a ceiling on the growth of rupee lending by licensed banks in March 2012, with the aim of arresting high credit expansion resulted in banks having to search for alternative forms of investing such as investment in local government and foreign securities and intra and inter-bank lending.

4. Financial Markets

- *During the first half of 2012, the Central Bank tightened its monetary policy stance to contain high credit growth and monetary expansion, increasing policy interest rates twice. Subsequently, as the credit growth and possible future demand driven inflationary pressures subdued monetary policy was eased in December 2012.*
- *In general, market liquidity levels were in surplus and the inter-bank call money rates moved in tandem with the policy rates adjustments. While the short periods of deficit liquidity exerted upward pressure, the tax adjusted weighted average call money rates remained within the policy rate corridor.*
- *Although the foreign exchange market witnessed a significant depreciation of Sri Lankan Rupee vis-a-vis the US$ and other major currencies during the first half of the year, the policy measures taken to curtail import demand as well as the inflows of US$ from the sovereign bond, IMF SBA tranche, etc., have stabilised the rate towards the year end.*
- *The yield rates in the government securities market increased during most part of the year responding to the increases in policy interest rates, the increased borrowing requirement of the government and rising inflation.*
- *However, the pressure on the yield rates was contained with the increased inflow of foreign investments into government securities. Moreover, towards the end of 2012, the yield rates declined significantly responding to easing of monetary policy.*
- *The price indices of the equity market continued its downward movement despite a rally seen in September. However, foreign buying interest continued during the year due to the attractive price earnings ratios.*

4.1 Inter-Bank Call Money Market

The inter-bank call money market is an overnight market that mainly assists commercial banks in meeting their immediate liquidity requirements by facilitating lending and borrowing among banks. These transactions are very short term in nature and reflect demand for and supply of liquidity in the market. The Central Bank adjusts bank reserves through its open market operations, thereby steering the overnight call money market interest rate in the desired path. This operation minimizes the persistent deviation of the call money market rate which otherwise could fluctuate to the extremes of the policy corridor. During the year of 2012, the Central Bank used overnight repo and reverse repo auctions, standing facilities, outright sales of Treasury Bills from its own holding, term repo and reverse repo auctions and moral suasion to steer the overnight call money rate.

The significant volume of excess liquidity which prevailed over two and half years in the inter-bank market turned into a deficit position by the end of 2011 and continued to swing between deficit and surplus positions in 2012. The main contributory factors for these developments were forex transactions done by the Central Bank in the domestic forex market, foreign loan repayments and retirement of Treasury bills out of the Central Bank holding. The official repurchase and reverse repurchase rates were revised upward twice from 7.00 per cent and 8.50 per cent to 7.50 per cent and 9.00 per cent, respectively on 3 February 2012 and to 7.75 per cent and 9.75 per cent, respectively on 5 April 2012 to facilitate containment of the inflationary pressures developing in macroeconomic environment. These measures further facilitated the containment of the pressure on overnight call money rates that were arising during the periods of deficit liquidity. On 12 December 2012, the policy rates were revised downward by 25 basis points to a repurchase rate of 7.50 per cent and a reverse repurchase rate of 9.50 per cent to address the possible signs of weakening demand.

The lack of appetite to lend, which was visible among market participants during the previous year, seemed to have reversed to a great extent during 2012 mainly due to the improved credit environment and selected administrative measures adopted by the Central Bank. The policy of limiting the repo standing facility up to a maximum of Rs.100 million per participating institution on the days when the Central Bank offers reverse repo auction was able to increase the call money market participation. Such measures were helpful in managing the liquidity pressure by compelling surplus banks to lend in the market. In addition, moral suasion was adopted whenever necessary to communicate the changing market conditions to market participants. Hence, the participants were seen increasingly engaged in lending among themselves before reverting to the Central Bank for placement of excess funds. Accordingly, the Central Bank was able to maintain the tax adjusted call money rate within the corridor during the year 2012.

Market liquidity levels saw some volatility during the 2012 (Chart 4.1). In terms of the operating days, market liquidity was in a surplus position for about 76 per cent of the time indicating surplus market liquidity in general, during the period. Market liquidity recorded its peak surplus of Rs. 58.9 billion

Chart 4.1 **Inter-bank Call Money Rates and Liquidity**

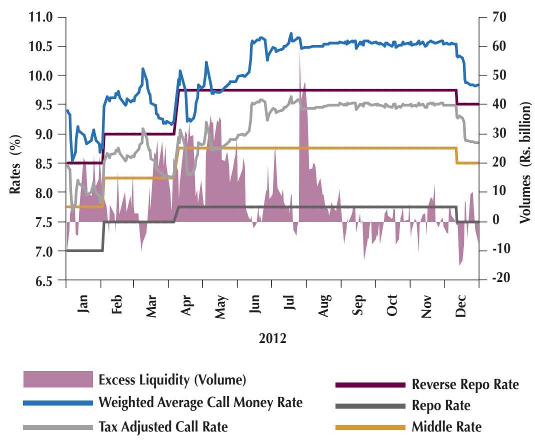
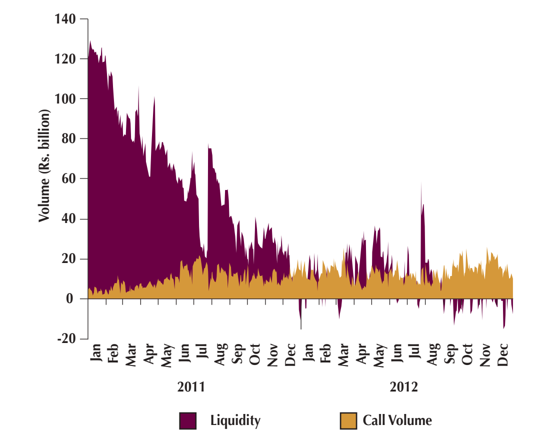


Chart 4.2 **Market Liquidity vs. Call Market Volume**



with the receipt of sovereign bond proceeds at the end of July while showing the largest deficit of Rs. 15.3 billion in mid-December 2012. The average liquidity position reported for the year was a surplus of Rs. 8.4 billion. The monthly average of excess liquidity recorded its highest in May 2012 amounting to a surplus of Rs. 24.6 billion and lowest in September 2012 as a deficit of Rs. 2.0 billion.

The daily weighted average call rate varied between 8.5 per cent and 9.4 per cent with an average of 9.0 per cent in January 2012. During the first two policy revisions from 3 February to 5 April weighted average call money rate varied within 9.2 per cent and 10.1 per cent with the weighted average of 9.5 per cent. Since 5 April until 12 December the weighted average call money rate hovered between 9.2 per cent and 10.7 per cent with the weighted average of 10.3 per cent. Consequent to the third policy rate (repo/ reverse repo) revision, on 12 December 2012, call money rate varied between 9.8 per cent and 10.3 per cent with an average of 10.0 per cent until the end of the year. The tax adjusted call money rate fluctuated between 7.7 per cent and 9.6 per cent with an average of 9.1 per cent in 2012. Even though the weighted average call money rate has shown substantial fluctuations before mid-July it was mostly stable and moved around 10.55 per cent thereafter until the policy rate revision in mid-December 2012. The tax adjusted weighted average call money rate varied within the corridor during the major part of the year and moved towards the middle of the policy corridor subsequent to the revision of repo and reverse repo rates in December.

The gross transaction volumes of the call money market in 2012 grew by 31.0 per cent compared to the previous year showing the signs of improvement in interbank lending (Chart 4.2). The gross transaction volume stood at a maximum of Rs. 26.1 billion and a minimum of Rs. 3.8 billion recording an average of the Rs. 13.1 billion during the year. The key highlight of the year was the tapering off of the dominance of liquidity holdings by foreign banks and their relaxing of their internal restrictions on lending to other domestic banking operations in the market.

Box 2

Reserve Management in a Challenging Global Market

A Foreign Reserves

A country's official international reserves comprise of the foreign currency financial assets held by their respective central banks and governments; including gold, special drawing rights (SDRs) and reserve positions maintained with the International Monetary Fund (IMF). Official foreign exchange reserves help maintain international liquidity and provide precautionary insurance by facilitating the settlement of foreign liabilities. When such reserves are depleted to levels inadequate to meet regular payments, it is deemed to be a Balance of Payments (BOP) crisis. Given that BOP crisis can be costly, in terms of lost output, bankrupt firms, high unemployment and foregone government revenue, they have the potential to destabilize economies from their envisaged growth paths. Thus, central banks hold foreign currency denominated financial assets, as a buffer, to be used in conjunction with sound macroeconomic policies to support the BOP in the event of adverse external shocks arising from "large jolts" to the terms of trade or "sudden stops" in the capital account. This way, official reserves helps the country achieve its macroeconomic objectives.

Why has Foreign Reserve Management become challenging?

Central bank reserve management has traditionally centered around three objectives: *Safety of capital* – through the prudent management of risks; *Liquidity* – to ensure the availability and ease of convertibility of reserves at short notice and at minimal cost to meet unforeseen requirements and; *Reasonable consistent rates of financial return* – to earn an income from the assets. The third objective is generally subordinated to the safety and liquidity objectives. In view of the conservative approach adopted by central banks, they have not suffered significant losses of capital despite the dramatic decline in the value of many different classes of financial assets on world markets. Although liquidity in many sections of the financial markets around the world dried up with the unfolding of the global financial crisis, liquidity of central bank reserves remained intact. However, the financial crisis brought about new challenges for reserve management by central banks. First, interest rates on fixed income securities and in money markets in the industrialized economies have fallen to near record low levels in view of the extraordinary measures taken by central banks in these countries to inject liquidity to bolster financial markets and aggregate demand. While the low nominal interest rates have dramatically limited the income prospects of central banks, the subsequent downgrading of government credit ratings has forced central banks to reconsider the so called "risk-free" investment strategies.

The recent spate of financial crises has also motivated many developing and emerging market economies to build up their international reserves to record levels. During the past decade, global central bank reserves have increased significantly from about US dollars 2 trillion in 2002 to over US dollars10 trillion by 2012, mainly on account of higher inflows to emerging market economies. This increased their ability to borrow and thereby, enhanced their ability to finance future economic growth. However, maintaining large reserves of foreign currencies can be costly, in terms of the relatively small return in interest, forgoing opportunities of investing in the private sector to garner a higher return.

How Central Banks have overcome these challenges?

Being the custodian of the country's savings of foreign currencies, foreign reserve management is one of the core functions of most central banks. While the challenges are the same for official and non-official institutional investors alike, the former is generally more sensitive to reputational concerns with respect to their investment decisions, as they are more likely to incur public contempt for making losses on their investments. They must

Box 2 (*Contd.*)

also be watchful about the costs of investments, to retain the public's trust. As such, they tend to be risk averse and are more inclined to pursue passive strategies that track various markets and indices, incurring minimal costs and generating low incomes. Investment incomes of official institutions can be improved by pursuing active strategies whose returns consistently outperform market indices. However, beating the market on a consistent basis requires financial expertise.

Many central banks, which relied heavily on the incomes generated by their foreign exchange reserves, are revisiting their investment strategies in view of their unsustainable financial trajectories and are exploring new approaches of managing risks. Investment guidelines are being broadened to include higher yielding assets and accommodate more counterparties. Investment opportunities in new asset classes such as corporate bonds, emerging market bonds, inflation linked bonds and equities, are being considered. Possibilities of including new reserve management currencies are being explored.

Implications for Sri Lanka

In recent years, Sri Lanka has been pursuing more active strategies in order to generate a reasonable income from its investments whilst safeguarding and enhancing the value of its overall reserves position. At the same time, in view of the higher levels of international trade in goods and services, and the gradual liberalization of its capital account, Sri Lanka increased its gross official international reserves by almost fivefold over the past decade years, from US dollars 1.3 billion as at end 2001 to US dollars 6.1 billion by end 2012. Thus, despite the challenging global circumstances, the Central Bank of Sri Lanka's reserve management operations has generated profits exceeding US dollars 200 million for the third consecutive year in 2012. Exchange rate risk was managed through portfolio diversification and strategically set currency combinations, giving due consideration to the impending foreign currency liabilities and global outlook of currency markets. Interest rate risk, derived through sensitivity analysis, was mitigated by varying the durations of the fixed income and money market investments and by shifting the term structure of portfolios in a timely manner. Appropriate systems were in place to assess the impact on counterparties by the Eurozone Debt Crisis in a timely manner while liquidity risk was also mitigated through cash flow forecasting and analysis of maturity profiles. More recently, Sri Lanka has employed more risk mitigating techniques and further diversified its reserve portfolio in terms of markets as well as currencies. Overall, in line with the global trends, Sri Lanka too has developed the means to cope with increasing sluggishness of the advanced economies and moderating growth in the emerging markets, shifting risk preferences of investors, a surge in inflation, globally, an increasingly uncertain outlook for commodities and a continued low interest environment.

Future measures

Although the unconventional monetary policies propounded by the US, UK, Japan and Eurozone have saved the global economy from greater disarray, the low nominal interest rates have significantly eroded the income earning prospects of central banks and other holders of Government bonds. Global growth prospects have been downgraded and inflation remained higher than money market rates, sometimes even leading to negative nominal interest rates. Given that interest rates are likely to remain at exceptionally low levels for an extended period of time, the traditional safe assets which dominated the portfolios of central banks are no longer considered lucrative. As such, reserve managers are facing increasing pressure to find novel ways of enhancing income. The income generated by reserves is the main source of operating revenue for many central banks, where surplus funds are generally transferred to the government coffers. Increasingly, central banks are seeking to diversify their reserve asset portfolios to embrace types of financial assets which can offer higher yields without impairing the liquidity and safety of their portfolios.

A second consequence of the global financial crisis for reserve management is that it has radically changed our view of risks in financial markets.

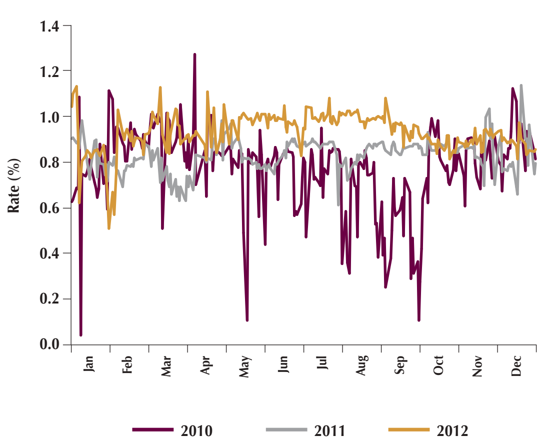
Box 2 (*Contd.*)

Some transactions with financial institutions and markets which, prior to the crisis, were perceived as being virtually risk free can actually carry significant counterparty credit risk, as well as liquidity risk. Thus, although high returns are generally associated with higher risks, it is pertinent that central banks seek to maximize their returns by adhering to the approved risk management frameworks. However, the subsequent global debt crisis, which prompted the down grading of many credit ratings of governments, has compelled countries to re-evaluate their investment decisions.

The calls for higher capital requirements and stricter standards of banks are bound to make credit more costly in the future, which may hurt growth prospects in emerging economies. Also, if global banks and institutions are required to hold more capital, as a result of which their cost of credit rises, the quantum of foreign capital coming into emerging economies might become less and this capital may be more costly. Premature liberalization of the capital account can also be harmful by increasing its vulnerability to volatile external cycles, sharp fluctuations in exchange rates and asset price build-up and bubbles. Gold is reclaiming its status as an important part of the international financial system. While strong demand and sustained above-trend growth in some parts of the world contributed towards the recovery process, going forward, moderating growth prospects across the emerging world is forcing policymakers to navigate their way through some murky macroeconomic circumstances.

Falling in line with the general rule, the weighted average call money rate increased in the low liquidity environment during 2012 as well. The spread between weighted average call money rates and weighted average repurchase rates in the interbank market showed less volatility compared to the previous year while recording a reduction of 93 basis points in the average spread in 2012 (Chart 4.3). Considering the 70 basis point of spread reduction occurred after the policy rate revision in mid-December 2012 the said spread reduction showed a minimum volatility and positive correction of short term interest rate towards the middle of the corridor.

Chart 4.3 **Spread Between Call Money Rates and Repo Rates**



4.2 Domestic Foreign Exchange Market

Inter-Bank Foreign Exchange Market

In February 2012, Sri Lanka changed its exchange rate policy from a managed floating rate system to a market based system allowing currencies to float freely responding to market demand and supply. After allowing the market to determine the exchange rate, the Sri Lankan rupee depreciated from Rs.113.90 to Rs.127.16 as at

Chart 4.4 Movement of Rupee per US$ (01.01.2008 – 31.12.2012)

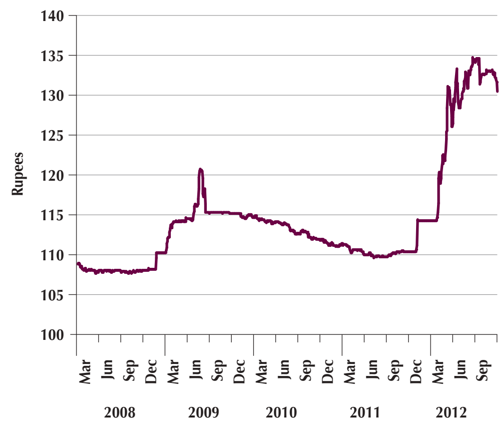
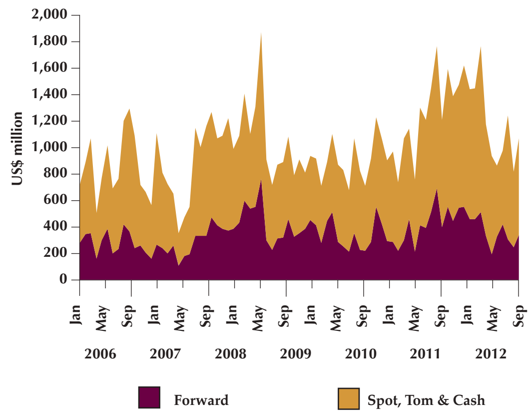
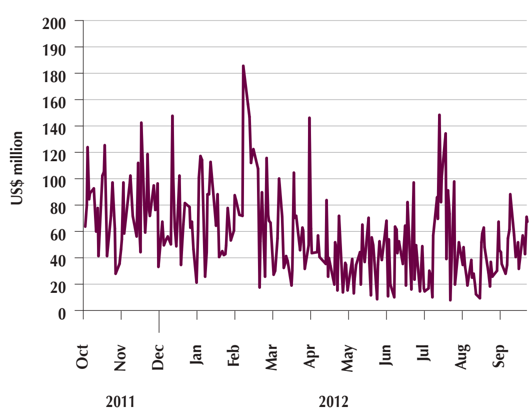


Chart 4.6 Monthly Inter-Bank FX Volumes



end 2012 (Chart 4.4). The higher demand for foreign currency, stemming from increased imports, exerted pressure on the exchange rate. Depreciation of the rupee was evident against other major currencies as well. A series of policy measures were also initiated by the government in order to curb the high demand of imports. As a result, growth of imports has decelerated and stability has returned to the foreign exchange market with a gradual appreciation of the currency. Inflows of funds to the country along with the sovereign bond issue, IMF SBA facility, investments in the stock market, increased worker remittances and enhanced income generated from the Tourism sector helped in increasing confidence in the forex market and reversing the depreciating trend in exchange rate.

Chart 4.5 Daily Inter-Bank FX Volumes



Trading Volumes

The trading volumes in the domestic foreign exchange market during the year 2012 recorded a significant decline when compared with the previous year (Charts 4.5 and 4.6). The total volume of inter-bank foreign exchange transactions decreased to US$ 13.42 billion in 2012 from US$ 16.44 billion in 2011. Similarly, the total volume of forward transactions also decreased to US$ 4.1 billion during 2012 compared with US$ 5.7 billion in 2011. The daily average turnover in the inter-bank Foreign Exchange market (including the forward market) was US$ 55.4 million as against US$ 68.5 million in 2011.

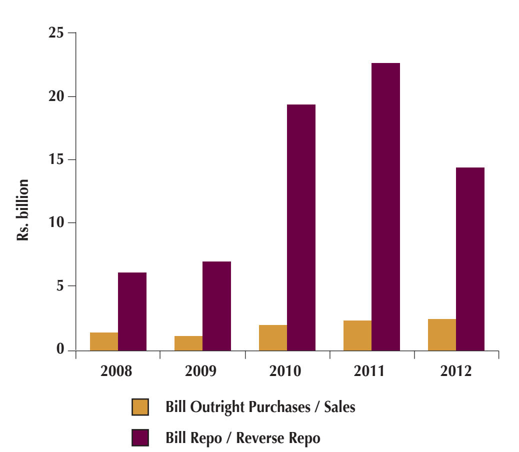
Excessive volatility was imminent from time to time in the domestic exchange market mainly due to the demand arising from the oil import bills. In order to minimize this volatility, the Central Bank engaged in limited interventions in the domestic foreign exchange market by providing foreign currency to meet part of oil bills. Such interventions were recorded at US$ 249.8 million, US$ 66.5 million and US$ 2.6 million, respectively, for second, third and fourth quarters showing a drastic decline.

4.3 Government Securities Market

Treasury Bill Market

Treasury bills continued to be the most liquid and largely traded instrument operating in the financial market during 2012, reflecting their popularity as a repo market and a short-term investment instrument (Chart 4.7). By end 2012, the outstanding stock of Treasury bills amounted to Rs. 709.3 billion. Total volume of Treasury bills transacted on an outright basis during 2012, stood at Rs. 2,472.3 billion, representing an increase of 4.5 per cent over Rs. 2,366.1 billion compared to the preceding year. The annualized total turnover ratio, including repo transactions, declined to 10.94 in 2012 from 18.63 compared with the previous year.

Chart 4.7 Secondary Market Activities in Treasury Bills

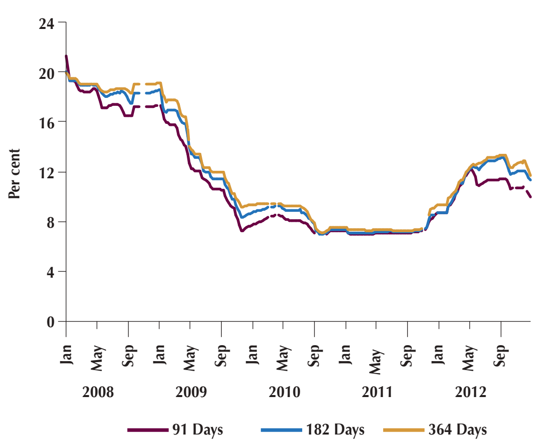


Treasury bills continued to account for a dominant portion of the total trading volume during January to December 2012. It accounted for 58 per cent of total outright volumes compared to 54 per cent in comparison to the previous year. The 'Average-Time-to-Maturity' (ATM) of the Treasury bill portfolio at end 2012, increased to 0.38 years compared to 0.31 years in end 2011. The Treasury bill maturity profile consisted of 48 per cent of 364-day bills, 49 per cent of 182-day bills and 2 per cent of 91-day bills by end 2012. During the year, the net issuance of Treasury bills amounted to Rs. 48.2 billion compared with the net issuance of Rs. 89.2 billion in 2011.

The Treasury bills yield rates recorded an upward movement during 2012. One of the reasons for this upward movement was the increase of the policy rates by the Monetary Board twice in the early part of 2012. The Repurchase Rate and the Reverse Repurchase Rate were increased by 50 basis points each on 03.02.2012 to 7.50 per cent and 9.00 per cent, respectively. On 05.04.2012, the Repurchase Rate was further increased by 25 basis points to 7.75 per cent and Reverse Repurchase Rate was increased by 75 basis points to 9.75 per cent. In addition, the considerable drop in excess liquidity in the domestic market and heavy domestic borrowing requirements of the government during the first half of 2012, also led to record an upward movement of market interest rates in 2012. As a result, the benchmark yield rate of the primary market on one year Treasury bills recorded an increase of around 405 basis points up to second week of September 2012 from end December 2011 (Chart 4.8).

However, with the easing of monetary policy in December, the yield rates have started to move downwards. The Central Bank revised down its policy rates by 25 basis points on 12.12.2012 indicating a need to support the

Chart 4.8 Primary Market Yield Rates



economy to realize its growth potential in 2013 coinciding with the moderation in inflation expectations in the second quarter of 2013. This was indicated in the yields of primary market by a reduction of 79 basis points, 77 basis points and 116 basis points in 91day, 182day and 364day maturities, respectively. Accordingly, the secondary market yields have also declined by 64 basis points, 83 basis points and 111 basis points in 91 day, 182 day and 364day maturities, respectively. The Treasury bill rates for 3 months, 6 months and one year at end 2012 stood at 10.00 per cent, 11.32 per cent and 11.69 per cent, respectively.

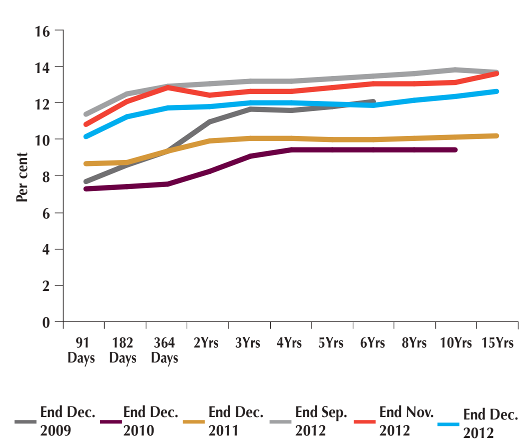
Continued foreign investments in Sri Lanka rupee denominated Treasury bills in 2012 led to a significant inflow of foreign funds to the domestic capital market. Favourable interest rate differential and overall improvements in the domestic financial market conditions resulted in this steady inflow of foreign funds into the government securities market. These inflows facilitated stabilizing the interest rates in the domestic market and assisted in easing the pressure in the government borrowing program. Treasury bills holdings of foreign investors increased by 14.4 per cent to Rs. 80.2 billion at end 2012 from Rs. 70.1 billion at end 2011.

Treasury Bond Market

In line with the upward movement in the policy rates and the short-term interest rates and the heavy reliance on the domestic market to finance the government's cash flow requirements during the first half of 2012, the Treasury bond yields edged upwards in 2012. The Treasury bond yields in the secondary market increased by a range of 247 basis points to 340 basis points across the yield curve (2 – 15 years) by end November 2012 from end December 2011. However, the reduction in policy rates by the Central Bank on 12.12.2012 and unavailability of Treasury bonds in the primary market caused the yields in the secondary market to decline in a range of 60 basis points to 119 basis points by end December compared with end November 2012 (Chart 4.9).

The total volume of Treasury bonds transacted on an outright basis during the year of 2012 recorded a decrease of 11 per cent and stood at Rs. 1,770 billion (Chart 4.10). By end December, the outstanding stock of Treasury bonds amounted to Rs. 2,495 billion. The ATM of Treasury bonds issued during 2012 was 6.86 years compared to 5.65 years in comparison to the previous

Chart 4.9 Secondary Market Yield Rates



Box 3

Developing the Government Securities Market in Sri Lanka

1. Government Securities Market in Sri Lanka

Government securities market plays a key role in the Sri Lankan financial market. It not only enables the Government to raise required financing in a cost effective manner but also helps the effective transmission of the Central Bank's monetary policy through open market operations for which government securities act as collateral. It is also regarded as the base for the domestic fixed income securities markets as it provides the benchmark yield and also, much needed liquidity.

The Government securities market in Sri Lanka consists of two segments: Primary market and Secondary market. Primary market provides the mechanism for the issue of government debt instruments as well as their price discovery. The secondary market provides the platform for primary market investors to trade their holdings of government debt instruments before maturity.

2. Major Developments in the Government Securities Market

The Central Bank as the manager of public debt has been able to transform the government securities market of Sri Lanka in terms of the system of issuance, instruments, investors and trading and settlement infrastructure. Some of the key reforms implemented are summarized below.

(a) Setting up of the Accredited/Dedicated Primary Dealer System to promote the government securities among market participants.

(b) Introduction of market-based price discovery.

(c) Introduction of the Real Time Gross Settlement (RTGS) system.

(d) Introduction of Scripless Securities and a Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS).

(e) Opening of Treasury-bond market and Treasury-bill market for foreign investors.

(f) Introduction of Sri Lanka Development Bonds in order to tap the domestic foreign currency market.

The aforementioned developments have contributed towards improving the government securities market to be on par with the developments in the rest of the world. Further, with the evolvement of Repo/Reverse Repo transactions, there has been a considerable improvement in the activities of the secondary market.

3. Further Developments / Improvements in the Government Securities Market

The need for further development of this market emanates from the three key roles it is expected to play.

(a) **Key player in the fixed income securities market:** The government securities market creates the benchmark prices for risk-free sovereign debt. It also offers highly liquid risk-free fixed income instruments which market participants are more willing to take positions with.

(b) **Facilitator of government borrowings:** A deep and liquid market facilitates the borrowings of the government from the market at a reasonable cost.

(c) **Facilitator of Central Bank's Monetary Policy:** A developed government securities market allows greater application of market based instruments for monetary policy purposes such as open market operations and also facilitates the conduct of monetary policy through an indirect set of instruments.

Accordingly, several areas have been identified for the development of primary and secondary markets for government securities as summarized below:

Box 3 (*Contd.*)

Primary Market

(a) ***Improving the issuance procedure*** **–** Increase efficiency of the primary auction system for government securities by conducting auctions in accordance with a pre-announced auction calendar to ensure the amounts offered at the auctions are fully subscribed by the market at market determined rates.

(b) ***'When-issued' trading of government securities*** **–** Securities trade on a 'when issued' basis when officially they are yet to be issued, but they trade as if they have been. These transactions are formally settled after the securities have been issued. A 'when-issued' market facilitates efficient distribution of auctioned debt instruments by allowing the market more time to absorb large issues without disruption. It also enhances the efficiency in price discovery process for both the issuer and the investor by enabling bidders to gauge the market demand.

(c) ***Improving transparency and efficiency*** **–** The proposed pre-announced borrowing plans and auction schedules (for both T-bills and T-bonds) enable the investors to plan their subscription to new issuances in advance.

(d) ***Expand investor base*** **–** Currently, the investor base for government securities in Sri Lanka mainly consists of Primary Dealers, banks, financial institutions, provident funds, insurance and pension funds, large corporates and retail participants. The retail participation in this market is less than 2 per cent in Sri Lanka, whereas it is about 5 – 10 per cent in most other countries including the developed countries. This may be due to the technical infrastructure required for the process of electronic bidding and also the high spread between buying and selling prices of government securities. Hence, it may be prudent to introduce a mechanism to attract a large section of medium and small investors who currently are not in the government securities market.

(e) ***Instrument development*** **–** In order to be sensitive to various risks associated with trading in government securities, it has become a prime necessity for the current simple and standardized instruments to be developed into a mix of conventional and more advanced and complex instruments. This would facilitate diversification of available instruments encouraging participation of various investors who require different kinds of instruments to meet their specific needs.

Secondary Market

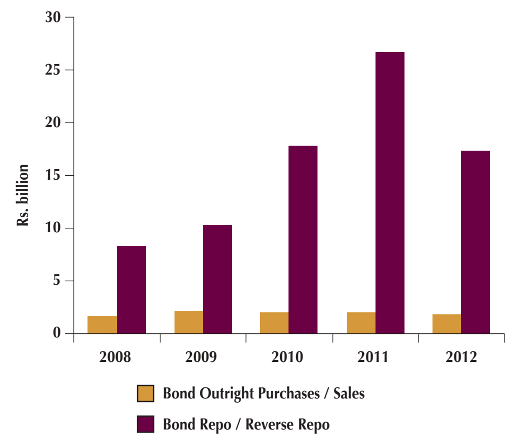
(a) **Benchmarking and consolidation:** Development of a benchmark yield curve is an essential element of a well-functioning government securities market. In order to reduce the refinance risk and the cost of borrowing, it is needed to develop the yield curve for longer tenors by issuing benchmark securities on a periodic basis and by minimizing fragmentation. Further, limiting the number of issuances and increasing the issue size of securities will improve market liquidity and facilitate the emergence of benchmark securities in the market.

(b) **Enhancing the secondary market liquidity by establishing a guaranteed central clearing arrangement on net-settlement basis:** A guaranteed central clearing arrangement for the net-settlement of funds as well as securities (DVP-III) would help eliminate counterparty credit risk while enhancing intraday liquidity of participants and thereby increasing the secondary market trading volumes, substantially.

4. Conclusion

These reforms would enable the development of a deep and liquid government securities market in Sri Lanka facilitating raising of funds required for the Government in a cost effective manner, effective transmission of monetary policy through open market operations which uses government securities as collateral, and also development of a benchmark yield curve which is regarded as the base for the domestic fixed income securities market.

Chart 4.10 Secondary Market Activities in Treasury Bonds



year. Accordingly, the ATM of outstanding Treasury bonds portfolio at end 2012 increased to 3.99 years from 2.9 years at end 2011. With this improvement, the ATM of the domestic debt portfolio increased to 3.23 years by end 2012 compared to 2.35 years by end 2011. The increase in the ATM in the Treasury bond portfolio was made possible mainly due to foreign inflows into the government securities market.

In December 2011, the Monetary Board approved of increasing the limit for foreign investments in Treasury bills and Treasury bonds from 10 per cent of the outstanding stock to 12.5 per cent. With this increase, the foreign investments in Treasury bonds recorded the highest level of Rs. 317.6 billion on a face value basis as at end 2012 recording an increase of Rs. 118.1 billion from end December 2011 (Chart 4.11).

4.4 Corporate Debt Securities Market

Commercial Paper Market

The commercial paper (CP) market has been relatively active in the first eleven months of 2012. The value of CP issued with the support of banks amounted to Rs. 32.6 billion in the first eleven months of 2012 in comparison to Rs. 9.2 billion in the same period of 2011 (Chart 4.12). A contributory factor for this increase is the credit restrictions imposed on banks and the high lending rates charged by banks as well as finance companies. However, the interest rates on CPs also increased to a range of 11.25 – 20 per cent in 2012 from a range of 8.26 – 12.80 per cent in 2011. CPs with a maturity of up to 3 months accounted for 86.5 per cent of the market, while the shares of

Chart 4.11 Non-Resident Investment Holdings in Government Securities

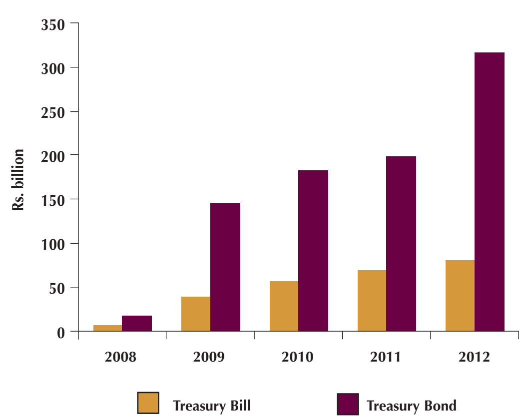
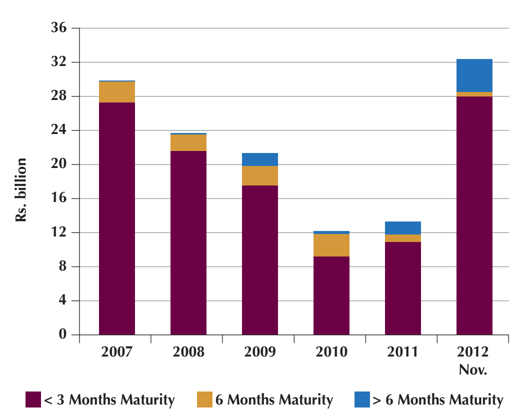


Chart 4.12 Commercial Paper Issues (Supported by Commercial Banks)



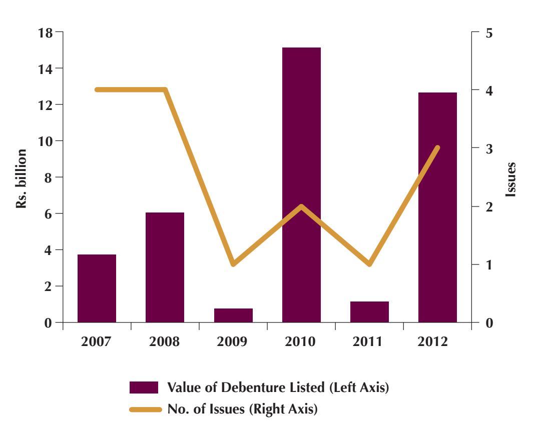
CPs of 6 month and 12 month maturities were 1.7 per cent and 11.8 per cent, respectively. The total outstanding value of CPs amounted to Rs. 11 billion as at end November 2012 compared to Rs. 5.6 billion at the November 2011.

Corporate Bond Market

Corporate bond market was relatively active in 2012 with nine listings of corporate debentures by two banking institutions with maturity period of 5 years. These debentures mobilised funds amounting to Rs. 12.5 billion, carrying both fixed and floating interest rates (Chart 4.13). The fixed rates of interest, payable annually, pertaining to six debentures were in the range of 10.50 – 16.50 per cent, while three debentures were issued with a floating rate. In addition, three debentures were issued in the market by way of introduction during 2012. The trading turnover of debentures listed on the Debt Securities Trading System (DEX) of the CSE was significantly low at Rs. 75.7 million in 2012 compared to Rs. 2,694 million in 2011.

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

Chart 4.13 **Listed Debenture Issues**



4.5 Share Market

Equity price indices of the Colombo Stock Exchange (CSE) saw a downward movement during the year 2012. Although, the prices rose significantly in September reflecting positive market sentiments among investors, it could not be maintained (Chart 4.14 and 4.15). The All Share Price Index (ASPI) declined by 7 per cent, which is relatively better than the decline in previous year and Milanka Price Index (MPI), which is composed of 25 of the most traded stocks, declined by 2 per cent at end December 2012. The CSE introduced a new index, namely S&P SL20 on 27 June in 2012 with a view to increasing the level of transparency and integrity in the market and this index has increased by 8 per cent

Chart 4.14 **ASPI, MPI and Market Capitalisation of the CSE**

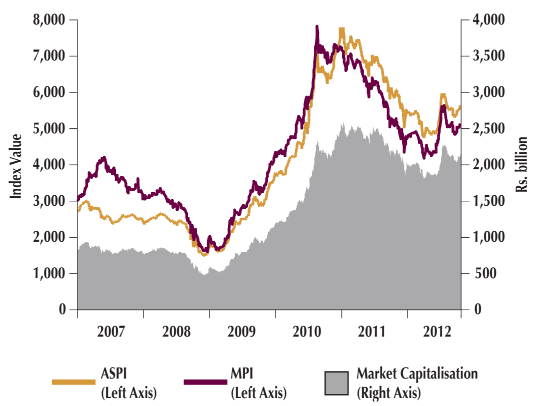
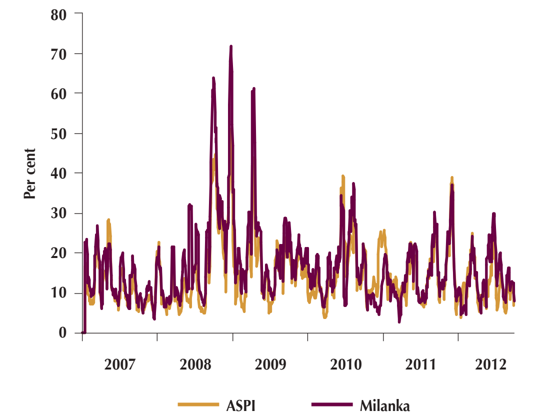


Chart 4.16 **Volatility in the Equity Market (CSE)**



by end December 2012. Increased interest rates, limits imposed on stock brokers' credit, lack of market liquidity, as well as the spill over effects of the developments in global financial markets primarily contributed to the downward trend in the equity market.

The volatility of the ASPI, as measured by the standard deviation, was relatively low in 2012 when compared with that of the previous year. This reflects an improvement in investor confidence in the equity market this year compared to 2011. However, the volatility of the MPI was marginally higher than that of ASPI during the period under review (Chart 4.16). In comparison with the performance of the equity market indices of other Asian countries, Sri Lanka has shown negative growth during the year 2012 (Chart 4.17).

The price indices of all sub sectors except one (Beverage, Food and Tobacco) declined, contributing to the slowdown of major price indices in 2012. Of the large sectors, the price indices of Diversified Holdings sector and Banks, Finance & Insurance sector declined by 4.6 per cent and 11.6 per cent, respectively. The smaller sectors that suffered relatively large declines were Information Technology

Chart 4.15 **Annual Growth in CSE Price Indices**

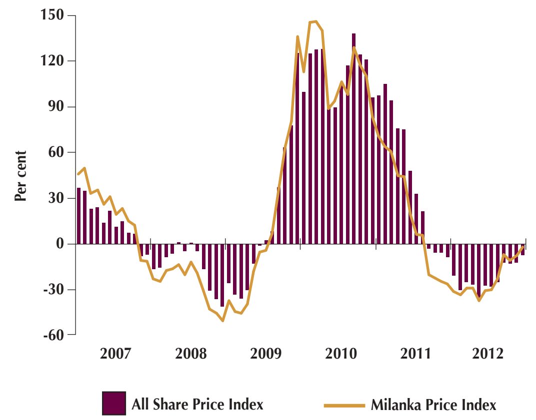
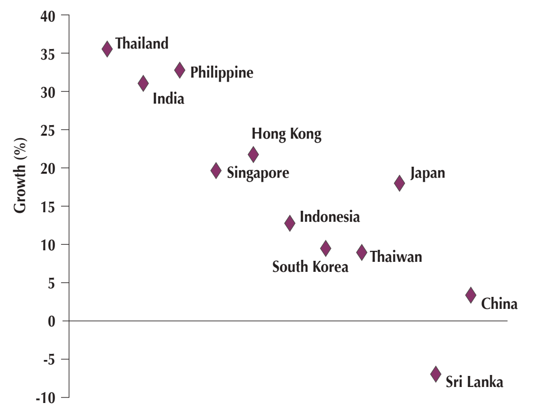
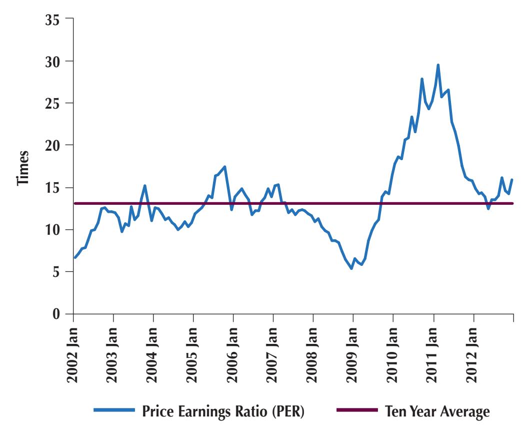


Chart 4.17 **Board Equity Market Index Performance of Asian Stock Exchanges (as at end Dec. 2012)**



Source : World Federation of Exchanges

Chart 4.18 **Price Earnings Ratio of the CSE (2002 – 2012)**



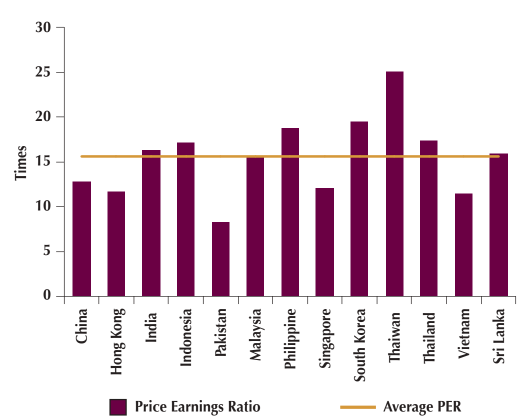
(53 per cent), Store Suppliers (39 per cent), Footwear & Textiles (31 per cent) and Motors (42 per cent).

The market price earnings (PE) ratio declined to its lowest of 11.4 (during the year) in May 2012 and subsequently increased to 15.9 by end December 2012 (Chart 4.18). The PE ratio was 15.8 in 2011. The relatively improved share prices towards the end of the year 2012 have contributed to an increase in PE ratio in the market. The current market PE ratio of the CSE is moderately higher than its long term average of 13 for the period 2002 -2012, but is considered to be broadly in line with high liquidity and company earnings potential, indicating that the market is not overvalued. However, when compared with other markets in the region the current domestic PE ratio is on par with the average PE ratio of the region (Chart 4.19).

The size of the CSE is still small, both in terms of market capitalization and the number of companies listed on the CSE, compared with the other counties in the region. Market capitalization, which declined by 2 per cent (or Rs. 46 billion) to Rs. 2.2 trillion at end December 2012, is equivalent to about 29 per cent of GDP (Table 4.1). The largest five sectors in terms of market capitalization were Banking, Finance & Insurance (22.6 per cent), Diversified Holdings (21.9 per cent), Beverage, Food & Tobacco (18.4 per cent), Hotels & Travel (7.3 per cent) and Telecommunication (6.8 per cent) (Chart 4.20). Furthermore, the five largest and ten largest companies accounted for 27.4 per cent and 42.1per cent, respectively, of market capitalization. The number of companies listed on the CSE increased by 16 during the year to 287 by end December 2012.

The CSE generated a lower equity turnover of Rs. 214 billion in 2012. Decreasing turnover

Chart 4.19 **Price Earnings Ratios of selected Asia-Pacific Countries (as at end Dec. 2012)**



Sources : World Federation of Exchanges
Bloomberg

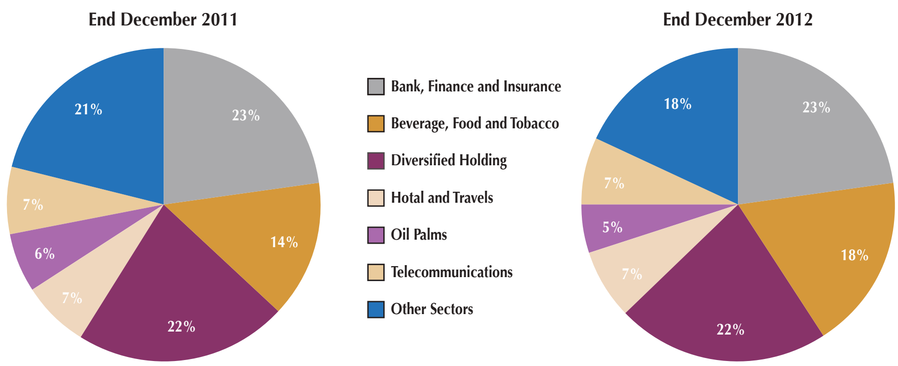
Table 4.1 **Market Capitalization to GDP Ratio of Selected Asia – Pacific Countries**

Per cent

Country	2009	2010	2011	2012
Hong Kong	1,102	1,210	925	1,097
Singapore	250	267	237	275
Taiwan	169	175	140	153
Malaysia	139	159	142	151
Korea	91	106	93	96
India	99	97	62	71
Thailand	65	83	80	104
Philippine	50	77	74	90
China	54	45	31	30
Indonesia	36	50	48	49
Japan	65	64	55	63
Sri Lanka	**23**	**39**	**34**	**29**

Sources : World Federation of Exchanges
World Economic Outlook Database
– International Monetary Fund

Chart 4.20 **Composition of Market Capitalization**



in rupees was partly due to the declining share prices. The average daily turnover declined to Rs. 884 million in 2012, compared with Rs. 2,286 million in 2011. Domestic investors accounted for about 75 per cent of turnover, 97 per cent of transactions and 86 per cent of shares traded on the CSE. Of them, local companies and retail investors accounted for 36 per cent and 30 per cent of the turnover, respectively.

Market liquidity measured by turnover velocity ratio (the ratio of total turnover to average market capitalization for the year) has significantly declined. The turnover velocity ratio of the CSE declined to 10.6 per cent in 2012 from 24.6 per cent in the previous year (Chart 4.21). This is relatively low in comparison with other exchanges in the region (Table 4.2). Low turnover velocity implies higher impact on cost of trading and low participation levels in the market. However, market liquidity can be improved increasing the volume of shares available for trading, introducing more products and expanding the investor base.

Chart 4.21 **Equity Market Turnover Velocity Ratio**

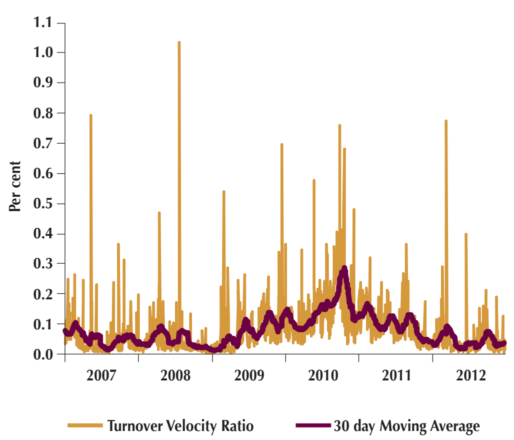


Table 4.2 **Equity Market Turnover Velocity Ratio[(a)]**

Per cent

Country	2009	2010	2011	2012
Hong Kong	78.6	62.7	56.6	43.5
Singapore	67.1	53.2	45.3	36.4
Taiwan	179.7	137.1	119.2	96.8
Malaysia	34.1	32.7	32.9	28.2
Korea	240.9	176.8	182.6	138.7
India	27.4	18	10.8	9.3
Thailand	89.8	96.5	80.6	71.0
Philippine	19.9	19.4	17.2	17.0
China	231	180.7	136.4	107.5
Indonesia	50.6	36.5	28.3	30.6
Japan	119.5	109.8	110.7	101.9
Sri Lanka	**18.3**	**33.4**	**24.6**	**10.6**

Source : World Federation of Exchanges

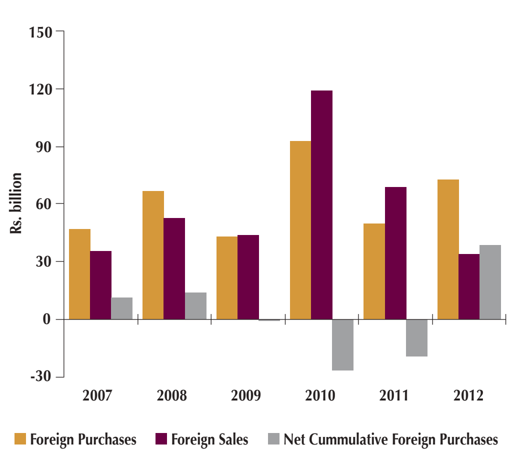
(a) The turnover velocity is calculated as share turnover / average market capitalization for the year.

A positive development was the significant increase in the net foreign inflows into the stock market. Total foreign purchases amounted to Rs. 72.7 billion, while total foreign sales were Rs. 34.0 billion during the year 2012 (Chart 4.22). This resulted in a net inflow of foreign funds to the market (Rs. 38.7 billion or US$ 304 million,) in 2012 compared to a net outflow of Rs. 19 billion (or US$ 167 million) in 2011. This was mainly due to the availability of fundamentally strong stocks at low prices, which has attracted foreign investors. Foreign companies dominated accounting for 95.8 per cent of the total foreign purchases, while foreign individuals accounted only for 4.2 per cent. The total foreign purchases have significantly increased by 46 per cent in 2012 compared to the decline in total foreign purchases by 46 per cent in 2011.

There were six Initial Public Offering (IPO) of shares on the CSE in 2012, which raised Rs. 1.7 billion. A further Rs. 11.7 billion was raised though nineteen rights issues.

The Securities and Exchange Commission of Sri Lanka (SEC) introduced several measures to facilitate the smooth functioning of the stock market. Several conditions were introduced to the listing rules for public companies seeking listings on the CSE, such as withdrawal of the option of listing of equity by way of an introduction, for listings of equity by way of an offer for subscription imposing a lock–in period for all shares issued prior to an Initial Public Offer (IPO) and for listing by way of an offer for sale imposing a lock-in period for all shares held by promoters and other existing shareholders, other than shares offered and accepted by the public through an IPO.

Chart 4.22 Foreign Participation in the CSE



In order to reduce liquidity constraints of retail investors and to reduce volatility in the market, the credit extension by stock brokers was further relaxed by the SEC. Accordingly, the stock brokers were permitted to extend credit to investors up to a limit of three (leverage 3) times that of the adjusted net capital in January 2012. Subsequently, in July 2012 a directive was issued to allow brokers more flexibility in managing their credit to clients. In addition, the SEC removed the 10 per cent price band imposed for 5 market days on volatile securities in April 2012.

Several measures were also introduced to mitigate settlement risk in the market. These include, prohibition on employees and directors of all market intermediaries to trade their shares until after 6 months of holding such shares, transactions made through crossings to have a 20 per cent upper limit unless exceptionally allowed by the CSE on a case by case basis, current 15 per cent margin requirement before execution to be strictly enforced and to have a more robust enforcement mechanism with clearly defined punitive measures for violation of rules by stock brokers, CEO's, directors and investment advisors. However, in October 2012, some of these restrictions such as the upper limit of 20 per cent on price for crossings and time bound restrictions on stock broking industry and related party sales in the secondary market were removed.

The proposed implementation of the minimum free float requirement is expected to increase the liquidity and turnover in the market. The establishment of a central counterparty clearing corporation is on the cards and this would mitigate settlement risks enabling moving to a delivery versus payment mechanism. Further, it will facilitate the introduction of new products, such as exchange traded derivatives. Emphasis is also being given to creating a well informed and educated investor base. The draft bill for the demutualisation of the CSE is being finalised by the Legal Draftsman. The lack of supply of high quality, large volume listings, lack of a broad investor base and the narrow product range are some of the main challenges currently faced by the CSE.

In order to enhance investor confidence, prevent systemic crises and develop the capital market, the SEC has initiated a consultative process with all key stakeholders. As a result, the SEC has identified the following ten tasks/projects in its capital market road map to be implemented over the next three years. (*a*) To expedite SEC Act amendments to be in line with International Organization of Securities Commission (IOSCO) standards, (*b*) encourage more public and private listings, (*c*) attract new foreign and local funds, (*d*) develop infrastructure such as trading, back office system *etc*., (*e*) develop corporate debt market, (*f*) intensify education and awareness, (*g*) develop unit trust industry, (*h*) strengthen risk management, (*i*) develop new products and (*j*) demutualize the CSE from a member owned company to a company owned by shareholders.

5. Banking Sector

- *The Sri Lankan banking system remained stable and supportive of the economic growth in 2012. The sector expanded further recording healthy stability indicators.*
- *Continued positive performance in terms of profitability, capital adequacy as well as other critical micro prudential indicators reflected the resilience of the banking sector to negative shocks.*
- *The high credit growth that prevailed in year 2011 and during the first quarter of 2012 eased out with the implementation of tight monetary policy.*
- *Deposits continued to be the main funding source. The share of borrowings in funding sources increased with the higher increase in foreign currency borrowings mainly from overseas sources.*
- *Despite the increase in non-performing loan (NPL) volumes, the NPL ratios were maintained at a healthy level of 4 per cent.*
- *Overall, the banking sector recorded healthy profits mainly through the greater increase in non-interest income. Net interest margin, which reflects the earnings from core business of banks, dropped from 4.2 per cent to 4.1 per cent due to the increase in cost of deposits.*
- *The interest rate risk exposure would not threaten the stability of the banking sector despite the increase in interest rates resulting in reduction of profits of a few banks. Foreign exchange risk, liquidity risk and operational risk of the banking sector were at a manageable level and did not indicate any signs of potential for increasing risk levels.*
- *The liquidity and capital adequacy of the banking sector were maintained at healthy levels with a statutory liquid assets ratio of 31 per cent and capital adequacy ratio of 15 per cent, both well above the minimum regulatory requirement.*
- *While further strengthening supervision of banks, the Central Bank continued to introduce new policy measures and regulations to reinforce the stability and resilience of the banking sector.*

5. The Banking Sector

Continuing to be the main player in the financial sector holding 56 per cent of the total assets of the financial system, the banking sector expanded its activities further. The adverse situation prevailed during the beginning of the year eased out gradually owing to the implementation of appropriate regulatory policies and adoption of enhanced risk management measures by the banks. This was reflected in the moderated credit expansion, improved direction of lending, satisfactory level of profitability, liquidity and capital, and maintenance of all the risks (credit, market, liquidity, operational and other risks) at manageable levels.

5.1 Business Operations/ Developments

Outreach

The outreach of the banking sector expanded further increasing access to finance. The number of licensed banks operating by end September 2012 was 33 comprising 21 domestic banks (including 09 licensed specialised banks) and 12 branches of foreign banks (Table 5.1). The total banking network expanded with the opening of 68 banking outlets and installation of 71 automated teller machines (ATMs) during the first nine months of 2012. Of these, 53 branches and 42 ATMs were established outside the Western Province. Accordingly, by end September 2012, the banking system was operating with 6,259 banking outlets and 2,308 ATMs.

Table 5.1 Banking Sector Network as at 30.09.2012

Type of Bank	No. of Institu-tions	No. of Banking Outlets	Total Assets	
			Rs. bn.	Market Share (%)
Licensed Commercial Banks (LCBs)	**24**	**5,464**	**4,207**	**85.6**
State banks	2	3,844	1,829	37.2
Private domestic banks	10	1,400	1,828	37.2
Foreign banks	12	220	550	11.2
Licensed Specialised Banks (LSBs)	**9**	**795**	**709**	**14.4**
State banks	6	698	604	12.3
Private banks	3	97	105	2.1
Total	**33**	**6,259**	**4,916**	**100.0**

Assets

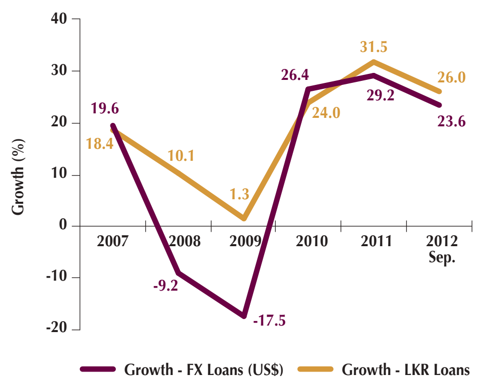
The asset base of the banking sector increased to Rs. 4.9 trillion or by 22.5 per cent over the 12 month period ending September 2012 against the year-on-year (YoY) growth of 19.4 per cent as at end September 2011 (Table 5.2). Despite the increase in the share of loans and advances in total assets from 58.5 per cent to 61.7 per cent, the YoY growth of loans and advances declined from 30.9 per cent in end September 2011 to 29.2 per cent by end September 2012. This was mainly due to the moderated growth in Rupee (LKR) loans due to the policy measures implemented to restrain the high increase in rupee loans (Chart 5.1).

The share of investments declined significantly from 28.2 per cent in end September 2011 to 23.7 per cent by end September 2012. However, the share of other assets increased to 14.5 per cent due to the high increase in interbank placements and reverse repos. With the introduction of the credit ceiling, the banks have invested their excess funds in short term highly liquid assets. In view of the current trend in loans and investments which are the main sources of income in the banking sector, banks

Table 5.2 Composition of Assets

Item	2011 Sep.		2012 Sep.		Growth (%)	
	Rs. bn.	% of Total	Rs. bn.	% of Total	2011 Sep.	2012 Sep.
Loans	2,350	58.5	3,035	61.7	30.9	29.2
Investments	1,333	28.2	1,168	23.7	4.0	3.1
Others	532	13.3	713	14.5	11.5	34.0
Total Assets	**4,015**	**100**	**4,916**	**100**	**19.4**	**22.5**

Chart 5.1 **LKR vs. Foreign Currency (FX) Loans and Advances**



would require to enhance fee based business (non-interest income earning business) in order to maintain their profitability.

Liabilities

The YoY growth in deposits declined marginally from 19.5 per cent in end September 2011 to 19.3 per cent by end September 2012 resulting in the share of deposits declining to 70.5 per cent of total funding (Table 5.3). This slower increase in deposits was mainly due to the reduced growth rate in rupee deposits (Chart 5.2). 93 per cent of the increase in deposits was

Table 5.3 **Composition of Liabilities**

Item	2011 Sep.		2012 Sep.		Growth (%)	
	Rs. bn.	% of Total	Rs. bn.	% of Total	2011 Sep.	2012 Sep.
Deposits	2,907	72.4	3,466	70.5	19.5	19.3
Borrowings	577	14.4	798	16.2	20.0	38.4
Capital funds	347	8.6	421	8.6	24.7	21.3
Others	184	4.6	231	4.7	8.3	25.1
Total Liabilities	**4,015**	**100**	**4,916**	**100**	**19.4**	**22.5**

contributed by the increase in fixed deposits which was reflected in the increased share of fixed deposits from 54 per cent in September 2011 to 60 per cent in September 2012 (Chart 5.3). Such increase in share of fixed deposits guarantees the banks with longer term funding. Nevertheless, the increasing interest rates would result in high funding costs to banks as term deposits are mobilised at higher interest rates.

The funding gap due to the low growth in deposits was bridged by increase in borrowings. The growth in borrowings was 38.4 per cent by end September 2012 against that of 20 per cent by end September 2011. Accordingly, the share of borrowings in funding sources increased from 14.4 per cent in end September 2011 to 16.2 per cent by end September 2012. The higher increase in borrowings was a result of the increased

Chart 5.2 **LKR vs. FX Deposits**

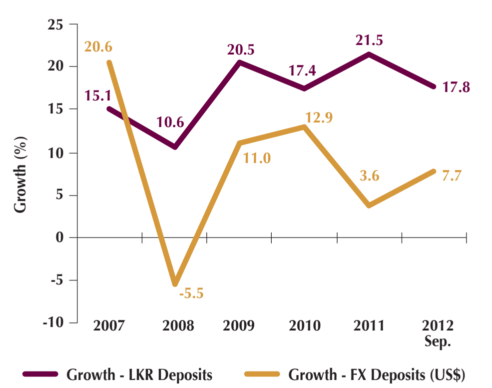


Chart 5.3 **Composition of Deposits as at 30.09.2012**

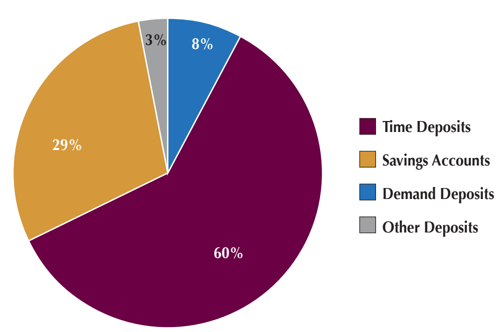


Chart 5.4 LKR vs. FX Borrowings

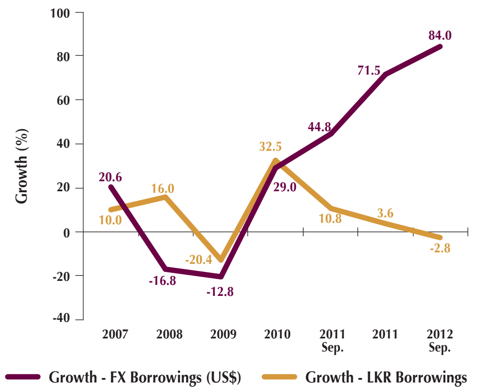
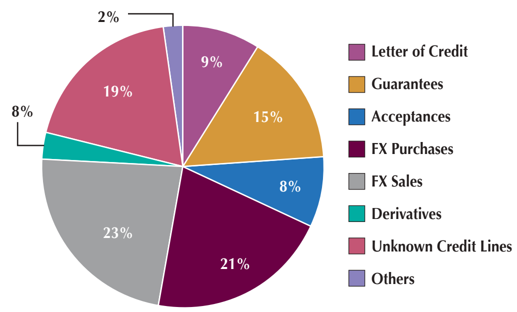


Chart 5.5 Composition of Off Balance Sheet Exposures as at 30.09.2012



foreign currency borrowings (YoY growth of 84 per cent) mainly from overseas sources (Chart 5.4) whereas the rupee borrowings recorded negative growth of 2.8 per cent from end September 2011. The banks were encouraged to explore the possibilities of raising funds from overseas sources at competitive rates which contributed to the increased foreign currency borrowings. The banks are required to monitor the increasing costs of funding and manage the possible foreign currency and liquidity risks associated with the foreign currency borrowings, prudently.

Off Balance Sheet Exposures

The off-balance sheet exposures increased at a slower rate of 14 per cent (YoY) by end September 2012 against that of 36 per cent by end September 2011. This slower increase is mainly due to the decline in documentary credit by 25 per cent (increase of 24 per cent in end September 2011) and sluggish increase in both acceptances and undrawn credit limits of 7 per cent and 13 per cent in end September 2012 against 68 per cent and 45 per cent in end September 2011, respectively. Accordingly, the share of documentary credit and acceptance declined from 21 per cent in end September 2011 to 17 per cent by end September 2012 (Chart 5.5). Both foreign currency purchases and sales accounted for 44 per cent of the total off-balance sheet exposures. 88 per cent of these foreign currency exposures are with financial institutions. Consequently, the off-balance sheet exposures as a percentage of total assets declined from 57 per cent in end September 2011 to 53 per cent in end September 2012.

5.2 Risk Assessment of Banking Sector

By end September 2012, the balance sheet of the banking sector exhibited a significant level of robustness to absorb potential market and credit risk shocks. The Table 5.4 below provides key financial soundness indicators relating to the banking sector.

Credit Risk

Credit risk or the default risk in the Sri Lanka banking sector is associated mainly with the credit growth, assets quality and concentration of lending.

Credit Growth

The Sri Lankan banking sector was experiencing an excessive credit growth in

Table 5.4 **Selected Financial Soundness Indicators of the Banking Sector**

Indicator	2008	2009	2010	2011	2012 Q3
Capital Adequacy					
Core (Tier 1) Capital Ratio (%)	12.5	14.1	14.3	14.4	13.3
Total Capital Ratio (%)	14.5	16.1	16.2	16.0	15.0
Net Non-Performing Loans to Capital Funds, (%)	18.5	26.2	15.2	11.5	14.1
Assets Quality					
Gross Non-Performing Loans (NPL) ratio (%)	6.3	8.5	5.4	3.8	4.0
Net Non-Performing Loans (NPL) ratio (%)	3.4	5.0	3.0	2.1	2.4
Provision Coverage (specific provisions to Gross Non-Performing Loans) (%)	47.6	42.8	45.3	46.0	40.2
Profitability					
Return on Assets (Before Tax) (%)	1.9	1.8	2.7	2.4	2.5
Return on Equity (After Tax) (%)	13.4	11.8	22.0	19.7	20.5
Efficiency Ratio (%)	55.6	56.3	47.2	52.3	48.8
Liquidity					
Statutory Liquid Assets Ratio (%)	31.3	39.2	36.6	32.4	30.9
Loans to Deposits Ratio (%)	87.0	71.5	76.4	84.7	87.6
Market Risk					
Foreign Currency Net Open Position (NOP) to Capital Funds (%)	2.2	(1.4)	(1.1)	(1.6)	0.1

year 2011 and during the first quarter of 2012, recording the annual credit growth of 32 per cent and 36 in the respective periods (Chart 5.6). In view of the potential adverse impact of such credit expansion on the stability of the economy and the banking sector, the Central Bank implemented a ceiling on rupee credit growth of licensed banks in mid-March 2012. As expected, through this monetary policy measure, the credit expansion of the banking sector moderated significantly during the 2nd and 3rd quarters of 2102. The annual credit growth as at end September 2012 was 29 per cent.

Assets Quality

The asset quality deteriorated marginally by end September 2012, as indicated by the increased non-performing loan (NPL) volumes and NPL ratios. The NPLs increased from Rs. 106 billion in end September 2011 and Rs. 99 billion in end 2011 to Rs. 121 billion by end September 2012 (Chart 5.7). Further, gross NPLs as a percentage of total loans and advances (NPL ratio) indicated a marginal increase from 3.8 per cent in end 2011 to 4 per cent by end September 2012 (Chart 5.8). Nevertheless, the ratio has improved since September 2011 (5.5 per cent). The increase in NPLs from end September 2011 was mainly from the increase in NPLs in the loss category (60 per cent) and special mention category (22 per cent). Accordingly, the loss category

Chart 5.6 **Credit Growth**

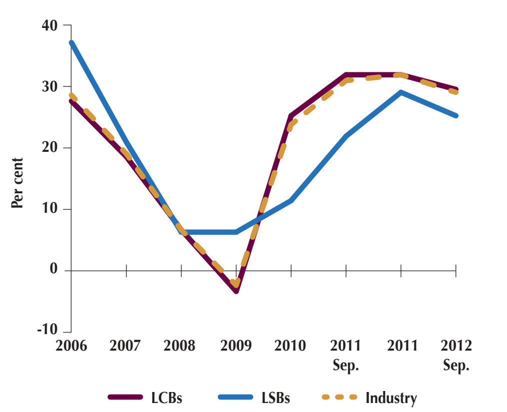


Chart 5.7 **Trend in NPL**

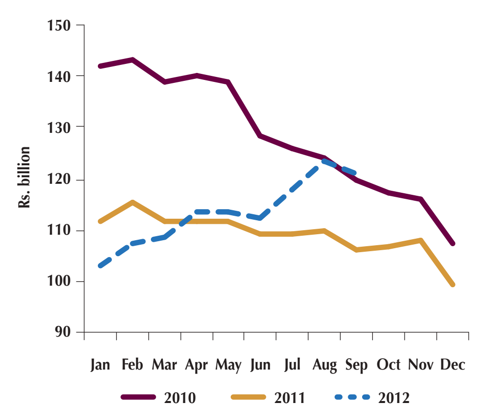


Chart 5.8 NPL Ratios

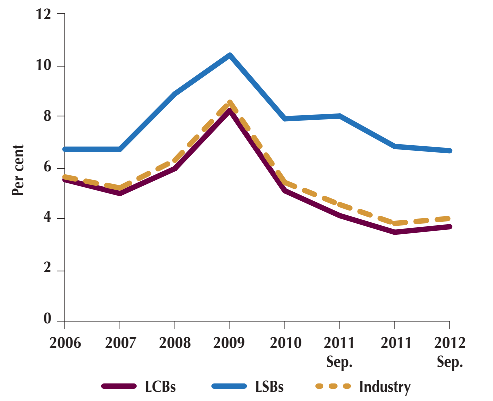
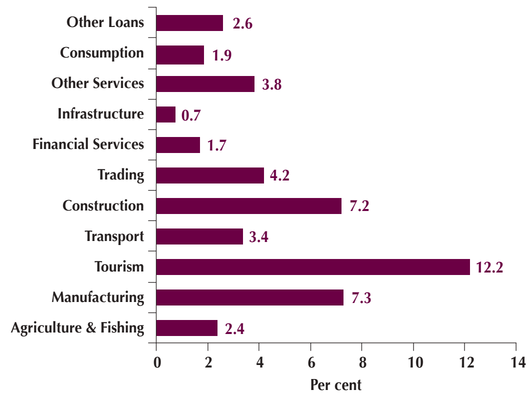


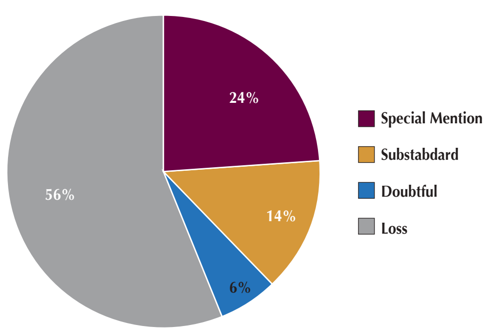
Chart 5.10 Sector-wise NPL Ratios as at 30.09.2012



continued to be the main category of NPLs (Chart 5.9) with provision coverage of 64 per cent.

The increase in NPLs since September 2011 was mainly due to the increase in NPLs in three sectors. These sectors are tourism (23 per cent), trading (19 per cent) and consumption related pawning advances (38 per cent). Further, tourism (12 per cent), construction and manufacturing (7 per cent) and trading (4 per cent) sectors also recorded high NPL ratios (Chart 5.10). Banks should continue to operate with proper credit risk assessment and monitoring and recognising any potential risks in advance to mitigate any adverse impact due to build-up of credit risks.

Chart 5.9 Composition of NPLs as at 30.09.2012



The level of adequacy of provision for credit losses, measured as the ratio of loan-loss provisions to gross NPLs declined. The loan loss provisions declined to 40 per cent by end September 2012 with the deteriorating assets quality of the banks and structural changes in NPL categories (Table 5.5). In addition to specific provisions, banks are required to maintain 0.5 per cent general provisions over loans in performing and special mention categories. Accordingly, by end September 2012, banking sector operated with total provision coverage of 51 per cent.

Sector Concentration

About 68 per cent of lending of the Sri Lankan banking sector is concentrated in five economic sectors. These sectors are trading (16 per cent), consumption (14 per cent), construction (14 per cent), agriculture

Table 5.5 Provisions Coverage – Specific Provisions on Non-Performing Loans

NPL Category	Required Provisions	NPL Value Rs. mn.	Available Provisions Rs. mn.	Provision Coverage (%)
Special Mentioned	0%	28,412.7	761.5	2.7
Substandard	20%	17,063.1	1,539.6	9.0
Doubtful	50%	7,112.0	2,425.8	34.1
Loss	100%	68,471.2	43,892.7	64.1
Total		**121,059.0**	**48,619.6**	**40.2**

Chart 5.11 Sector-wise Credit Exposure as at 30.09.2012

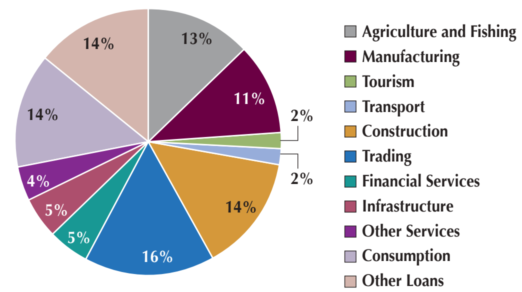
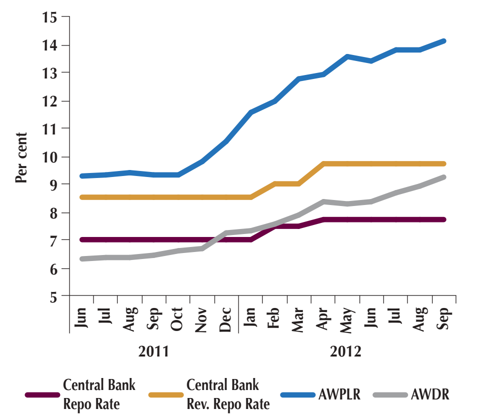


Chart 5.12 Policy Rates of the Central Bank's and Bank's Interest Rates



and fishing (13 per cent) and manufacturing (11 per cent) (Chart 5.11). Concentration of lending to few sectors or customers would expose a bank to credit risk due to a crisis situation in one sector or a customer affecting the recoverability of the majority of the loans portfolio. Moreover, given the high NPL ratios of the trading, construction and manufacturing sectors, banks should closely monitor the potential credit risk of these sectors.

The banks are required to ensure that their large exposures are maintained within the applicable maximum amount of accommodation limits (single borrower/ obligor limits) for individuals, companies or group of companies. Further, lending to a single party, exceeding 15 per cent of the bank's capital base, should not exceed 55 per cent of the total loan portfolio of the bank. The lending of few banks to certain entities has been exempted from these limits considering the national interest as permitted by the relevant regulation. As at end September 2012, the banking sector operated with such exposures amounting to Rs. 832 billion which is 27 per cent of the total loans and advances.

Market Risk

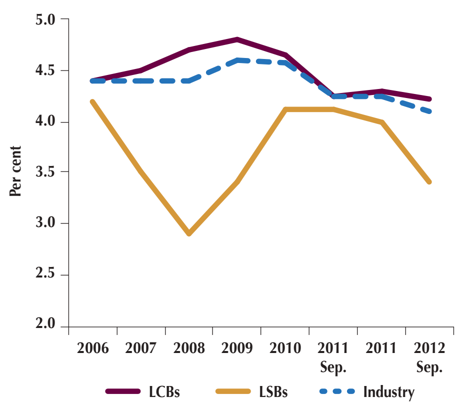
The banking sector would be exposed to market risk mainly due to the volatilities in interest rates, foreign currency exchange rates and share prices.

Interest Rates

Banking business operates with assets and a funding structure which are highly sensitive to the interest rates. As at end September 2012, the interest income was 85 per cent of the total income whereas 65 per cent of the costs accounted for interest expenses. As such, the banks by nature of their business are exposed to interest rate risk. Over the period under review, interest rates on various financial instruments displayed an increasing trend (Chart 5.12).

Effects of increased interest rates were reflected in both increased interest income (36 per cent against 8 per cent in September 2011) and interest expenses (49 per cent against 7 per cent in September 2012). The higher increase in interest cost resulted in marginal decline in interest margin from 4.2 per cent as at end September 2011 (4.6 per cent in end September 2010) to 4.1 per cent by end September 2012 (Chart 5.13). Further, with the increase in interest rates, the banking sector incurred substantial losses due to re-pricing of Government securities held in the trading portfolio.

Chart 5.13 Net Interest Margin



Prices of Equity

The exposure of the banks to equity risk was negligible due to the minimal exposure to equity market. The exposure to the equity market through investments in shares is only 3 per cent and 0.7 per cent of the total investments and total assets, respectively.

Exchange Rates

Foreign currency financial instruments constituted a significant part of banks' balance sheets. At end September 2012, 11 per cent and 12 per cent of the banking system assets and liabilities, respectively, were denominated in foreign currency. Individual banks were exposed to foreign exchange risk to varying degrees, based on their different net open positions (NOPs) in various currencies.

However, the foreign exchange risk was not a significant threat to the banking sector stability as the aggregate value of net open foreign currency positions was less than 1 per cent of banks' regulatory capital as at end September 2012. Foreign currency positions of the banking sector declined in 2012 primarily due to reduction in existing regulatory NOP limits of banks in March 2012. Additionally, banks reversed their exposure to fluctuations in foreign exchange rates by reducing their NOPs, particularly in US$ from negative NOP of Rs. 2.4 billion by end September 2011 to Rs. 0.3 billion. The depreciation of rupee against US$ by 12 per cent during 2012 had a positive impact on the banks' profitability through the revaluation of foreign currency assets and liabilities, where a significant gain of Rs. 10 billion was recorded during the first nine months of 2012 compared to Rs. 3 billion gains reported in the corresponding period of 2011.

Capital Charge for Market Risk

The capital charge for market risk declined from Rs. 7 billion in end September 2011 to Rs. 5 billion by end September 2012. This decline in capital charge for market risk was mainly due to the decline in capital charge for interest rate risk resulting from the reduction in Government securities held in trading account.

Liquidity Risk

The maturity mismatch that arises due to banking sector assets typically comprising of relatively illiquid assets such as long-term loans while their main liabilities are liquid short-term deposits, gives rise to liquidity risk. In performing the key role of financial intermediation banks manage both financial claims (*e.g.*, loans and securities) and liabilities (*e.g.*, deposits and inter-bank borrowings). Improved confidence in the banking system and the successful implementation of the deposit insurance scheme by the Central Bank has reinforced the stability of deposits as a source of funding. As at end September 2012, deposits and inter-bank borrowings accounted for 71 per cent and 16 per cent of total funding, respectively.

Chart 5.14 Liquidity Ratios

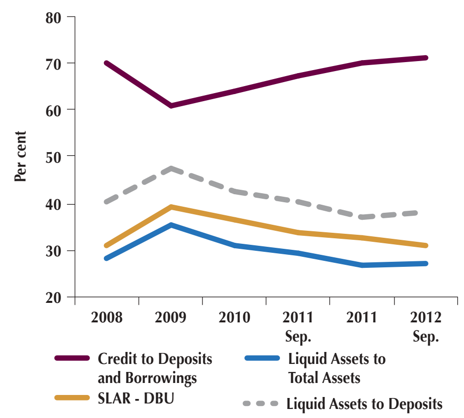
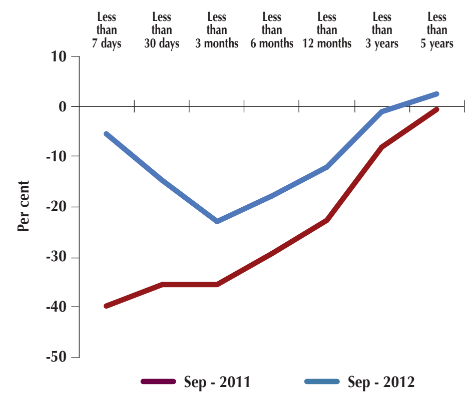


Chart 5.15 Cumulative Maturity Gap (% of Cumulative Liabilities)



Liquid Assets

The Statutory Liquid Assets Ratio (SLAR) of the banking sector was significantly higher than the regulatory minimum requirement. Every bank is required to maintain a statutory reserve ratio (cash held at the Central Bank over the rupee deposit liabilities) of 8 per cent and a SLAR, which is a ratio between approved liquid assets and total deposits and borrowing liabilities, of over 20 per cent. Accordingly, the banks have the ability to utilise at least 70 per cent of their funds for lending purposes. Responding to the increase in credit to deposits and borrowings ratio from 67 per cent in end September 2011 to 71 per cent by end September 2012, SLAR of the banking sector declined from 34 per cent in September 2011 to 31 per cent by end September 2012 (Chart 5.14). The moderation in the liquidity position of the banking industry was further reflected in both liquid assets to total assets ratio and liquid assets to deposits ratio.

Assets and Liabilities Management

The maturity mismatches between assets and liabilities in the banking sector decreased during the period from September 2011 to September 2012. Identification of maturity mismatches between assets and liabilities, based on either behavioural maturity or remaining contractual maturity, and designing appropriate funding strategies where necessary are main practices of assets and liabilities management of the Sri Lankan banking sector. The Sri Lankan banks are required to maintain a prudential ratio of cumulative gap to cumulative liabilities in each maturity time period. Further, during Statutory Examinations conducted by the Central Bank, the effectiveness of banks' assets and liabilities management policies and practices are assessed and recommendations made for further improvements, where necessary. Given the increasing interest rate environment and improved assets and liabilities management practices, the cumulative maturity gap as a percentage of cumulative liabilities in all maturity time periods (buckets) narrowed from September 2011 to September 2012 (Chart 5.15). Noticeably, the ratio in the less than 01 year period came down from negative 23 per cent in September 2011 to negative 12 per cent in September 2012.

Operational Risk

The operational risk is defined in Basel III as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." The Sri Lankan banking sector is moving towards offering highly advanced and technology based banking solutions where systems and processes are very important. In such circumstances, banks are required to operate with advanced internal controls and operational risk management practices in order to mitigate adverse impacts of possible operational risk events.

Currently, the Sri Lankan banks compute the capital charges for operational risks for the purpose of capital adequacy ratio based on the basic indicator approach. With a view to better managing the increasing operational risk events with the advancements in the banking sector, an exposure draft on moving towards advanced approaches in calculating the capital charge for operational risk under Pillar I of Basel II capital accord was issued to the banks. This would require the banks to compute capital charges for business segments separately based on an industry wide proxy for a given business line. Further, adequacy of the internal controls, internal audit procedures and other operational risk related policies and practices of the banks and the compliance with the regulations such as Directions on outsourcing are reviewed during Statutory Examinations.

5.4 Adequacy of Resources to deal with Potential Risks

In addition to managing the various risks inherent to the banking sector, it is important to maintain adequate buffers to absorb any potential losses due to risk exposures. The main risk absorption buffers of the banking sector are earnings, capital and management capabilities. Hence, maintaining a healthy level of earnings and capital and a sound management is expected to strengthen the risk absorption capacity of the banking sector.

Table 5.6 Income and Expenditure

Item	2011 September Amount (Rs. bn.)	2011 September As a % of Avg. Assets	2012 September Amount (Rs. bn.)	2012 September As a % of Avg. Assets
Total Interest Income	260.2	9.1	352.8	10.0
Total Interest Expenses	139.4	4.9	208.3	5.9
Net Interest Income	**120.8**	**4.2**	**144.5**	**4.1**
Non-Interest Income	44.3	1.6	60.8	1.7
Foreign Exchange Income	10.1	0.4	23.2	0.7
Non-Interest Expenses	85.1	3.0	98.8	2.8
Staff Cost	41.6	1.5	49.4	1.4
Loan Loss Provisions	(1.7)	(0.1)	4.8	0.1
Profit Before Tax (after VAT)	69.0	2.4	87.9	2.5
Profit After Tax	**46.8**	**1.6**	**61.4**	**1.7**

Profitability

The profit after tax recorded during the first nine months of 2012 (Rs. 61 billion) of the banking sector was significantly higher than that of (Rs. 47 billion) during first nine months of 2011 (Table 5.6). Further, despite the marginal decline in the net interest margin from 4.2 per cent in September 2011 to 4.1 per cent in September 2012, the banking sector recorded a higher return on assets and

Chart 5.16 Return on Assets (Before Tax)

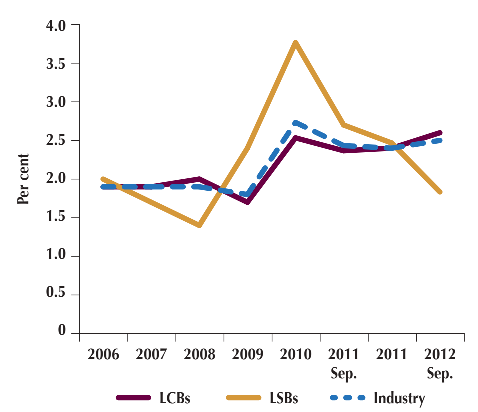
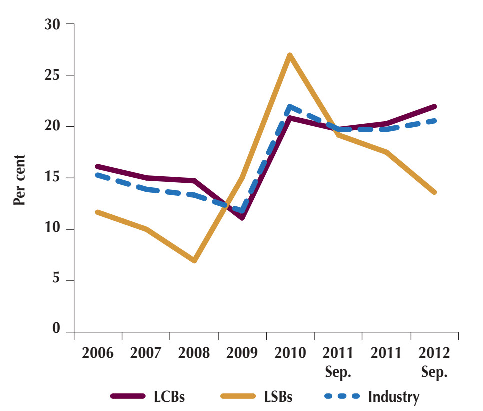


Chart 5.17 Return on Equity



return on equity ratios of 1.7 per cent and 20.5 per cent in end September 2012 (Chart 5.16 and 5.17).

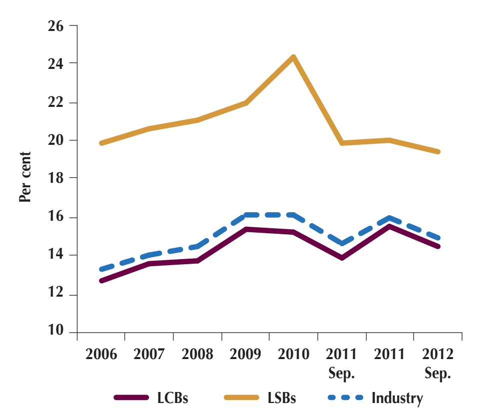
Although there was a decline in the interest margins, the profitability of the sector was buoyed by non-interest income. The decline in net interest margin was mainly due to increased interest cost on high cost funding sources in an increasing interest rate environment. Nevertheless, the non-interest income of the banking sector indicated a significant increase of Rs. 16 billion from end September 2011 against the decline of Rs. 9 billion reported during the period September 2010 to September 2011. This significant increase in non-interest income was mainly contributed by the foreign exchange income driven by the forex revaluation gains which accounted for 45 per cent of the increase in non-interest income.

As reflected in the improved profitability ratios, the banking sector operated with a healthy level of earnings which has enhanced the risk absorption capacity. However, despite the interest income continuing to be the main source of earnings of the banking sector, the banks should focus on more sustainable non-interest income sources since dependency of non-interest income on unrealised gains will not ensure the continuation of high profitability in an increasing funding cost environment. Further, banks would be able to enhance their earnings if the asset quality of the banking sector is maintained at satisfactory levels. The provisioning from earnings has increased from a reversal of Rs. 1.7 billion in September 2011 to Rs. 5 billion in September 2012.

Capital Funds and Capital Adequacy

Capital funds of the banking sector increased by 21 per cent by end September 2012, mainly through the internal generated funds (profits). This increase was lower than 25 per cent capital growth reported in end September 2011. In 2011, a few banks raised their capital through new issue of shares and right issues to meet the minimum capital requirement of banks. Despite the marginal decline in the growth rate of the capital funds the total capital adequacy ratio of the banking sector increased from 14.6 per cent in end September 2011 to 15.0 per cent by end September 2012. Further, the core capital ratio also increased marginally to 13.3 per cent reflecting on the availability of adequate high quality capital in the Sri Lankan banking sector (Chart 5.18).

Chart 5.18 Capital Adequacy Ratio



During 2012, the Central Bank issued the Consultation Paper on implementation of the supervisory review process under Pillar II of Basel II. Further, the Sri Lankan banking sector is currently in compliance with the new capital requirements under Basel III. By end September 2012 the banking sector operated with the common equity ratio of 13.3 per cent and a total capital ratio of 14.6 per cent, well above the requirements of Basel III. With the limited lending resulting in moderated growth in risk weighted assets, the capital adequacy ratios of the banking sector is expected to improve further by the end of the year 2012.

Management

The Central Bank continued to assess the fitness and propriety of directors, chief executive officers and key management personnel in keeping with the prudential directions issued in this regard. The International Accounting Standards define key management personnel as those who are in a position to (*a*) significantly influence the policy; (*b*) direct activities; (*c*) exercise control over business activities, operations and risk management. Therefore, the existence of a well-structured Board of Directors and a team of key management personnel comprising fit and proper individuals facilitate the functioning of banks in an effective and ethical manner, thus reducing any system wide risks to the industry. Further, the Boards of Directors of several banks witnessed a change in composition during the year, mainly due to complying with the provisions of the Corporate Governance directions relating to the transitional period for complying with the 70 year age limit and 9 year service period for directors, as well as effecting new appointments to further strengthen the management of banks.

5.5 Policy Measures and Regulations

During the period from end September 2011 to end September 2012, the Central Bank introduced several policy measures and regulations to the banking sector in view of the developments in the banking sector and economy and to keep abreast with the developments in the international regulatory framework.

(*a*) **Integrated risk management framework:** Directions on integrated risk management framework for banks were issued with a view of encouraging the banks to develop integrated risk management techniques for monitoring and managing risk and to ensure maintenance of adequate capital to various risk exposures.

(*b*) **Customer Charter of licensed banks:** In view of safeguarding the interest of the customers and improving the customer confidence in the banking sector to promote and ensure stability in the banking sector, the Central Bank issued Directions requiring the banks to adopt a code of conduct in line with the Customer Charter issued to the banks.

(*c*) **Adoption of LKAS 32, 39 and SLFRS 7:** Draft guidelines on statutory reporting by banks to the Central Bank under LKAS 32, 39 and SLFRS 7 were issued to the banking sector, requiring the banks to publish the financial statements in accordance with the new accounting and disclosure standards, with effect from the annual periods beginning on or after 01.01.2012.

(*d*) **Ceiling on credit growth:** Considering the excessive credit growth prevailed in the beginning of the year 2012 resulting in undesired levels of monetary aggregations and inflation, the Central Bank issued an Order to the banking sector specifying a ceiling of 18 per cent or Rs. 800 million, whichever is higher, for growth in rupee credit for the year 2012. However, banks could lend up to 23 per cent or Rs. 1,000 million, whichever is higher, if they are in a position to raise corresponding funds from overseas sources.

(*e*) **Foreign exchange trading activities of banks:** With the view to further improve the standard of business conduct and good market practices for the effective and efficient functioning of the foreign exchange trading activities in Sri Lanka, the Central Bank issued the Banking Act, Direction No. 1 of 2012 on foreign exchange trading activities, after a consultative process with the respective stakeholders and considering the international best practices.

5.6 Global Regulatory Reforms

(*a*) **With the issuance of the draft guidelines on adoption of the of LKAS 32, 39 and SLFRS 7, the Central Bank facilitated the transition of the financial reporting of the Sri Lankan banking sector to internationally accepted accounting practices.** Nevertheless, banks are required to follow existing regulatory framework for regulatory reporting purposes. Further, banks are required to maintain adequate data/records to reconcile significant deviations between the account balances published under LKAS/SLFRS and the balances reported to the Central Bank under the existing regulatory framework.

(*b*) **The Central Bank is in the process of developing the capital and liquidity standards under the Basel III regulations.** With the use of the existing data and information, studies are being conducted on the current position of the banks in meeting the advanced capital and liquidity requirements. Appropriate regulations will be issued after a comprehensive analysis on the gaps between the existing regulatory requirements and the Basel III requirements as well as the capacity building requirements of both the regulator and the banking sector in order to implement the new global regulatory standards.

Box 4

Challenges and Implications of Implementing the New Capital and Liquidity Reforms under Basel III

1. Introduction

The global financial system entered the financial crisis with too little capital and liquidity buffers and a capital and valuation regime with significant pro-cyclical impact. Consequently, a new global regulatory standard named Basel III has been agreed upon by the members of the Basel Committee on Banking Supervision to be introduced on a staggered basis. Basel III comprises a revised capital framework, which aims at achieving stronger protection for banks through improved risk coverage, greater and higher quality capital, countercyclical buffers and constraints on the build-up of excessive leverage, complemented with liquidity standards that will promote higher liquidity buffers and limit maturity mismatches.

2. The New Capital and Liquidity Reforms

2.1 Capital Reforms:

(a) **Higher quantity and quality of capital:** Banks are required to hold more common equity as its ability to absorb losses is higher in order to ensure higher quality and quantity of capital as reflected in Table B4.I.

(b) **Introduction of a regulatory leverage ratio:** With effect from 2018, the core capital should be 3 per cent to 4 per cent of the total balance sheet assets including on-balance sheet and off-balance sheet assets. This ratio known as the leverage ratio is introduced to complement the new capital standards and will curtail excessive expansion of a bank's balance sheet.

(c) **Higher loss absorbency (HLA) capital for systemically important banks (SIBs):** Considering the negative externalities created by systemically important banks which are not fully addressed by current regulatory requirements, SIBs will be required to maintain more capital with higher loss absorbency.

2.2 New Framework for Liquidity Risk Management

Banks will need to maintain adequate levels of high quality liquid assets to ensure that short-term and long-term liquidity requirements are met. For this purpose, quantitative liquidity standards namely, the Liquidity Coverage Ratio and the Net Stable Funding Ratio were introduced.

Table B4.1 Higher quantity and quality of capital under Basel III requirements

Items of capital	Main Components	Requirement as a percentage of risk weighted assets: Basel II	Requirement as a percentage of risk weighted assets: Basel III	Basel III requirements with Capital Conservation Buffer[1/] of 2.5%
Common Equity	Share capital, retained profits and disclosed reserves	2.0%	4.5%	7.0%
Tier I Capital	Common equity plus other capital instruments which are subject to strict eligibility criteria and which encompass a loss absorption mechanism	4.0%	6.0%	8.5%
Total Capital	Tier I capital and capital instruments subordinated to depositors and general creditors of the bank subject to strict eligibility criteria	8.0%	8.0%	10.5%
Counter Cyclical Buffer	Common Equity		2.5%	

Note 1: Capital conservation buffer constitutes common equity

Box 4 (*Contd.*)

(a) Liquidity coverage ratio (LCR) aims at covering possible short-term mismatches, through the comparison of expected cumulative net cash outflows for a 30 calendar day time horizon with high quality unencumbered liquid assets at the bank's disposal.

(b) Net stable funding ratio (NSFR) aims at coping with possible structural mismatches in the composition of balance sheet assets and liabilities over a one-year horizon. It compares the total sources of funds with maturity greater than one year with the portion of stable non-maturity deposits and the less liquid assets.

(c) Both ratios must be at least 100% and, LCR and NSFR will come in to force by 1 January 2015 and 2018, respectively.

3. Implications and Challenges in Implementing Basel III

3.1 Revamping the strategic planning process: Banks will need to factor the implications of the new regulatory requirements into their strategic planning process while dealing with the implementation of the new requirements.

3.2 Moving forward with Basel II and the implementation of Basel III: Basel II deals mainly with assessing capital adequacy considering the risks encountered by banks and facilitates banks to assess risks using different approaches. Moving to advanced approaches in Basel II will benefit banks in the allocation of capital. Banks will be required to allocate resources for implementation of appropriate Information Technology Systems and the capacity building necessary for implementing advanced approaches under Basel II and the new requirements under Basel III.

3.3 Better capital and liquidity management: Banks will be compelled to improve capital efficiency in terms of risk taking and to address suboptimal liquidity management practices to reduce the negative impact on their Return on Equity.

3.4 Balance sheet restructuring: Banks will no longer be able to optimise assets and liabilities independently. The new interdependencies are such that, in practice, each asset has an impact on the bank's capital and leverage position and each asset and liability affects the bank's short-term liquidity position as part of its assets.

3.5 Business model adjustment: Banks will be required to reduce investments and lending to facilitate the buildup of high quality liquid assets, higher levels of capital and lower leverage. The effect of deleveraging will result in reduced expansion of banks' balance sheets leading to lower growth in credit. Profitability may be impacted due to scarcity of funding and capital in future. In such circumstances, banks may need to re-visit their long-term business strategy and assess their viability. The potential constraints on supply of credit during the transition period can hinder economic growth. However, any adverse impact on credit expansion of banks needs to be assessed in terms of incremental benefit of new capital requirements *vis-à-vis* impact on economic growth.

3.6 Data quality and reporting complexity: Given that high quality data are essential for effective risk management, banks must from the start clearly identify and ensure the quality of target data and the resulting requirement for data and IT governance processes and systems.

4. Implications on Banks in Sri Lanka

4.1 Meeting higher capital requirements:

(a) Banks in Sri Lanka, maintain high core capital ratios represented by common equity consisting of share capital, retained profits and eligible reserves (Chart B5.1). The core capital and total capital ratios of the banking industry were maintained at 13.3 per cent and 15.0 per cent, respectively, as at 30 September 2012. These ratios are much higher than the requirements under Basel III (Chart B5.2), reflecting the strong capital position of the banking system.

Box 4 (*Contd.*)

Chart B5.1 Composition of Tier I Capital of the Banking Industry

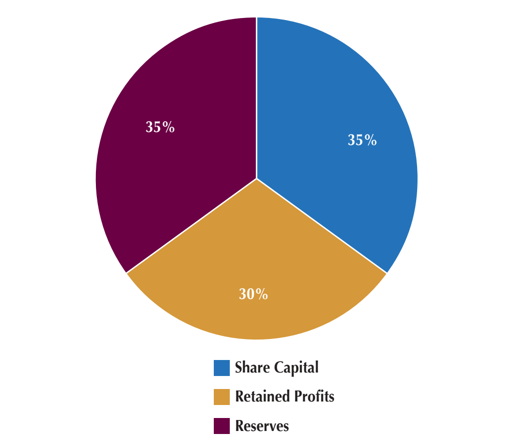
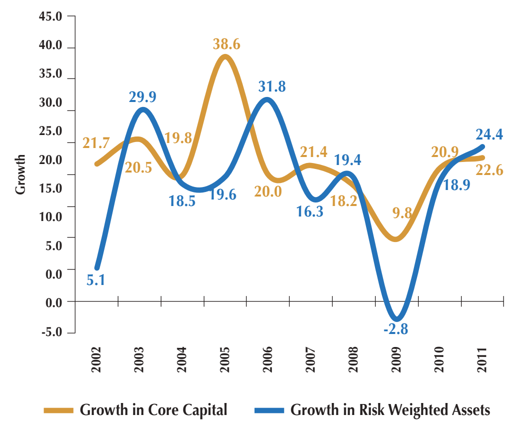


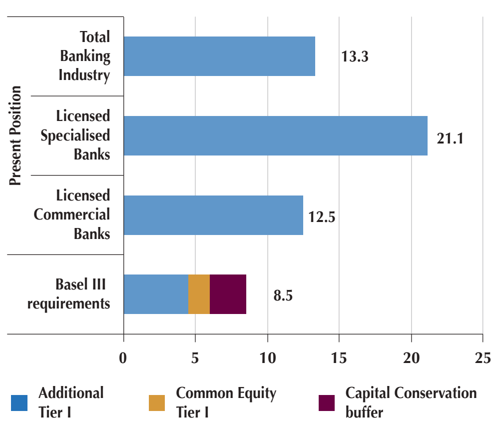
Chart B5.3 Compisition of Growth rates of Risk Weighted Assets with Tier I Capital



(b) During the last decade, the growth in capital accumulation of the banking industry has surpassed the growth in risk weighted assets resulting in high capital levels (Chart B5.3).

(c) Internal generation and retention of profits is vital. In Sri Lanka, the equity capital market is active; however, the corporate debt market is still at a nascent stage. All domestic private banks are required to list their equities, and bank equities are frequently traded. Further, banks are also required to list their debt capital and in the recent past many state and private domestic banks have been in a position to list their long term corporate debt to raise Tier II capital.

Chart B5.2 Banking Industry Core Capital as at 30th Sep. 2012 Vs Basel Requirements



(d) Considering that banks in Sri Lanka maintain very high common equity which forms a significant portion of core capital, the challenges for meeting the Basel III capital requirements remain relatively low.

4.2 Maintaining higher leverage ratio:

With the improved capital position the leverage ratio of the banking industry remains at 4.7 per cent as at 30 November 2012 above the Basel III requirements of 3 per cent.

4.3 Assessment of liquidity ratios: Under liquidity risk management, the Central Bank is at present assessing the implications of the quantitative standards. Initial focus will be on the Liquidity Coverage Ratio (LCR), where banks' high quality liquid assets as against the net cash outflows over the next 30 days are being assessed. Initial assessment on the LCR for the large banks varies between 75 per cent and over 500 per cent. Considering the significant portion of high quality liquid assets already maintained by banks based on the existing statutory requirements and the time period available for implementation of the LCR, the challenges of meeting the new liquidity requirements under LCR are low.

Box 4 (*Contd.*)

4.4 Higher loss absorbency (HLA) capital for Domestic Systemically Important Banks D-SIBs: Considering the relatively significant size of the banking sector to GDP in Sri Lanka of approximately 65 per cent, it may be prudent to require D-SIBs to maintain HLA capital in future.

4.5 Capacity building in the banking industry: It may be necessary for banks in Sri Lanka to further strengthen risk management mainly in areas such as risk quantification, risk modeling, understanding different capital and liquidity instruments into capacity building of banks. Also other stakeholders including Auditors and Rating Agencies too need to factor the new regulatory requirements into their capacity building programmes.

5. Conclusion

Considering the favourable capital position of the banking sector in Sri Lanka, the challenges to credit growth remain minimal. However, going forward, expansion of banks' balance sheets, accumulation of capital and taking on risks will need continued attention to ensure that the banking system in Sri Lanka remains strong and stable especially as Sri Lanka continues to strive towards achieving USD 4,000 per capita income during the next 3 years.

References:

Basel III and Beyond: A Guide to Banking Regulation after the Crisis.

A Framework for dealing with domestic systemically important banks issued by the Basel Committee on Banking Supervision.

Basel III and European Banking: Its impact, how banks might respond and the challenges of implementation.

6. Non-Bank Financial Institutions

- ***Licensed Finance Companies*** *(LFCs) and* ***Specialized Leasing Companies*** *(SLCs) continued to record a robust growth. The growth in the asset base is attributed to the credit expansion in the sector. The high interest rates and the increased number of deposit taking entities have contributed to the expansion in the deposit base.*

- *While the non-performing loan ratio has marginally improved and liquid assets have been maintained over and above the statutory requirement, the increased interest rates pose a challenge to asset quality as well as liquidity risk management.*

- *The strengthened supervisory, regulatory and the legal frameworks, enhanced capital and liquidity buffers and continued profitability have improved the performance of the sector.*

- ***The Insurance Sector*** *experienced growth in total assets and profitability despite the marginal decline in premium income and slower growth in investment income. Compliance with solvency margin requirements indicates soundness of the insurance sector.*

- *The recent increase in claims on weather related damages, have exerted pressure on underwriting risk. The dynamics of the insurance sector is expected to change with the new regulatory requirements on business segregation and listing.*

- *A recovery in* ***Primary Dealers*** *(PDs) performance was seen in terms of total assets, total portfolio, profitability and capital since June this year. Despite the repricing losses on their trading portfolios, profits have been recorded for the year so far.*

- *The value of the overall* ***Unit Trust*** *(UT) sector declined as a result of the lacklustre performance of the equity market. However, with diversification and effective portfolio management UTs have recorded a better performance compared to CSE's price indices.*

- *The performance of* ***Stock Brokers*** *and* ***Other Market Intermediaries*** *were also affected by downward movement in the equity market, declining market liquidity, increasing interest rates as well as restrictions on broker credit.*

- *The overall performance of the* ***Superannuation Funds*** *improved in terms of the assets, investment and contributions, while the risks have been adequately managed.*

6.1 Non-Bank Financial Sector

Licensed Finance Companies (LFCs) and Specialized Leasing Companies (SLCs), accounting for 6.4 per cent of the financial sector, expanded during 2012. The main performance indicators on capital, profitability, asset quality, credit growth and deposit base recorded notable growth rates (Table 6.1). However, during second quarter and third quarter of 2012, the macro-economic dynamics on interest rates, exchange rates and the fiscal policy measures increasing the tax on vehicle imports affected the LFC/SLC sector performance to some degree. With increased competition for business, some consolidation is expected in the sector in the near future.

Business Growth/Developments

Outreach

As at end September 2012, the Non-Bank Financial Institutions (NBFIs) under the supervisory and regulatory purview of the Central Bank comprised of 45 LFCs and 13 SLCs. During the first nine months of 2012, three companies were granted the LFC licenses, while three companies migrated from SLC to LFC status. Meanwhile, the branch network increased by 132 to 836 during the first nine months of 2012 out of which 20 branches were opened in the Northern and Eastern provinces reflecting the growth prospects in these areas (Table 6.2).

Table 6.1 Selected Data and Key Financial Soundness Indicators of LFCs and SLCs

Indicators	As at end Sep. (Rs. Bn.)		% Change (Y-O-Y)	
	2011	2012 (a)	2011	2012 (a)
Total Assets (Gross)	454.9	564.0	29.6	24.0
Total Accommodations (Gross)	356.1	451.0	48.3	26.6
Total Deposits Liabilities	181.6	233.6	31.4	28.6
Total Borrowings	156.7	171.6	32.3	9.5
Total Capital Funds	59.2	83.9	41.0	41.7
Risk Weighted Assets	357.1	436.3	37.4	22.2
Profit After Tax (b)	15.1	11.9	208.0	(20.9)
Performance Ratios (%)				**% Change**
Net Interest Margin	6.6	7.1	0.9	0.5
Gross NPA Ratio	5.5	5.0	(4.2)	(0.5)
Net NPA Ratio	1.9	1.6	(2.9)	(0.3)
Total Provision Coverage Ratio	57.0	55.7	4.3	(1.2)
Total CAR	14.2	17.4	9.0	3.2
Return on Assets (ROA)	5.9	4.0	2.1	(1.9)
Return on Equity (ROE)	33.9	18.9	16.3	(15.0)

(a) Provisional
(b) During the period under review

Table 6.2 Branch Distribution of LFC/SLC sector by Province

Province	As at end of		No. of branches opened in 2012
	Dec - 2011	Sep - 2012	
Western	224	256	32
Southern	86	101	15
Sabaragamuwa	54	64	10
North Western	67	89	22
Central	72	88	16
Uva	42	50	8
North Central	50	59	9
Eastern	63	72	9
Northern	46	57	11
Total	**704**	**836**	**132**

The LFC and SLC sector expansion in the first three quarters of 2012 is reflected among the large 22 companies accounting for 87 per cent of the market share. The asset base of this category has increased from Rs.390 billion to Rs.491 billion as at end of September 2012 (Table 6.3).

Assets and Liabilities

Assets

The total asset base of LFCs and SLCs increased by 15 per cent to Rs. 564 billion during the first nine months of 2012 compared to the 17 per cent growth recorded in the corresponding period of 2011. The growth in the accommodations portfolio was the main contributory factor for the expansion of the asset base, while the investment portfolio has remained constant. The accommodations portfolio of NBFIs grew by 16 per cent to Rs. 450 billion during the first nine months

Table 6.3 **Market Share of LFCs and SLCs (in terms of the total assets)**

Asset Category	No. of LFCs / SLCs		Total Assets (Gross)			
	End September (Rs. Bn)		End September (Rs. Bn.)		Share (%)	
	2011	2012	2011	2012	2011	2012
Small (assets < Rs.1 Bn)	13	13	7.9	6.6	1.6	1.2
Medium (Assets between Rs. 1 Bn – Rs. 5 Bn)	22	23	56.8	66.6	12.5	11.8
Large (Assets > Rs. 5 Bn)	21	22	390.4	491.0	85.9	87.0
All Companies	**56**	**58**	**455.1**	**564.2**	**100.0**	**100.0**

of 2012, where as the previous year's corresponding period recorded a growth of 34 per cent (Table 6.4). Accommodations accounted for 80 per cent of NBFI sector assets while finance leases, hire purchases and other secured advances were the major sources of accommodations accounting for 45 per cent, 27 per cent and 15 per cent, respectively (Charts 6.1 and 6.2).

Liabilities

Deposits were the major source of funding for the LFCs, while borrowings were the major source of funding for the SLCs, representing 41 per cent and 30 per cent of the total sector liabilities, respectively. The total deposits increased by 25 per cent to Rs. 232 billion during the first nine months of 2012, compared to a growth of 24 per cent of the corresponding period in 2011 reflecting increased depositor confidence in the LFC sector (Table 6.5 and Chart 6.3). The deposit mobilization was primarily through time deposits and savings accounting for 98 per cent and 2 per cent, respectively, of the total deposits. The borrowings portfolio remained static during the period under review compared to a growth of 13 per cent in the previous year. The higher interest rates and several SLCs which obtained LFC status mobilizing public deposits instead of borrowings are the main reason for lack of growth in borrowings in the sector.

Capital

Capital element increased by a healthy 19 per cent to Rs.92 billion as at end of September 2012, compared to an increase of 32 per cent in 2011. Sustained profitability and the revival of the distressed companies have been instrumental in strengthening the capital funds of the sector.

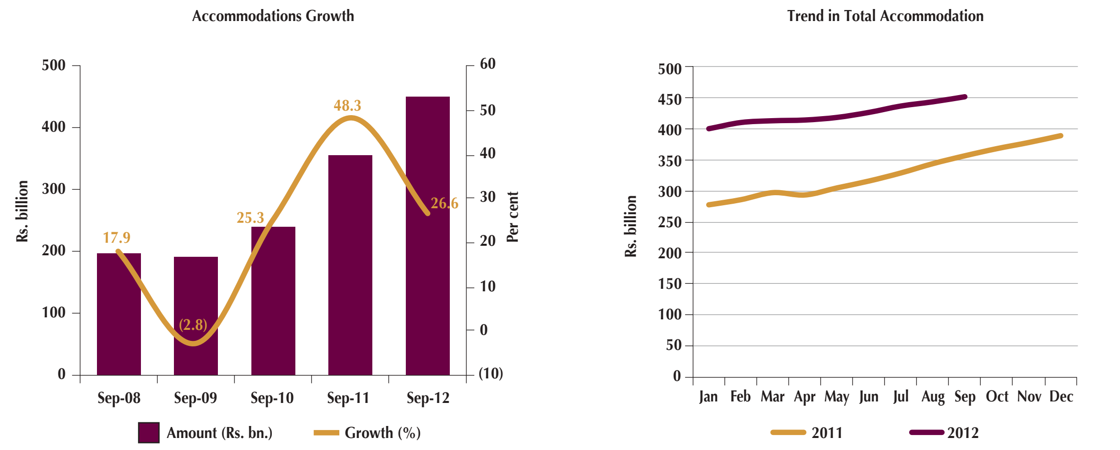
The statutory capital adequacy ratios of the LFC/SLC sector remained above the required minimum level. The core capital ratio, where the required minimum is 5 per cent, increased to 17 per cent as at end September 2012 from 14 per cent in 2011 due to increased capital. Further, the total capital ratio, where the required minimum is 10 per cent, increased to 17 per cent as at end September 2012 from 14 per cent in 2011. The ratio of LFCs' capital funds to total deposits increased to 22 per cent

Table 6.4 **Composition of Assets of LFC/SLC Sector**

Item	As at end of September 2011		As at end of September 2012(a)		Growth % during the first nine months of the year	
	Amount (Rs. bn.)	% of share	Amount (Rs. bn.)	% of Share	2011	2012
Accommodations	356.1	78.2	450.3	79.8	34.1	15.9
Investments	14.5	3.2	14.5	2.6	(42.4)	7.4
Other Assets	84.5	18.6	99.4	17.6	(13.1)	13.0
Total Assets	**455.1**	**100.0**	**564.2**	**100.0**	**17.3**	**15.2**

(a) Provisional

Chart 6.1 Total Accommodations of LFC/SLC Sector



as at end September 2012 from 17 per cent recorded in 2011. The statutory minimum level of this ratio is 10 per cent.

Profitability

The LFC/SLC sector profitability recorded a decrease, during the nine months of 2012 with a decline in non-interest income and an increase in non-interest expenses. Profitability is expected to decelerate further due to the fiscal policy measures taken during the beginning of the year, such as increase in duty on import of vehicles and fuel prices hike. The leasing portfolios which are predominantly on vehicles were affected due to the increased cost of vehicles.

The sector posted a sustained profit after tax of Rs. 12 billion during the nine month period ended 30.09.2012 compared to a profit of Rs.15 billion in previous year's corresponding period (Table 6.6). Sustained profitability was mainly attributed to the improvement in net interest income from the core business products of LFCs and SLCs, reduced provisioning requirements due to increased recoveries and lower written off loans. The LFC/SLC sector return on assets and return on equity remained modest

Chart 6.2 Product-wise Accommodations of LFC/SLC Sector

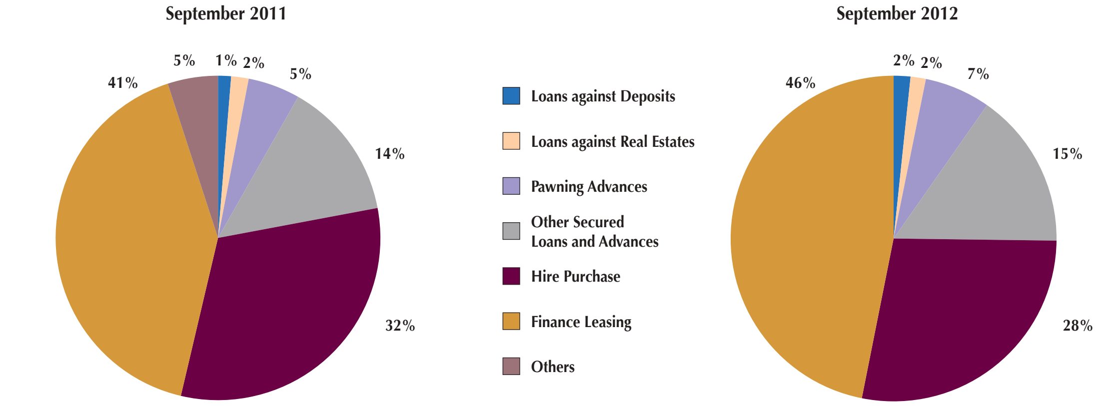


Table 6.5 Composition of Liabilities of LFC/SLC Sector

Item	As at end of September 2011		As at end of September 2012 (a)		Growth % during the first nine months of the year	
	Amount (Rs. bn.)	% of share	Amount (Rs. bn.)	% of Share	2011	2012
Capital Element	63.6	14.0	91.8	16.3	32.2	19.2
Deposits	180.8	39.7	232.4	41.2	23.8	24.9
Borrowings	156.7	34.4	171.6	30.4	12.8	0.0
Other Liabilities	54.0	11.9	68.4	12.1	(1.3)	23.7
Total Liabilities	**455.1**	**100.0**	**564.2**	**100.0**	**17.3**	**15.2**

(a) Provisional

which stood at 4 per cent and 19 per cent, respectively, annualized for the nine month period ended 30.09.2012, compared to 6 per cent and 34 per cent, respectively, in the previous corresponding period.

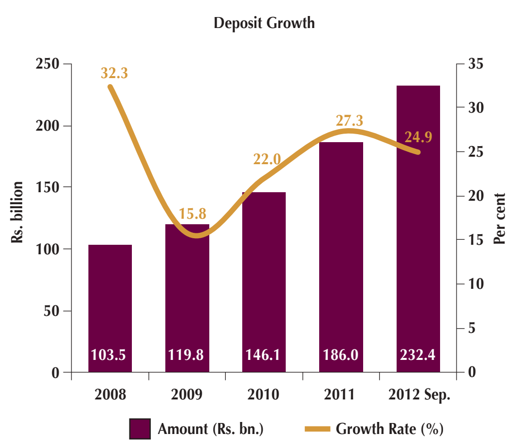
Risk Assessment

There has been a significant impact on the leasing sector subsequent to the increase in import duty on vehicle importation in April 2012. Even though a significant drop in demand for leasing was reported immediately, the impact is expected to gradually ease off with the economic growth and demand for motor vehicles increasing eventually.

With the increased number of LFCs in the country, there will be peer pressure in sustaining the business operations, especially in mobilizing funds and lending. Hence, companies need to have effective asset liability management, remove inefficiencies to improve margins and follow best practices to service customers.

The prognosis is that the large LFC/SLC category will augment further with the elevation of the medium sized companies to large category in terms of the asset base, with expansion of business. Hence, there would be peer pressure applied to LFCs and SLCs in the small category with lower asset and capital base which could pose liquidity constraints due to lack of funding. Further, LFCs and SLCs would continue to face severe competition from the banking sector as more banks are now diverting from their low risk

Chart 6.3 Total Deposits of LFCs and SLCs Sector



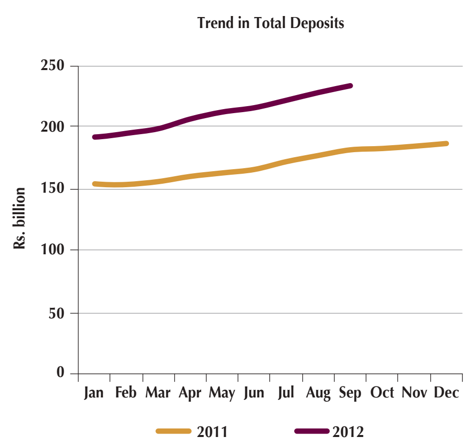


Table 6.6 Composition of Profit and Loss Account of LFC/SLC Sector

Item	During the nine months period ended Amount (Rs. bn.)		Growth %
	Sep 2011	Sep 2012 (a)	
Interest Income	48.4	67.1	38.7
Interest Expenses	25.2	36.9	46.3
Net Interest Income	23.2	30.2	30.5
Non-Interest Income	14.1	10.0	(29.1)
Non-Interest Expenses	18.8	22.1	17.4
Profit Before Tax	20.0	16.9	(15.2)
Profit After Tax	15.1	11.9	(20.9)

(a) Provisional

core business products to high risk products such as finance leases, margin trading and pawning. This sector requires infusion of new capital in order to meet the revised minimum core capital requirement for 2013. As at end of year 2012, 13 companies are required to raise an aggregate of around Rs. 8 billion of capital.

Credit Risk

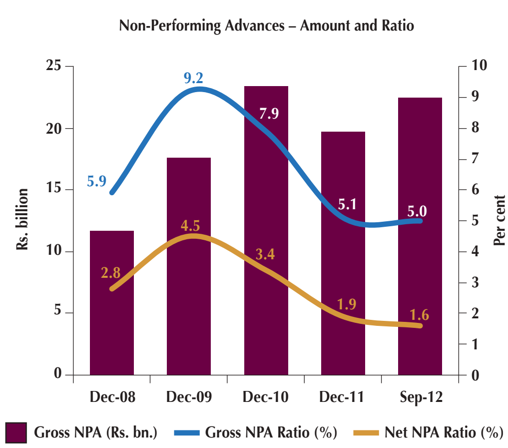
Asset quality of the LFC/SLC sector has shown a marginal improvement during the period under review. The exposure to Non-Performing Accommodations (NPAs) relative to the total accommodations outstanding improved to 5.0 per cent as at end September 2012 from 5.1 per cent recorded as at end 2011, mainly due to growth in accommodations (Chart 6.4). However, the total amount of NPA increased to Rs. 22.5 billion as at end September 2012 from Rs. 19.8 billion as at end 2011. LFC sector accounts for 88 per cent of the total NPAs of LFC/SLC sector, consisting mainly NPAs of distressed companies. The asset quality may come under pressure with increasing interest rates pushing borrowers to default status. However, deterioration of asset quality would be minimized with rapidly expanding loan portfolios and action taken by the distressed companies to reduce their exposures in NPAs.

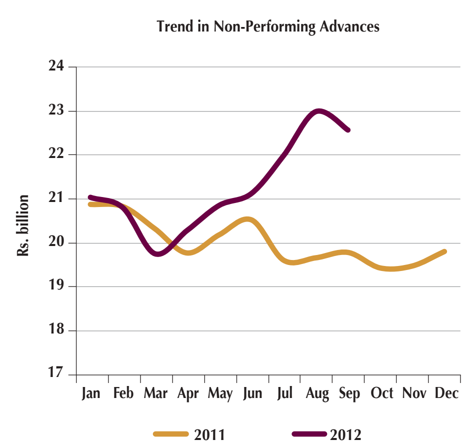
When the loan loss provision is considered, the net NPA ratio was 1.6 per cent as at end September 2012, compared to 1.9 by end September 2011. The total provision coverage for NPAs remained constant at 56 per cent as at end September 2012.

Liquidity Risk

The overall statutory liquid assets available in the LFC/SLC sector by end September 2012 recorded a surplus of Rs. 6.8 billion from the stipulated minimum requirement of Rs. 26 billion. This can be directly attributed to the

Chart 6.4 Credit Risk Indicators of LFC / SLC Sector





few distressed companies which faced severe liquidity constraints being turned around with their respective revival plans, increased sector earnings and growth in funding channels. The upward moving and volatile interest rates have increased liquidity risk of these entities which have significant asset and liability mismatches in the shorter end.

Market Risk

The robust credit growth of LFC/SLC sector continued to have a favourable impact on the earnings during 2012 as well. The interest margin, which is the net interest income as a percentage of total assets of the sector, improved to 7.1 per cent for the twelve months period ended 30.09.2012 compared to 6.6 per cent in corresponding period of the previous year. The net interest income of the sector increased by 32 per cent to Rs. 40 billion during the nine month period ended 30.09.2012, from Rs. 30 billion recorded in previous year. However, the increasing borrowing cost could result in lower profitability in the current milieu as the sector is sourced with external borrowings as well.

Supervisory and Regulatory Measures

Several policy measures were taken during 2012 to improve the soundness of the LFC/SLC sector and boost public confidence in the sector.

Policy Measures and Regulations

- During 2012, the interest rates direction for finance companies was revised four times to reflect the changes in the market interest rates. The revisions made to the interest rate upper limits are indicated below (Table 6.7);
- SLCs were issued with the following directions,

Table 6.7 Changes in Upper Limit of Interest Rates and Maximum Interest Rates During 2012 for Time Deposits and Non-Transferable Certificate of Deposits

Effective Period during 2012	364-day Wgtd. Ave. Rate	Upper limit of interest rate %		Maximum interest rate %	
		One year or less	More than one year	One year or less	More than one year
1st Jan – 29th Feb	9.23	4.00	5.00	13.23	14.23
1st Mar – 31st Mar	9.23	5.50	6.50	14.73	15.73
1st Apr – 29th May	10.82	5.50	6.50	16.32	17.32
1st Jun – 30th Jun	10.82	4.75	5.75	15.57	16.57
1st Jul – 30th Sep	13.79	3.00	4.00	16.79	17.79
1st Oct – 31st Dec	14.65	2.00	3.00	16.65	17.65

i. With a view to promoting the financial soundness, the minimum core capital to be maintained by SLCs which was Rs.100 million until end December 2012 was increased to Rs. 150 million by 01 January 2013 and further raised to Rs. 200 million, 250 million and 300 million as at 01 January 2014 to 2016 respectively. This direction revised the definition of the core capital used by the SLCs to be in line with the definition of core capital under BASEL II.

ii. The maximum outstanding amount of borrowings of a SLC should not exceed seven times the amount equal to the core capital less equity investments in subsidiary companies and associate companies of such SLC.

iii. To ensure good governance and effective risk management in SLCs and a direction was issued on assessment of fitness and propriety of all directors on the board and officers performing executive functions.

iv. The liquidity direction was revised excluding asset-back bank borrowings and securitization loans from the definition of borrowings.

Box 5

Reshaping the Business Model of the Non-Banking Sector

Non-banking sector is entrenched in a traditional business model

The finance companies and the leasing companies in the non-banking sector have been vital elements in the Sri Lankan financial landscape which complements the mainstream banking sector. Albeit being a small player in the financial system, it has a deeply rooted business model concentrating mainly on collateralized lending based on moveable assets. Traditional products such as finance leasing, hire purchases and pawning constitute a major portion of this sector's lending portfolio. Another specific characteristic of this sector is that it caters to a specific segment of the population which includes those that do not have or are reluctant to access the banking sector and those who are willing to take higher risks for higher returns. Due to the stringent regulatory framework of banks and consequent regulatory costs, the risks and returns of a bank deposit is lower compared to that of a non-bank financial institution.

Dynamics reshaping the non-banking sector in Sri Lanka

Akin to many emerging nations, Sri Lanka is undergoing many structural reforms with its national income being spread across the economy. Rising income levels have resulted in poor and lower middle income segments in the society moving upwards to higher levels of standard of living. In such a transformation process, the financial sector, including the non-bank financial institutions, would be re-examined by the demanding customers pursuing new value added financial products and services. Such customers would expect nothing but the best from the financial sector in prudential standards and customer centric services with embedded technological advances.

With the envisaged growth in the economy and the expansion in business activities, competition is expected to intensify significantly. This competition will not be only within the non-banking sector. The banking sector is also expected to expand in extending its services to facilitate economic growth. Moreover, the banks will also be competing for the market share of the traditional lending products such as finance leasing, hire purchases and pawning while being in a position to offer better rates to their customers due to their lower borrowing costs. Under such circumstances, retaining and/or expanding market share will be very challenging for the non-banking sector. Intense competition may give rise to survival of the fittest, purging out the weak. Consolidation might be an unavoidable option for the weaker entities.

But to effectively face the competition from the banking sector, it would be pertinent for the non-banking sector to reshape its business model diversifying into products and services not offered by the banking sector and more so, meeting the specific financial requirements of segments of the population catered to by the non- banking sector. In order to expand its market share, it would be necessary to attract new customers as well. Offering products and services to attract a larger segment of the population may also be a dampener to any conduct of unauthorized finance business.

The recent regulatory reforms introduced to the non-banking sector have already raised its capital and liquidity requirements. But if there is to be further expansion and diversification, the requirement for further strengthening of prudential norms would arise. Moreover, improving productivity, efficient cost structures, effective risk management, are also essential requirements of such a transformation in order to face the competition effectively.

Box 5 (*Contd.*)

Core transformations required to reshape non-banking sector

- **Integrated risk management**

  All entities in the financial sector are exposed to various types of risks that are interdependent. An event that triggers one type of risk can have major implications on the entire financial sector. To ensure soundness of the financial sector, regulators have now identified that the risks have to be managed in an integrated manner. Considering this requirement, an integrated risk management framework was introduced to the banking sector by the regulator to be adopted by all banks. Similarly, the non-banking sector financial institutions also need to adopt such a framework to monitor and manage all risks to the financial sector.

- **Corporate governance at the strategic level**

  It is evident that corporate governance, (its absence or full compliance) at the top of an organization's hierarchy has been the main reason for propelling an entity towards insolvency or a world class operation. Best corporate governance practices at the strategic decision making level and drilling down through the organizational structure would ensure a smooth, transparent and a healthy business operation. During the past crisis periods in Sri Lanka, the entities that lacked in corporate governance were the entities that were also financially weak and thereby the severely affected by the crisis. Hence, strengthening of corporate governance should be a vital component of any transformation process for the non-banking financial sector.

- **Simplify business processes**

  Some non-banking financial institutions continue to be entrenched in archaic and inefficient business models, out dated processes and weak human resources. Hence, the existing business processes need to be revisited and aligned in line with the customer demands and prudent market practices. Each business process needs to be evaluated piece by piece in every perspective to identify the rationale for its existence, and revamped in line with an effective internal control system, integrated risk management framework, efficient cost benefit mechanism.

- **Technology to be a catalyst of transformation**

  With the expansion of the economy, the banking sector has experienced fast tracked development primarily due to the use of advanced technology. The banking sector embraced advanced technology with aggressive investments during the past decade. Adoption of real time centralized systems, web based banking facilities and mobile banking are key highlights in the banking sector and these have given the Sri Lankan public greater flexibility in financial services. However, the non-banking sector has not kept pace with such technological developments except for a few large companies. Technology can be used effectively for risk management, to obtain cost efficiencies, improve productivity and financial accessibility and to strengthen the business operations of an entity. Hence, use of state of the art technology would emerge as both a key enabler and a differentiator over the next couple of years for non-banking sector business operations.

- **Diversify business risks**

  In the non-banking sector, the typical business operation was often defined as mobilizing public deposits or issuing debt instruments and providing leasing facilities with substantial margins. The exorbitant penal rates and the unconventional methods used for recovery of defaulted facilities made a substantial contribution to their margins. However, with competition intensifying for market share, survival would be very challenging if such practices are continued. Hence, it is imperative for the non-banking sector to enlarge its business scope to facilitate multiple income streams, introduce diversified products, and create business models in the line of

Box 5 (*Contd.*)

"one-stop-financial-services" focusing on the customers' diverse financial needs and requirements.

Generally, financial institutions prefer to extend credit facilities to the rich or urban segments of the population as well as corporates considering their level of credit worthiness. But it is the small and medium enterprises that form the foundation of an economy, meeting the needs at the grass root level and creating employment. Therefore, foraying into areas such as microfinance and focusing on business models based on the micro, small and medium enterprises would provide the required diversification needed to stay in the competition. Expected economic growth would provide opportunities to lend to sectors such as construction, tourism, manufacturing and agriculture and these would on the other hand facilitate the achievement of national goals.

- **Vibrant human capital**

  Lack of professional, competent and dynamic human resources have given rise to lack of professionalism, accountability, transparency, corporate governance and financial strength in certain sections of the non-banking sector. There is stiff competition with banks for the best human resources in the market with talented staff being attracted towards better prospects in the banking sector. The need for dynamic and resourceful human capital in the non-banking sector is the need of the moment for the industry to emerge as a vital player in the Sri Lankan economy.

Conclusion

The non-banking sector entities should make the best use of the opportunities offered by a growing economy to successfully face the intense competition from the banking sector. It is essential that the sector expands and diversify out of its traditional business model. Focusing on the financial needs at the grass root level and developing products to suit the needs of the micro, small and medium enterprises as well as the sectors of the economy that are crucial to the nation's development, would be essential. Investing in technology and human capital would be a basic necessity to face the competition head on. If the non-banking sector makes the right moves in reshaping and redefining its business models, it would enable greater wealth creation, financial mobility and financial safety in the country.

- Information systems have become significantly important for the strategic operations and risk management of the LFCs and SLCs. Hence, a direction relating to an Information Systems Security Policy has been issued to provide guidelines which stipulate the minimum requirements to be adhered to.

- There have been situations where some external auditors have not carried out audits in a professional manner resulting in misreporting the financial status of some companies. Hence, the Central Bank has set up a panel of auditors for the LFC/SLC sector in order to ensure the external audits of these companies are carried out effectively.

- A sub committee has been setup with representatives from the Institute of Chartered Accountants of Sri Lanka, Leasing Association of Sri Lanka (LA), the Finance Houses Association of Sri Lanka (FHA) and the Central Bank to evaluate and facilitate the application of SLFRS/LKAS to the LFC/SLC sector. The FHA and LA have communicated the finalized sector specific accounting treatments. A guideline is to be issued by end 2012 on areas where the SLFRS/LKAS and the Central Bank directions contradict.

- Resolution Measures; Seven distressed finance companies affected by the liquidity crisis were restructured during 2011. The performance of these distressed companies is being closely monitored through off-site supervision and regular meetings held with Boards of Directors and senior management. Strategic investors were found for all seven distressed companies. However, the investment process has not been successful in two companies and they are currently in the process of inviting strategic investors to enhance their capital positions.

- The Central Bank has finalised an Early Warning and Follow up System to identify potential risk areas and to propose remedial actions in order to mitigate such risks. Further, an internal rating system has been implemented to rank these entities based on their financial strength.

Action Taken to Combat Unauthorized Finance Institutions

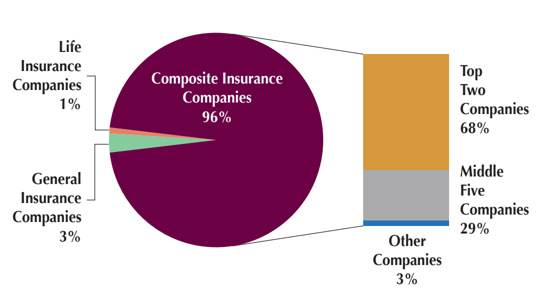
The Central Bank continued its investigations on institutions allegedly engaging in finance business without authorization and regularized the activities of one institution and initiated legal action against several institutions during the period concerned. Further, the Central Bank continuously educated the public of the risk of investing in unauthorized finance business through seminars, audio programs and via print media. During the period under review, the customer complaints received by the Central Bank on unauthorized institutions have reduced compared to the previous corresponding period which reflects the downward trend of the activities of unauthorized finance business. Further, increased vigilance among public is noted as inquiries on the legality of institutions prior to making investment decision, have increased.

6.2 Insurance Companies

The insurance sector accounts for about 3 per cent of the total assets of the financial sector, while there are 22 insurance companies registered by the Insurance Board of Sri Lanka (IBSL). Of these, 21 companies are currently in operation. A total of 12 companies are composite insurers engaged in both long-term and general insurance business, while 6 companies engage exclusively in general insurance business and 3 companies conduct only long - term insurance business. There are 7 insurance companies that are listed on the Colombo Stock Exchange (CSE).

The insurance business is highly concentrated among a few large insurers, with 2 companies accounting for 63 per cent of total assets and 5 companies accounting for 89 per cent of total assets of the sector at end September 2012 (Chart 6.5). The state-owned composite insurance company accounts for 39 per cent of total sector assets and 41 per cent of composite insurance assets. The life insurance sub-sector is dominated by 3 insurers accounting for 82 per cent of

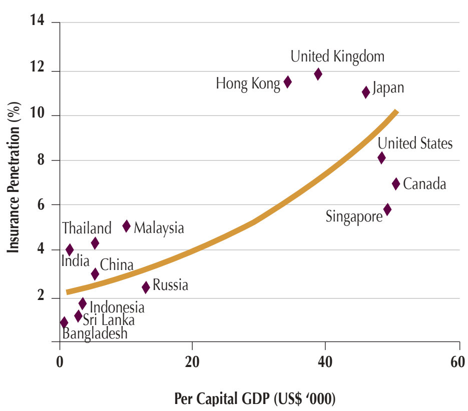
Chart 6.5 The Assets Composition of the Insurance Sector



total assets and the 2 largest general insurers account for 58 per cent of the assets of this sub-sector. In terms of premium income, the insurance industry continues to be dominated by the two largest insurers, who collectively accounted for around 47 per cent of the industry's Gross Written Premium (GWP). However, smaller insurers have continued to capture market share from their large counterparts, by way of price undercutting to a certain extent, particularly in the general insurance sector.

Insurance penetration which measures the level of insurance activity relative to the size of the economy in Sri Lanka is low in comparison with other Asian countries (Chart 6.6). This is particularly because insurance generally is viewed as a risk management tool rather than an investment vehicle in Sri Lanka. In addition, relatively low income as measured by GDP per capita and lack of awareness regarding the benefits of insurance among the general public were other contributory factors for low penetration in the country. Insurance penetration (total premium as a percentage of GDP) in Sri Lanka was 1.2 per cent, with general insurance accounting for 0.7 per cent and long–term insurance accounting for 0.5 per cent (Table 6.8). The average level of insurance penetration in Asian countries is 5.8 per cent (general insurance – 1.6 per cent and long-term insurance – 4.3 per cent).

Chart 6.6 Insurance Penetration Vs. Per Capita GDP of Selected Countries



Sources : Swiss Re, Sigma No. 3/2012, World Insurance in 2011
World Economic Outlook, October 2012, IMF

Table 6.8 Insurance Penetration and Density in Selected Asian Countries

	Insurance Penetration (in per cent)			Insurance Density (Premiums per capita US$)		
	Total Business	Long-Term	General	Total Business	Long-Term	General
Japan	11.0	8.8	2.2	5,169	4,138	1,031
Singapore	5.9	4.3	1.5	3,106	2,296	810
India	4.1	3.4	0.7	59	49	10
Malaysia	5.1	3.3	1.8	502	328	175
Thailand	4.4	2.7	1.7	222	134	88
PR China	3.0	1.8	1.2	163	99	64
Philippines	1.3	0.8	0.4	30	20	10
Sri Lanka	**1.2**	**0.5**	**0.7**	**33**	**15**	**18**
Indonesia	1.7	1.1	0.6	60	40	20
Pakistan	0.7	0.4	0.3	8	4	4
Europe	**7.1**	**4.1**	**3.0**	**1,886**	**1,083**	**802**
Asia	**5.8**	**4.3**	**1.6**	**314**	**229**	**85**
Africa	**3.6**	**2.5**	**1.2**	**65**	**44**	**21**
World	**6.6**	**3.8**	**2.8**	**661**	**378**	**283**

Source : Swiss Re, Sigma No. 3/2012 , World Insurance in 2011

Insurance density (the ratio of premium to total population) in Sri Lanka was US$ 33, while the average for Asian countries was US$ 314. These figures indicate that there is an immense potential for the future expansion of the sector, specifically for life insurance products, such as single premium insurance policies, unit linked insurance products, pension and retirement products, annuities and Takaful insurance. Chart 6.6 posits that income, as measured by GDP per capita, is the main factor deriving insurance market penetration and hence in countries with low per capita GDP, penetration is also low.

Assets

Total assets of the insurance sector recorded a slower growth of 14.7 per cent during the first nine months of 2012 compared to 19 per cent growth during the corresponding

period in 2011. As at end September 2012, the total assets of the insurance sector stood at Rs. 287 billion (Table 6.9). The moderate growth in the assets of the general insurance sector was the main contributory factor for the slower growth in the total assets.

The average annual growth of total assets of insurance companies for the past 5 year and 10 year periods were 17 per cent and 19 per cent, respectively. The total assets of long-term insurance increased by 13 per cent to Rs. 178 billion at end September 2012 and accounted for 62 per cent of total insurance assets (Chart 6.7). The total assets of general insurance increased by 18 per cent to Rs. 109 billion at end September 2012 against that of 37 per cent growth during the corresponding period of 2011 and accounted for 38 per cent of the total insurance assets.

Premium

The total Gross Written Premium (GWP) income of insurance companies increased in 2012, recording a double digit growth. The growth momentum continued supported by the overall improvement in macroeconomic conditions and increased disposable income. The effect of the increase in import duty on motor vehicles had only a marginal effect on motor insurance. Hence, the general insurance sector continued to be the primary driver of growth, while the long–term insurance sector also performed positively. The total GWP of insurance companies rose only by 12.1 per cent to Rs. 66 billion in the first nine months of 2012 compared with an increase of 22.5 per cent in the same period of 2011. The average annual growth of GWP for the last ten years was 16 per cent.

The GWP of general insurance continues to dominate the industry, accounting for 59 per cent of total GWP during the period under review. The GWP in the general insurance sector increased by 17.4 per cent to Rs. 39 billion in the first nine months of 2012, compared with an increase of 23.5 per cent in the first nine months of 2011. The annual growth of GWP for general insurance was 17.5 per cent for the ten year period from 2002 to 2011. The GWP for long-term insurance which accounted for 41 per cent of total GWP, grew only by 5.4 per cent to Rs. 27 billion in the first nine months of 2012 compared with an increase of 21.2 per cent in the first nine months of 2011 (Chart 6.8). The average annual growth of GWP for long-term insurance was 16.9 per cent during the period 2002 -2011.

Chart 6.7 Total Assets of Insurance Companies

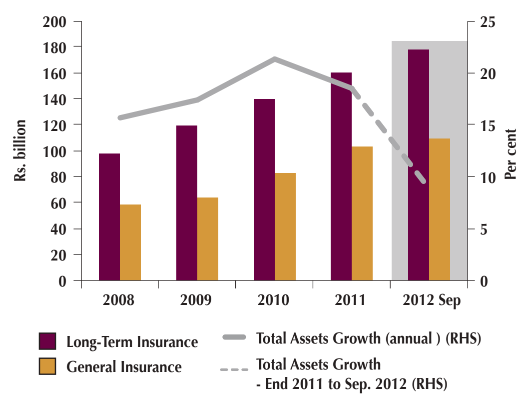


Chart 6.8 Premium Income and Growth of Insurance Companies

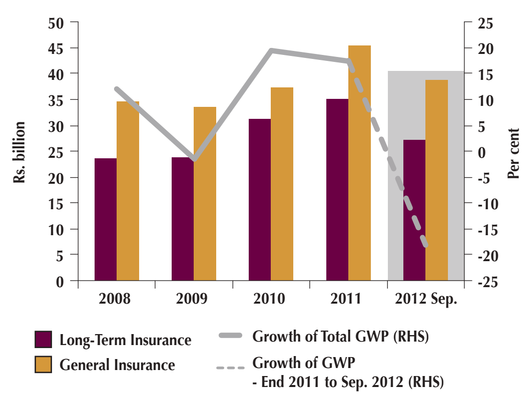
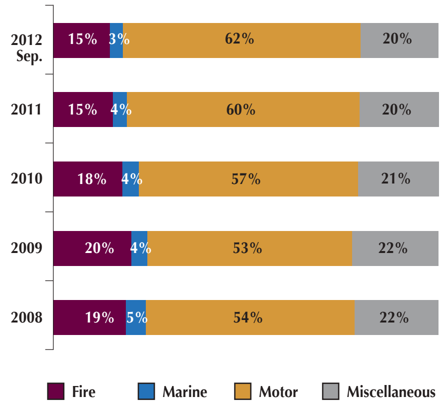


Chart 6.9 Sector-wise Premium Distribution of General Insurance



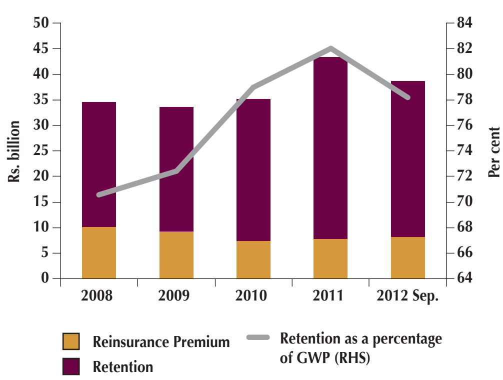
All major sub-classes of general insurance positively contributed to its GWP in the first nine months of 2011. The composition of the GWP remained relatively unchanged within the general insurance sector, with the motor insurance contributing to 62 per cent of total GWP (Chart 6.9). The GWP of motor insurance increased moderately by 19.9 per cent in the first nine months of 2012 compared with an increase of 32.3 per cent in the corresponding period of 2011. The comparatively slower growth in motor insurance was due to the decelerated demand for motor vehicles arising from the price escalation of motor vehicles as a result of the rupee devaluation, the tax increases and the high interest rates on leases and loans. The GWP of miscellaneous insurance which is predominately from medical insurance (representing 20 per cent of total premium) increased by 21.5 per cent, while the GWP of fire insurance (representing 15 per cent of total premiums) and marine insurance (representing 3 per cent of total premiums) increased by 6.1 per cent and 6.2 per cent, respectively.

The net premium income (GWP minus reinsurance premium) for general insurance also rose by 18.4 per cent in the first nine months of 2012 compared to the increase of 27.9 per cent in the corresponding period of 2011. The net premium income in all sub classes except marine of general insurance increased during the period under review. The net premium for long term insurance also increased only by 5.1 per cent in the first nine months of 2012.

The retention ratio (the ratio of net premium to total GWP) of general insurance sector marginally increased to 78.8 per cent in the first nine months of 2012 from 78.2 per cent in the same period of 2011 (Chart 6.10). Consequently, the ceded ratio (reinsurance premium to total GWP) which covers the large risks of insurance companies declined to 21.2 per cent in the first nine months of 2011. Motor insurance continued to maintain the highest retention ratio of 97.2 per cent. In contrast, fire insurance recorded the lowest retention ratio of 18.5 per cent given the relatively larger size of individual claims and unpredictability. The retention ratios for miscellaneous and marine insurance were 73.5 per cent and 39.2 per cent, respectively. The retention ratio of long-term insurance remained unchanged at 96.0 per cent.

The total claims of insurance companies increased by 11.2 per cent to Rs. 26.7 billion in the first nine months of 2012 against that

Chart 6.10 Total Retention and Reinsurance Premium of Insurance Companies



of 6.7 per cent in the corresponding period of 2011 primarily due to higher claims incurred in general insurance. General insurance claims increased by 16 per cent, while the claims on long -term insurance increased only by 3 per cent (Chart 6.11). However, the ratio of claims to earned premium (earned premium is GWP adjusted by the unearned premium provisions at the beginning and end of the accounting period) for general insurance declined to 62.5 per cent in the first nine months of 2012 from 65.9 per cent in the same period of 2010 mainly due to higher earned premium for general insurance (motor, miscellaneous and fire) and lower claims recorded for fire insurance.

The claims ratio for long-term insurance also declined from 35.3 per cent to 34.8 per cent, during the period under review. The bulk of the claims were on account of motor insurance and the claims ratio for motor insurance declined to 65.3 per cent in the first nine months of 2012 from 68.5 per cent in the same period of 2011. The claims ratio for miscellaneous had remained relatively stable at around 65 per cent, while the claims ratios for marine and fire insurance were 36.1 per cent and 4.2 per cent, respectively, in the first nine months of 2012.

Investments

The total investment income of insurance companies increased marginally during the first nine months of 2012. However, the lacklustre performance of the stock market and the re-pricing losses in government securities due to increased yield rates negatively affected the investment income of the insurance sector. The total investment income of insurance companies increased only by 0.1 per cent to Rs. 18.1 billion during the first nine months of 2012, as against a decline of 20.7 per cent in the same period of 2011 (Chart 6.12). Consequently, the investment income ratio (investment income to net premium) of insurance companies slightly increased to 32.0 per cent in the first nine months of 2012 from 31.3 per cent in the same period of 2011. Insurance companies with high exposure to equity and government securities market have incurred marked to market losses.

Insurance companies are required to invest a minimum of 20 per cent of technical reserves of general insurance and 30 per cent of long-term funds in government securities. Investments in government securities accounted for 43.4 per cent of the total assets of insurance companies. Government securities accounted for 54.3 per cent of long-

Chart 6.11 Earned Premium, Claims Incurred and Claims Ratio of General Insurance

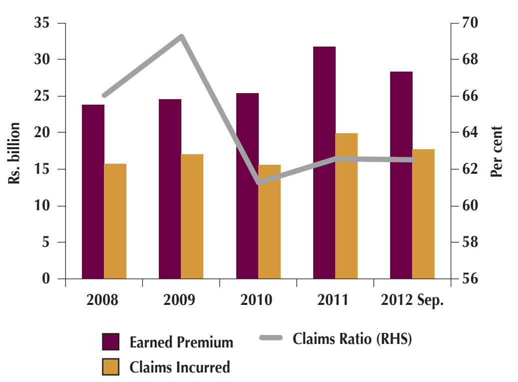


Chart 6.12 Total Income (GWP + Investment Income) of Insurance Companies (Quarterly Basis)

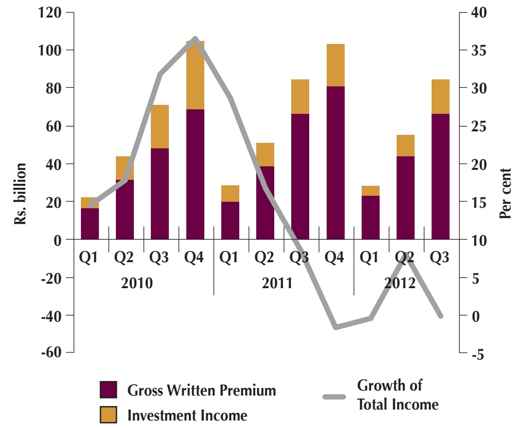
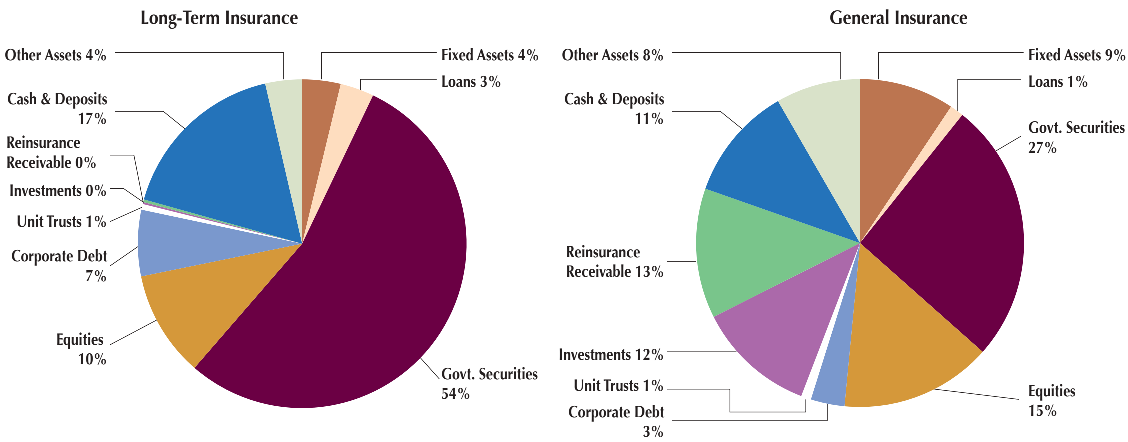


Chart 6.13 Distribution of Assets of Insurance Companies



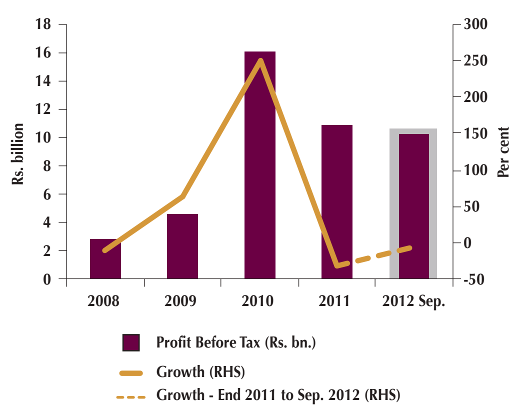
term insurance assets and 25.8 per cent of general insurance assets (Chart 6.13). This is in excess of the amount of investment in government securities required by the Act and all insurance companies have complied with this statutory requirement during the period under review. In addition, the total share of equities and corporate debt securities in the total assets of insurance companies amounted to 12.2 per cent (15.5 per cent at end September 2011) and 5.3 per cent (5.5 per cent at end June 2011), respectively.

Profits

The aggregate profit before tax of the insurance sector increased by 43.6 per cent in the first nine months of 2012 on account of higher profits generated through general insurance (Chart 6.14). The majority of the companies recorded overall profits. Profit before tax of general insurance increased significantly by 252 per cent mainly due to higher investment income recorded in the general insurance sector, while profit on long-term insurance declined by 43.8 per cent reflecting a decline in investment income and premium income.

The profitability ratios of the general insurance sector improved while a decline was seen in that of the long term insurance sector. The return on equity (ROE) for general insurance increased to 17.6 per cent in the first nine months of 2012 from 6.3 per cent in the same period of the previous year. The return on assets (ROA) for general insurance also increased to 9.5 per cent in the first nine months of 2012 from 3.2 per cent in the same period of 2011. However, the ROA for long-term insurance declined to 2.2 per cent in the first nine months of 2012 from 4.5 per cent in the same period of 2011 (Table 6.9).

Chart 6.14 Profit Before Tax and Growth of Insurance Companies



Underwriting profits of general insurance increased by 34 per cent in the first nine months of 2012, reflecting the higher premium earned in the sector. However, the intense price competition in the industry, coupled with the marginally increased management expenses, has affected the underwriting performance during the period under review. The underwriting ratio (the ratio of underwriting profit to net earned premium) of general insurance increased to 19.9 per cent in the first nine months of 2012, from 18.3 per cent in the first nine months of 2011.

The combined operating ratio for general insurance declined to 100.5 per cent in the first nine months of 2012 from 103.7 per cent in the same period of 2011 (Table 6.9). The combined operating ratio is a financial measure of insurance underwriting (core) profitability and is expressed as the total of claims costs, commissions and management expenses as a percentage of premiums.

Table 6.9 Selected Data and Key Financial Soundness Indicators of Insurance Companies

Item	2010	2011	2012 End Sep. (a)
Data (Rs. bn)			
Total Assets	219.1	261.8	286.6
Total Income (b)	**104.3**	**102.7**	**84.0**
Gross Premium Income (b)	68.5	80.5	65.9
Investment Income (b)	35.8	22.2	18.1
Profit Before Tax (b)	16.6	12.1	10.2
Indicators			
Solvency Margin Ratio			
– Long-Term Insurance	5.1	6.4	6.5
– General Insurance	2.6	2.1	2.2
Retention Ratio (%)			
– Long-Term Insurance	97.0	96.4	96.0
– General Insurance	75.5	78.4	78.8
Claims Ratio (%)			
– Long-Term Insurance	38.3	33.0	34.8
– General Insurance	61.6	60.1	62.2
Combined Operating Ratio (%)			
– Long-Term Insurance	60.4	59.0	79.9
– General Insurance	75.4	82.3	100.5
Return on Assets (ROA) (%)			
– Long-Term Insurance	2.6	4.6	2.2
– General Insurance	18.1	5.6	9.5
Return on Equity (ROE) (%)			
– General Insurance	36.9	11.1	17.6
Underwriting Ratio (%)			
– General Insurance	32.0	24.5	19.9

(a) Provisional
(b) During the period under review

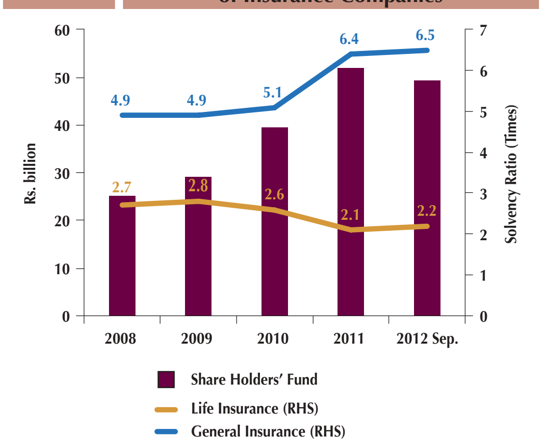
Source : Insurance Board of Sri Lanka

Solvency

All insurance companies met the statutory solvency margin requirement for general insurance as at end September 2012 whereas one company was non –compliant with the minimum solvency requirement for long term insurance. The solvency margin is the main indicator of soundness of insurance companies, as it measures the adequacy of capital to meet obligations. The solvency margin ratio for the general insurance increased to 2.2 times at end September 2012 from 1.8 times at end September 2011, while the solvency ratio for long-term declined to 6.5 times at end September 2012 from 7.5 times at end September 2011 (Chart 6.15).

In 2011, the Insurance Board of Sri Lanka (IBSL) revised downward the weightage allowed for certain asset classes of general insurance such as listed equity, land and buildings and unit trusts for the calculation of the solvency margin. The weightages of listed equity, land and buildings and unit trusts were downgraded to 30 per cent, 10 per cent and 25 per cent, respectively

Chart 6.15 Shareholders' Funds and Solvency Ratio of Insurance Companies



in 2011 from 35 per cent, 15 per cent and 35 per cent, respectively. The total outstanding amount of the fund was Rs. 1.3 billion as at end 2011.

The IBSL requires all insurance companies to obtain a rating of Insurers' Financial Strength (IFS) and the Claims Paying Ability (CPA) from a recognized rating agency. Accordingly, 5 insurance companies had obtained this rating by end 2011. The IBSL administers the Policy Holders Protection Fund which is funded from a cess collected from insurance companies. The amount lying to the credit of the Policyholders Protection Fund is invested in government securities.

Capital

All operating insurance companies met the minimum regulatory capital requirements for both general and long-term insurance. The ratio of shareholder funds to total assets increased to 55 per cent at end September 2012 from 51 per cent at end September 2011. The ratio of capital to technical reserves also increased to 184 per cent, from 160 per cent in the corresponding period of 2011. The capital position of the insurance companies is expected to strengthen with the increase in minimum capital requirement for new licensees with the expectation that this increase would be extended to existing companies as well in the near future. Moreover, with the initiation of the risk based capital model, the capital positions of the companies would be further strengthened based on their risk profiles.

Risks

The main risks currently faced by insurance companies are underwriting risk and market risk. The underwriting performance of the sector has deteriorated during this year due to reasons such as high competition, higher claims and higher management expenses. Hence, the underwriting risks have exerted increased pressure on the insurers' ability to meet all the claims. The higher claims have arisen due to seasonality (health insurance claims which increase towards the end of year) and damages caused by the effects of climate change, such as frequent floods and inclement weather.

The continuous rise in interest rates and expected inflationary pressures could reduce the affordability of insurance products, thereby decelerating the growth of the sector. Hence, insurance companies would need to focus on expanding their business activities making use of the greater opportunities afforded by a growing economy. The exposure to market risk increased with declining values of investment assets. Insurance companies with heavy exposure to the equity market may see their overall profitability affected at least in the near term due the depressed stock market. The value of the government securities portfolios have also declined in an environment of increasing interest rates. However, these losses might be partially offset by increased income from the rising interest rates on fixed income securities.

Non-availability of long-term investment assets in the market to match the long term liabilities of the sector owing to the underdeveloped corporate debt market will continue to be a challenge for the insurance sector. The increased import duty on motor vehicles may also affect the insurance sector, particularly, motor insurance. Industry dynamics are also expected to change in terms of regulatory requirements such as segregation and listing that are to be complied with over the next five to six years. The segregation of composite insurers into two separate entities is expected to be challenging for smaller insurance companies who do not have the capacity to absorb the extra costs associated with the replication of certain functions after segregation. Consolidation might be an inevitable option for some companies. The requirement to move to a risk-based capital model and the mandatory listing requirement are expected to strengthen the overall risk management framework and accountability and transparency of insurance companies.

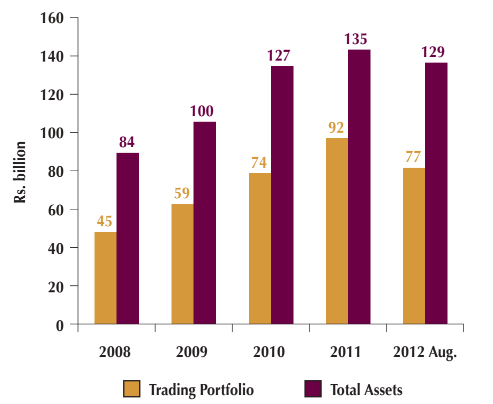
Regulations

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

6.3 Primary Dealers in Government Securities

The Primary Dealer (PDs) sector recorded improvements in terms of total assets, total portfolio, profitability and capital base since June 2012, after a declining trend during the first five months of the year. The total assets held by PDs declined from Rs. 135.3 billion at end 2011 to Rs. 112.6 billion by end

Chart 6.16 Total Assets and the Trading Portfolio of Primary Dealers



May 2012, but increased to Rs. 129.0 billion by end August 2012 (Table 6.10 and Chart 6.16). The decline in assets can be attributed to the downsizing of the trading portfolio of government securities by the PDs in order to avoid larger marked to market losses resulting from increased interest rates. The total portfolio of government securities declined from Rs. 133.5 billion at end 2011 to Rs. 110.5 billion by the end of the first five months and subsequently increased to Rs. 126.7 billion by end August 2012 (Chart 6.17). However, the recent recovery was not adequate to reach the levels that prevailed during the corresponding period in 2011.

Chart 6.17 Total Portfolio and Repo of Primary Dealers

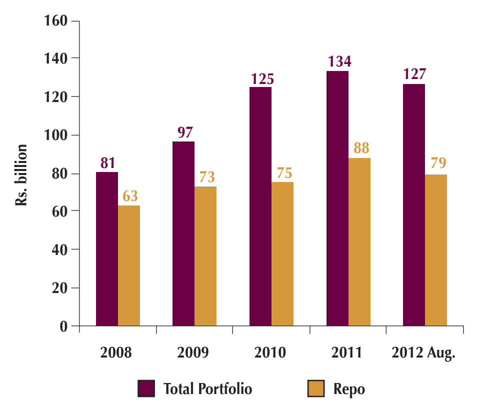


Table 6.10 Selected Financial Data and Indicators of Primary Dealers

Item	2010	2011	End August 2011	End August 2012
Total Assets (Rs. mn)	127,248	135,307	148,659	128,951
Total Portfolio (Rs. mn)	125,024	133,549	146,988	126,695
Trading Securities (Rs. mn)	74,339	91,688	115,772	77,177
Investment Securities (Rs. mn)	36,813	23,179	21,643	26,425
Reverse Repo (Rs. mn)	13,872	18,682	9,574	17,848
Equity and Liabilities (Rs. mn)	127,248	135,307	148,659	128,951
Total Capital (Rs. mn)	13,516	14,173	14,777	14,156
Repo (Rs. mn)	75,297	87,971	94,460	79,155
Profit before Tax (Rs. mn) (a)	4,916	1,700	2,349	792
Profit after Tax (Rs. mn) (a)	4,594	1,454	2,104	661
Return on Assets %	3.9	1.2	2.5	0.6
Return on Equity %	34	10.2	22.3	4.6
Risk Weighted Capital Adequacy Ratio %	22.6	23.3	21.5	25.5
Leverage (Times)	5.6	6.2	6.4	5.6
Dealings	7,950,922	8,951,533	5,952,111	6,972,999
Primary Market Dealings	1,508,645	1,767,521	1,238,977	2,029,207
Secondary Market Dealings	6,442,277	7,184,012	4,713,134	4,943,792

(a) During the period under review

The industry recorded a profit before tax of Rs. 792 million over the eight-month period in 2012, while for the year 2011, it was Rs. 2,349 million. The annualized return on equity (ROE) and return on assets (ROA) declined to 4.6 per cent and 0.6 per cent, respectively, for the eight-month period in 2012 compared to 22.3 per cent and 2.5 per cent of the corresponding period in 2011 (Chart 6.18). All PDs maintained capital over and above the minimum requirement of Rs. 300 million and the Risk Weighted Capital Adequacy Ratio (RWCAR) of the industry was 25.5 per cent as at end August 2012, well above the minimum regulatory requirement of 8 per cent, maintaining stability of the sector (Chart 6.19). Moreover, the capital leverage ratio of the industry declined to 5.6 times in August 2012 compared to 6.4 times at end August 2011, somewhat easing the liquidity risk exposure of the industry.

Chart 6.18 ROE and ROA of Primary Dealers

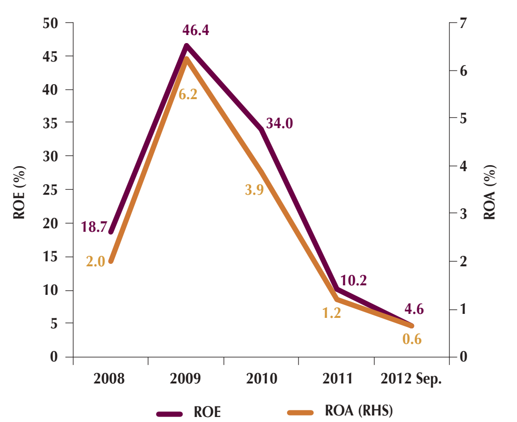
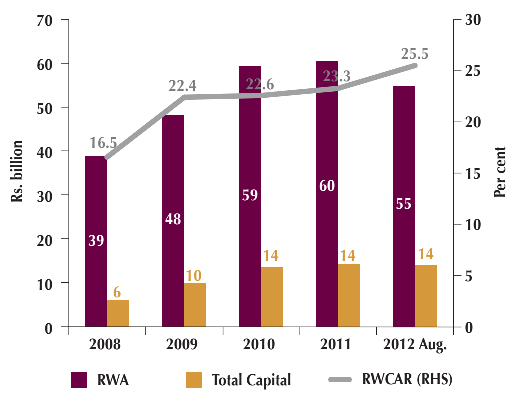


Chart 6.19 Capital Adequacy of Primary Dealers



Market Activities

Primary Market

During the first three quarters of 2012, the PD units of Licensed Commercial Banks recorded the highest effective participation at Treasury bill auctions, subscribing to 63.6 per cent of the amount offered. Meanwhile, non-bank primary dealer companies increased their effective participation at T-bill auctions to 25.0 per cent during the first nine months of 2012 compared to 20.5 per cent in the corresponding period of 2011. Both bank primary dealer units and non-bank primary dealer companies increased their share of effective participation in Treasury bond auctions from 6.8 per cent and 8.6 per cent to 7.4 per cent and 14.1 per cent, respectively. However, effective participation of non-bank PDs in both Treasury bill and Treasury bond auctions remained low at 5.3 per cent in the first nine months of 2012.

Secondary Market

Secondary market transactions in government securities increased during the first nine months of 2012 contributed mainly by the increase of Treasury bill secondary market transactions by 37 per cent. Secondary market transactions comprising of outright sales, outright purchases, repurchase transactions and reverse repurchase transactions of both Treasury bills and Treasury bonds of PDs amounted to Rs. 5,706 billion for the nine month period ending September 2012. This is an increase of 6.5 per cent compared to Rs. 5,359 billion in the corresponding period in 2011.

Assessment of Risks

Market Risks

Market risk, which is one of the main risks faced by the PD industry, was contained to a large extent by reducing the proportion of the trading portfolio held by PDs. The increase in the interest rates can lead to marked to market losses in the trading portfolio. Moreover, the stress test results, which are used to measure the sensitivity of the capital base and RWCAR to a change in the interest rate, revealed that if the interest rate increased by 100 basis points, the capital base of PDs would erode by Rs. 551 million resulting in a reduction of the RWCAR by 1.0 per cent. The modified duration of the trading portfolio, a measurement of the price sensitivity of securities to interest rate fluctuations, was 0.66 as at end August 2012 compared to 1.12 at end August 2011, indicating that the market risk exposure of PDs declined by end August 2012.

Liquidity Risks

The liquidity position of the industry remained tight during the first nine months of 2012. The cumulative negative mismatches of PDs for overnight, up to one week and up to one month maturities increased to 5.5 per cent, 23.1 per cent and 31.9 per cent of the total portfolios of government securities at the end September 2012, compared to 5.2 per cent, 9.0 per cent and 18.2 per cent respectively at end September 2011, respectively. However, contingency funding arrangements using securities as collateral helped in mitigating liquidity risk.

Operational Risks

The operational risk mainly arises due to the failure of systems and internal controls implemented by PDs. The Central Bank continues to carry out its risk based supervision through on-site examinations and off-site surveillance ensuring a lower operational risk exposure in each PD and the PD industry as a whole.

6.4 Unit Trusts

Unit Trusts offer an alternate investment avenue where investors could select an appropriate fund in accordance with their risk return goals. There were 35 Unit Trusts (UTs) in operation (including 10 new UTs) managed by 11 Unit Trust management companies at end September 2012. Of these, 33 UTs are open-ended funds and 2 UTs are close-ended funds. UTs can also be categorized according to their investment focus. There were 7 income funds, 6 money market funds, 5 growth funds, 4 equity funds, 4 balanced funds, 4 gilt edged funds and 5 specialised funds (Shariah, IPO, equity growth and tourism and finance). One close-ended fund is listed on the Colombo Stock Exchange.

Net Asset Value (NAV) of the UTs declined by 13.4 per cent to Rs. 23.1 billion at end September 2012, from Rs. 26.9 billion at end September 2011 (Table 6.11). Funds with significant investments in equities were affected by the continued decline in stock market prices during the year. However, most funds were able to perform better than the CSEs price indices on account of portfolio management and diversification. The value of investment in government securities also suffered marked to market losses due to increasing interest rates. The share of equities and government securities (Treasury bills, bonds and Reverse Repos) in the investment portfolios of unit trusts declined to 39.8 per cent and 20.9 per cent, compared to 40.3 per cent and 52.4 per cent as at end September 2011, respectively. The share of other investments (such as commercial paper, debentures, trust certificates and bank deposits) increased significantly to 33.6 per cent (Charts 6.20 and 6.21). A positive development was the increase in the total number of unit holders to 27,479 and the number of units issued to 1,468 million as at end September 2012.

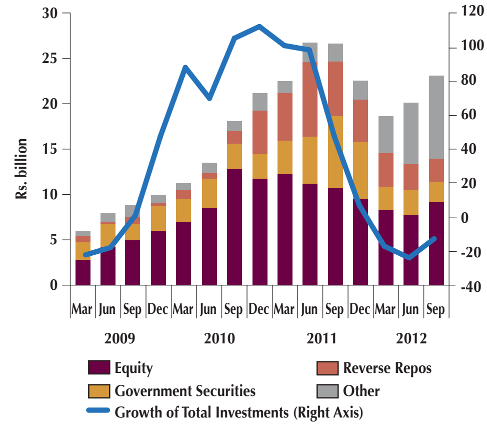
Table 6.11 Selected Data of the Unit Trust Industry

Item	2010	2011	2012 End Sep. (a)
Total Assets (Rs. mn)	22,176	22,674	23,226
Net Asset Value – NAV (Rs. mn)	22,060	22,547	23,067
Investments in Equities (Rs. mn)	11,743	9,549	9,180
Investments in Equities as a % of NAV	53	42	40
Total No. of Unit Holders	24,640	23,403	27,479
No. of Units in Issues (mn)	1,159	1,286	1,468
No. of Unit Trusts	21	24	35

(a) Provisional

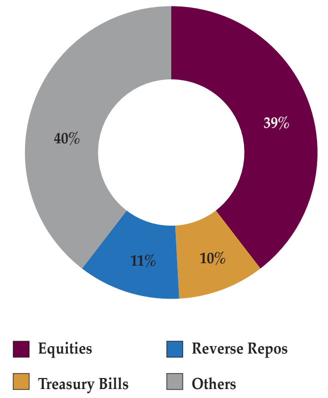
Source : Unit Trust Association of Sri Lanka

Chart 6.20 Investment Portfolio of Unit Trust Industry (Quarterly)



The eleven UT management companies are licensed and supervised by the Securities and Exchange Commission (SEC). They are subject to rules and regulations pertaining to operations of UTs under their management.

Chart 6.21 The Sahre of Investment Portfolio of Unit Trusts as at End September 2012



Investment guidelines and limitations are set out in the relevant Trust Deeds and the Unit Trust Code. The total assets of UT management companies increased by 11.9 per cent to Rs. 1.2 billion as at end September 2012 from Rs. 1.1 billion at end of the previous year. Moreover, the income of these companies increased by 3 per cent to Rs. 360 million, while the overall net profits (profits before tax) declined by 52 per cent to Rs. 84 million in the first nine months of 2012.

Several measures have been taken during the year to attract more investors to unit trusts. These include, SEC's ruling on allocation of 10 per cent of shares of all Initial Public Offerings to UTs and permission granted by Controller of Exchange for foreign investment in all types of UTs, which will broaden the investor base and stimulate the formation of different types of UTs. The inclusion of a regulatory framework for Exchange Traded Funds (ETFs) in the Unit Trust Code will pave the way for the introduction of such funds in Sri Lanka.

However, there are continuing concerns that the UT industry has been grappling with over a considerable period of time. Inaccessibility in smaller towns due to lack of an efficient distribution network, heavy reliance on institutional sales and low financial literacy levels in the rural areas have resulted in low penetration in such areas.

UTs are useful investment vehicles for individual investors who do not have the time or resources to manage their portfolios effectively and for institutional investors looking for diversification. Hence the UT sector is an attractive investment option although it is yet to be popularized beyond the urban areas. Reaching out to the provinces to capture a wider share of investors, broadening of distribution channels through publicity campaigns, and product innovation to satisfy a diversified customer base are some of the key measures needed to redefine and broad base the UT sector.

6.5 Stock Brokers and Market Intermediaries

The performance of the stock brokers declined due to the decline in market liquidity, the rise in interest rates and restrictions on broker credit. Total earnings and profits of the 29 stock brokers declined in the first nine months of 2012, mainly due to the marked to market losses in investments in the stock market. The total income of the industry declined by 70 per cent to Rs. 1,540 million in the first nine months of 2012 from Rs. 5,095 million in the corresponding period in 2011 (Table 6.12). Hence, a net loss (before tax) of Rs. 354 million has been recorded for the first nine months of 2012, compared to the net profit before tax of Rs. 2,318 million for the same period in 2011. However, total assets and net capital of the stock broking industry increased by 25 per cent and 7 per cent, to Rs. 18.2 billion and Rs. 4.4 billion, respectively as at end September 2012 due to higher performance recorded by two stock broking companies during the third quarter.

In order to reduce liquidity constraints of retail investors and to reduce volatility in the market, the credit extension by stock brokers was further relaxed by the SEC. They were permitted to extend credit to investors up to

Table 6.12 Selected Data of the Stock Broking Industry

(Rs. mn)

Item	2010	2011	2012 End Sep. (a)
Turnover (b)	6,599	5,710	1,540
Net profit before tax (b)	3,661	2,362	(354)
Total Assets	13,210	11,257	18,223
Total liabilities	6,973	4,596	11,653
Net capital	4,468	3,347	4,438

(a) Provisional
(b) During the period under review

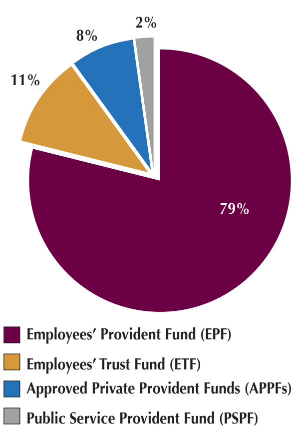
Source : Securities and Exchange Commission of Sri Lanka a limit of three (leverage 3) times that of the adjusted net capital and subsequently, in July 2012 another directive was issued to allow brokers more flexibility in managing their credit to clients.

The SEC also registers and supervises several other market intermediaries to ensure that they comply with applicable rules and regulations. Companies that fall within this category are margin providers, investment managers and underwriters. The overall income of market intermediaries declined significantly by 48 per cent to Rs. 1.9 billion in the first nine months of 2012, compared to Rs. 5.5 billion in 2011, while they recorded a lower net profit (before tax) of Rs. 51 million in the first nine months of 2012, compared to the net profit of Rs. 2.2 billion in 2011.

6.6 Superannuation Funds

The superannuation funds sector accounts for 17 per cent of financial sector assets. The sector consists of two major publicly managed funds - the Employees Provident Fund (EPF) and the Employee Trust Fund (ETF) and about 171 privately managed Approved Pension

Chart 6.22 Assets Distribution of Superannuation Fund Sector



and Provident Funds (APPF). There is one state sector superannuation fund which is the Public Service Provident Fund (PSPF). The superannuation funds sector is dominated by the EPF, which accounts for about 79 per cent of the superannuation sector assets, and represented 13.2 per cent of the total assets of the financial sector (Chart 6.22).

Employees' Provident Fund (EPF)

As at end September 2012, the value of the EPF was Rs. 1,113 billion with 2.2 million active members of the Fund. There were 11.8 million non-contributory accounts, which are accounts of members under their previous employers. The EPF is administered by the Commissioner of Labour, while the responsibility for the management of the Fund lies with the Monetary Board of the Central Bank of Sri Lanka.

Total contributions in the first nine months of 2012 increased by 14.0 per cent to Rs. 52 billion, while the refunds increased by 1.3 per cent to Rs. 37 billion. Hence, net contributions (contributions minus refunds) stood at Rs. 15 billion (Chart 6.23 and Table 6. 13). As at end September 2012, total assets of the EPF increased by 12.8 per cent to Rs. 1,113 billon while the total investment portfolio of the EPF amounted to Rs. 1,083.2 billion. Investment income of the

Table 6.13 Key Information of Major Superannuation Funds

	End Sep. 2011		End Sep. 2012 (a)	
	EPF	ETF	EPF	ETF
Number of Accounts (mn)	14.0	9.8	14.0	9.8
o/w, Active Accounts (mn)	2.2	2.2	2.2	2.2
Total Contributions (Rs. bn) (b)	45.6	8.2	52.0	9.4
Total Refunds (Rs. bn) (b)	36.5	6.0	37.0	6.6
Total Assets (Rs. bn)	987	137	1,113	154
Total Investment Portfolio (Rs. bn)	960	119	1,083	132
o/w, Government Securities (%)	89.0	90.0	92.9	91.0
Gross Income (Rs. bn) (b)	86.5	10.3	83.4	10.0

(a) Provisional
(b) During the period under review

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

Chart 6.23 **Total Contribution, Total Refunds and Net Contribution of EPF**

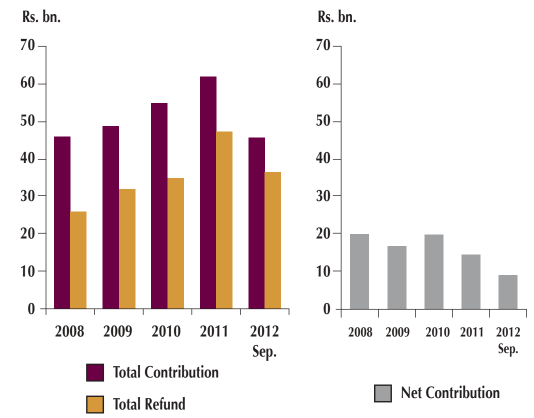
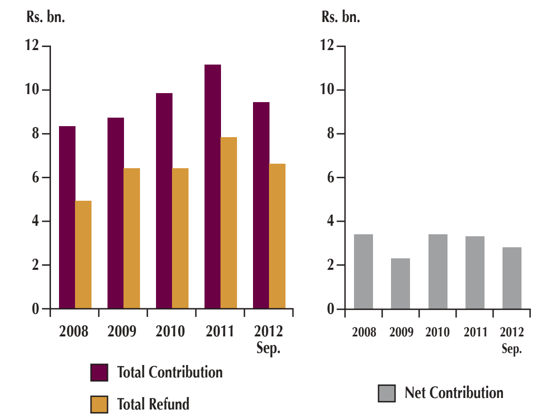


Chart 6.24 **Total Contribution, Total Refunds and Net Contribution of ETF**



Fund during the nine month period ending September 2012 was Rs. 83.4 billion.

The investment portfolio consisted of government securities (92.9 per cent), equity (6.2 per cent) and corporate debt and reverse repos (0.9 per cent) as at end September 2012. In order to facilitate effective management of the Fund and to extend further benefits to the members, the EPF Act was amended in February 2012. Under the amended Act, members can withdraw 30 per cent of their individual balances for housing or medical purposes.

The EPF was able to manage its risks prudently during the first nine months of 2012. The main risks faced by the EPF are market risk, credit risk, liquidity risk and operational risks. Credit risk is negligible as around 93 per cent of the investment portfolio is in government securities. The decline in share prices adversely affected the equity portfolio in the short term. However, with the Fund's holding ability as well as the long-term perspectives of the companies and the economy, higher returns are expected in the mid to long term period. The liquidity risk is also relatively less as majority of the investments are in government securities and the monthly contributions continued to be higher than the monthly refunds.

For the year 2011, the EPF declared a rate of return of 11.5 per cent to its members and it is expected that the same rate of return would be provided for the year 2012 as well. In comparison, the Unit Trust Industry which had 40 per cent of its investments in equities and 30 per cent in government securities has recorded a negative weighted average return of 0.03 per cent for the year 2011, while during 2012 with the share of equities and government securities decreasing to 29 per cent and 18 per cent, the weighted average return has improved to a positive 1.96 per cent. Hence, the rate of return declared by the EPF for the year 2011 and the expected rate to be declared for 2012 are substantially above the annual returns of the Unit Trust Industry in 2011 and 2012.

Employees' Trust Fund (ETF)

The ETF had a value of Rs. 154 billion as at end September 2012, and has about 9.8 million accounts, of which, about 2.2 million are active. Total contributions and benefits paid to members during January to September 2012 increased to Rs. 9.4 billion and Rs. 6.6 billion, respectively, compared to Rs. 8.2 billion and Rs. 6.0 billion during the corresponding period of 2011 (Table 6.13). The net contribution increased by 29.5 per cent to Rs.2.9 billion during the period under consideration (Chart 6.24).

Total assets of the ETF increased by 12.4 per cent to Rs. 154.3 billion, as at end September 2012. As in the case of the EPF, the investment portfolio is concentrated in government securities, which accounts for 91 per cent of the total portfolio. Investments in equity and corporate debt securities accounted for 5.2 per cent and 0.6 per cent, respectively.

Public Service Provident Fund (PSPF)

The Public Service Provident Fund (PSPF) is managed by the Department of Pensions and had 227,743 active members at end September 2012. Total assets of PSPF increased by 16 per cent to Rs.31.5 billion as at end September 2012. Total contributions and refunds during the first nine months of 2012 amounted to Rs. 1,030 million and Rs. 367 million, respectively. The share of investment in government securities was 99 per cent as at end September 2012.

Approved Provident and Pension Funds (APPFs)

There are 171 privately managed APPFs with around 167,096 members, which are being monitored by the Department of Labour. The total assets of APPFs declined by 4.2 per cent to Rs. 110 billion as at end September of 2012. The absence of a prudential regulator for APPFs has been identified as a gap in the regulation of this sector. Hence, in order to ensure that these funds are safeguarded and more professionally managed, the Central Bank initiated action to have them supervised by the Insurance Board of Sri Lanka. A draft legislature in this regard has been prepared by the Legal Draftsman and is under consideration by the Ministry of Finance.

7. Financial Infrastructure

- *The Central Bank adopted measures to maintain a secure, reliable and efficient payment and settlement system, which is a key requirement for achieving financial system stability.*
- *The key payment and settlement systems, namely, the Real Time Gross Settlement System and LankaSecure, operated without disruption and recorded a high degree of availability and safety.*
- *These payment and settlement systems facilitated the smooth operations of money and capital markets such as equity, government securities and corporate debt markets and demonstrated their capacity to meet the increased market demands.*
- *The Central Bank continued its efforts to promote e-payment systems through mobile phones to create more secure and cost effective means to transfer small value payments.*
- *In order to achieve the targeted economic growth, measures were taken to provide access to basic banking facilities at an affordable price to unbanked population in rural areas.*
- *Legal provisions were strengthened to regulate and supervise electronic retail payment system. Operational guidelines were issued to streamline the operations of credit card issuers and to protect the interest of credit card users.*
- *Several measures were also taken to improve contingency planning among the key participants and to ensure customer protection.*

Payment and Settlement System

The Central Bank, under the powers vested through the Payment and Settlement Systems Act No. 28 of 2005 (PSSA) supervises and regulates the payment and settlement systems in Sri Lanka. In this regard, the Central Bank has adopted measures to maintain a secure, reliable and efficient payment and settlement system, which is a key requirement for achieving financial system stability.

In recent years, new and advanced electronic retail payment instruments such as payment cards, mobile phone based payments and internet payments had become popular as a means of settling transactions. With the increased usage of these new electronic retail payment systems, it became necessary to minimise risks and to increase efficiency levels by reducing costs. Accordingly, the Central Bank introduced policy measures to provide a safe and sound environment for easy adoption of electronic payment systems and to maintain public confidence in electronic retail payment and settlement systems.

LankaSettle System

LankaSettle System which is a systemically important high value payment system in Sri Lanka comprises of two well integrated systems *i.e.*, Real Time Gross Settlement (RTGS) System and LankaSecure System. RTGS System handles high value and time critical interbank transactions, customer transactions as well as the funding of government securities transactions while LankaSecure handles settlement of government securities transactions on a delivery verses payment basis and the functions of the Central Depository System for government securities.

The Central Bank as the operator of the LankaSettle System maintained the RTGS System with a high level of resilience and the system availability was recorded at 99.76 percent for the first nine months of 2012. To ensure uninterrupted system availability during any contingency event, CBSL successfully conducted live operations twice from its Disaster Recovery Site (DRS). The RTGS System being the main fund transfer system in the country accounted for 90 percent of the total value of non-cash payments. Total volume and value of transactions effected through the RTGS System for the first nine months of 2012 were 211,705 and Rs. 33.56 trillion, respectively.

LankaSecure

The Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS) for Government Securities, collectively known as the LankaSecure, held scripless securities amounting to Rs.3,184 billion (face value) consisting of Treasury Bills amounting to Rs.704 billion and Treasury Bonds amounting to Rs.2,480 billion, as at 30 September 2012. The corporate and individual customer accounts maintained by the LankaSecure stood at 78,520 as at end September 2012 compared to 75,871 accounts maintained as at end September 2011. The value of secondary market transactions in government securities during the first three quarters of 2012 amounted to Rs.29,231 billion (face value) which consisted of Rs. 3,294 billion outright transactions and Rs. 25,937 billion Repo transactions.

The LankaSecure continued to issue three types of statements relating to transactions, payments and holdings to the respective investors confirming their investments in government securities. During the first three quarters of 2012, LankaSecure issued 152,241 such statements. The statements issued to the customers were restructured and simplified to enable the customer to clearly monitor their investments. The software used for LankaSecure was upgraded from LCSS 3.5 to LCSS 3.6 version during the first quarter of 2012, to comply with the new messaging standards of the Society for Worldwide Interbank Financial Telecommunication (SWIFT).

Axis Bank Limited was appointed as a Dealer Direct Participant of LankaSecure during the last quarter of 2011, increasing the number of Dealer Direct participants to 31.

Electronic Retail Payment and Settlement Systems

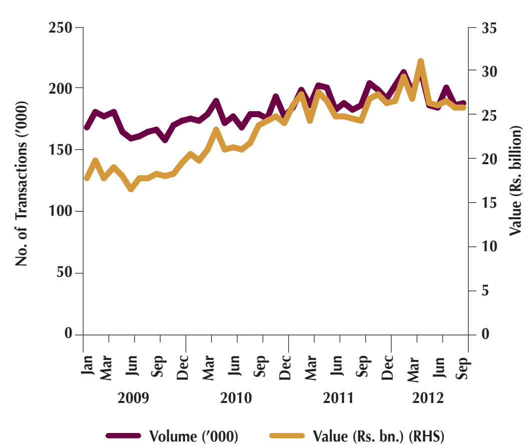
The usage of electronic retail payment systems such as payment cards, mobile phone based payments and internet payment systems has shown significant growth in recent years, due to customer convenience and efficiency provided by such payment systems. Credit and debit cards have become the most popular electronic retail payment instruments used in settling transactions. Mobile payment solutions which allow customers to perform banking functions using mobile phones provide a convenient payment mechanism with easy access to customers and also reduce the operating costs of banks by eliminating the need to operate bank branches. Further, in order to achieve the targeted economic growth, it is necessary to provide access to basic banking facilities at an affordable price to unbanked population in rural areas. Mobile payment solutions have been identified as one of the efficient and economical ways of providing banking services to the unbanked segment of the country. Therefore, while adopting measures to develop safe and secure mobile payment systems to facilitate efficient and economical payment mechanisms, financial inclusion is also being facilitated.

As a result of its inherent convenience, electronic payment cards have become a popular payment mode in the tourism industry all over the globe. Therefore, providing a secure environment for the payment card industry is an essential requirement to promote the tourism industry. Hence, considering the importance of minimizing the fraudulent activities of payment card businesses, the National Payment Council (NPC) which is the highest decision making body with regard to payment and settlement developments in Sri Lanka, mandated financial acquirers to install the Terminal Line Encryption (TLE) technology to Point of Sales terminals. The Central Bank is monitoring the process of applying TLE technology by financial acquirers.

Cheque Imaging and Truncation (CIT) System

Cheque Imaging and Truncation system, which was introduced in 2006 is a systemically important retail payment system operated by the LankaClear (Pvt) Ltd, (LCPL). CIT System was introduced with the objectives of streamlining the cheque clearing operations, reducing risks inherent in paper-based cheque presentment for clearing and enhancing efficiency of cheque clearing in Sri Lanka.

Chart 7.1 Average Value and Volume of Cheques Cleared per day

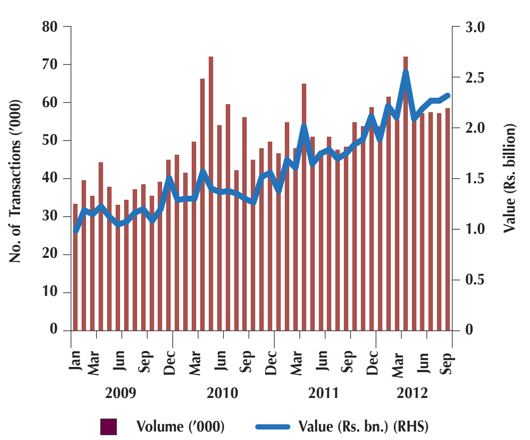


With the introduction of the CIT System, island wide cheque realization time was reduced to T+1 (T is the day LCPL receives the cheque for clearing and 1 is the next business day). During the first nine months of 2012, CIT System cleared 34,633,156 cheques to the value of Rs. 4.9 trillion. Having observed an increasing trend in cheque returns during the first half of 2012 and considering the settlement risk arising from cheque returns affecting the stability of the payment and settlement system, all licensed commercial banks were informed to adopt necessary measures to minimize cheque returns to ensure smooth functioning of the system.

Sri Lanka Interbank Payment System

Sri Lanka Interbank Payment System (SLIPS), which cleared pre-authorized low value payments through an off-line mechanism was upgraded to an on-line payment system facilitating same day (T+0) settlements. The SLIPS handles small value bulk payments such as salaries, dividends and pensions up to the value of Rs. 5 million per transaction. Transactions are cleared electronically on a multilateral net settlement basis. The inter-bank net balances arising from SLIPS transactions are settled in the RTGS system. Migration of SLIPS to an on-line system has resulted in higher operational efficiency and greater reliability ensuring security of all financial transactions routed through SLIPS. The volume of SLIPS transactions grew by 16.0 per cent while value of SLIPS transactions increased by 30.6 per cent during the first nine months of 2012 when compared with the same period in 2011. The volume and value of transactions settled through the SLIPS were 10,559,196 and Rs. 398 billion respectively, during the first nine months of 2012.

Chart 7.2 Average Value and Volume of SLIPS Transactions



Business Continuity Plan

The Central Bank, having considered the systemic importance of the LankaSettle System, issued business continuity planning guidelines to LankaSettle participants in order to ensure the preparedness to continue critical operations in an emergency and to improve the operational robustness of the LankaSettle System. Business Continuity Plans (BCP) and Disaster Recovery Sites (DRS) of LankaSettle participants, prepared in accordance with the guidelines were continuously evaluated and recommendations were given to improve their BCPs, as well as DRS arrangements.

Considering the possible systemic risk which could arise in the event of interruption to the RTGS System, participants were instructed to further revise their BCP documents and to conduct test runs from their DRSs in order to ensure their readiness to continue critical businesses in contingency situations. The Central Bank is at present reviewing the revised BCP documents and test run reports submitted by the participants. Based on the observations, recommendations are being made to further improve the BCPs and DRS arrangements of participants.

BCP and DRS arrangements of LCPL were also evaluated to ensure uninterrupted operations of CIT System and SLIPS. The

Box 6

Recirculation of Coins Lying Idle with the Public

In terms of the Monetary Law Act, No. 58 of 1949, the Central Bank of Sri Lanka (CBSL) is the sole authority to issue currency in Sri Lanka, in order to facilitate payment and settlements associated with various transactions among economic units. Accordingly, the CBSL on a regular basis issues currency through licensed commercial banks to meet the demand of the public and banks in return deposit currency with the CBSL on a regular basis.

Idle Coins

However, coins issued into circulation through commercial banks usually do not come back to the CBSL by way of deposits from commercial banks, when compared to issues and deposits of currency notes. In 2012, CBSL has issued 413 mn. pieces of currency notes to commercial banks while commercial banks have deposited 385 mn. pieces of notes with the Central Bank. In the case of coins, Central Bank had issued 164 mn. Pieces, but only 2.6 mn. pieces of coin had been deposited by commercial banks.

Accordingly, it is clear that a large amount of coins issued for circulation remain idle at many places, out of circulation. The main reason can be the nature of the coins. Naturally, coins are both hard and heavy, and hence, inconvenient to handle compared to notes. Therefore, people tend to prefer carrying notes to coins. The low denominations of coins too contribute to this behaviour, since the required number of coins to meet a given value is more. The cultural and religious practices of the people also lead to a large volume of coins being collected in tills in religious places.

This practice of the public has resulted in accumulation of idle coins at many places for long periods requiring CBSL to issue more and more coins from its stocks into circulation. The most common places identified where coins lay idle for long period of time include households, religious places, charity institutions and large tills especially used by children for their savings. When coins lay idle in large amounts in boxes, tills *etc*. for long period of time, it can lead to deterioration of the quality of such coins, resulting in rendering them unusable.

High Cost of Issuing Coins

When coins issued into circulation by CBSL go out of circulation due to most coins lying idle, CBSL has to continue to issue more into circulation. As a result, CBSL has to mint significant amounts of coins on a regular basis and issue to the commercial banks to meet the demand of the public. In doing so, CBSL spends large sums of money annually to mint coins.

The cost of minting of coins is comparatively higher compared to the face value of coins other than the cost of Rs. 10 coin. Since the coins are produced by foreign Mints, substantial amounts of foreign exchange is utilized to make relevant payments. The cost of issue of coins during the three years 2010–2012 has been Rs.462 mn., Rs. 543 mn. and Rs. 864 mn.

Lifespan of Coins

The average lifespan of a coin is considered to be more than 25 years, which is comparatively much longer than the lifespan of a note. Even though the issue of coins is costly, if there is effective use of coins, the CBSL can save a significant amount of foreign exchange spent on minting new coins. Hence, if coin usage is to be cost effective, coins issued by CBSL should be in circulation at least throughout its lifespan.

Even though some institutions where coins get collected in large numbers have developed programs with financial institutions to deposit such coins in their respective accounts on a regular basis, many other places do not have a formal mechanism to introduce them back to circulation. Therefore, inculcating the practice of bringing into circulation all idle coins would not only be a significant cost saving to the CBSL but to the public as well, since the CBSL uses public funds to issue more and more coins into circulation.

Box 6 (*Contd.*)

Measures taken by the CBSL

In order to reduce the cost incurred by the CBSL in issuing coins, the Bank has taken various measures to educate the public on good coin handling practices and effective utilization of coins. These measures include TV and Radio programmes, press notices, press advertisements and other public awareness programmes for targeted groups.

Further, with the introduction of electronic payments with the expansion of the payment and settlement system, it is intended to reduce the requirement of notes and coins in circulation thus enabling significant cost savings to the country.

The CBSL has proposed a special coin collection programme for collection of such idle coins in 2013.

In order to achieve this objective of CBSL, the support of all financial institutions and the public is very much essential in many ways.

Need for Public Cooperation

In the efforts of the CBSL to enable significant cost saving to the economy as well as to the society, the cooperation of the public is essential for its successful implementation. Hence, the public can assist this venture by regularly depositing such coins at commercial banks or handing them over to the Central Bank at its Head Office or Provincial Offices. The role played by commercial banks is also vital in educating their customers in this regard and assisting in developing a mechanism to collect such idle coins from identified places.

BCP and DR site of the Lanka Financial Service Bureau Ltd., which was established to provide SWIFTNet connectivity to participants of the LanksSettle system and management and data processing services to SWIFT users, were also monitored in order to ensure smooth flow of financial transactions.

Regulations

With the objective of minimising risks associated with the electronic retail payment systems and thereby ensuring stability, safety and efficiency of the payment and settlement systems, the Central Bank strengthened its legal provisions to regulate and supervise electronic retail payment systems in Sri Lanka.

- Accordingly, Service Providers of Payment Cards Regulation No. 1 of 2009 was issued to regulate and supervise the activities of service providers of payment cards. Under the provisions of this regulation the Central Bank issued licenses to two new service providers of payment cards and one license to a mobile telecommunication network operator to operate an e-money system during the year 2012.
- In terms of the license issued to a mobile telecommunication network operator, an e-money system was introduced to facilitate transactions through mobile phones by using electronic money stored in virtual accounts.
- Based on the powers vested by the aforementioned Regulation, the Central Bank issued Credit Card Operational Guidelines to streamline the operations of credit card issuers and protect the interests of customers, and continued to ensure adherence to conditions stipulated in the guidelines by credit card issuers.
- In terms of the provisions of the mobile payment guidelines, banks and other non-bank service providers are required to implement adequate information security measures and reliable systems that adequately address risks related to mobile payment mechanisms.

Appendix Tables

Appendix Table 1

Financial Soundness Indicators – All Banks

	2009	2010	2011	2012 September
1. Capital Adequacy				
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	16.1	16.2	16.0	15.0
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	14.1	14.3	14.4	13.3
1.3 Net Non-Performing Loans to Total Capital Funds	26.2	15.2	11.5	14.1
1.4 Debt to Capital Funds	160.1	172.0	171.4	189.5
1.5 Capital to Assets Ratio	8.1	8.3	8.7	8.6
2. Asset Quality				
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	8.5	5.4	3.8	4.0
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	10.7	7.3	6.2	6.0
2.3 Net Non-Performing Loans to Total Gross Loans	5.0	3.0	2.1	2.4
2.4 Provision Made against Gross Loans	4.5	3.1	2.2	2.0
2.5 Provision Coverage Ratio (Total)	53.0	58.1	57.1	50.9
2.6 Provision Coverage Ratio (Specific)	42.8	45.3	46.0	40.2
2.7 Sector-wise NPL to Total Sector Loans				
Agriculture and Fishing	4.2	3.2	2.5	2.4
Manufacturing	11.4	8.7	6.4	7.3
Tourism	5.3	4.7	11.4	12.2
Transport	6.7	4.2	2.8	3.4
Construction	12.5	8.4	7.5	7.2
Traders	10.9	7.5	5.3	4.2
New Economy	4.4	3.4	2.7	2.7
Financial and Business Services	4.4	2.4	1.4	1.7
Infrastructure	5.5	3.9	2.6	0.7
Other Services	6.3	3.2	2.1	4.2
Other Customer	5.5	3.3	1.7	2.6
2.8 Sectoral Distribution of Loans to Total Gross Loans				
Agriculture and Fishing	10.7	13.4	13.1	13.1
Manufacturing	15.1	13.0	12.0	10.5
Tourism	2.7	2.1	2.2	2.2
Transport	1.6	1.7	2.2	2.0
Construction	17.2	16.5	13.9	13.6
Traders	13.8	14.0	11.2	15.4
New Economy	1.4	0.9	0.9	1.0
Financial and Business Services	4.1	4.6	6.1	5.4
Infrastructure	1.3	1.3	1.3	4.6
Others Services	4.9	6.4	7.2	3.0
Other Customer	27.2	26.0	30.0	29.0
2.9 Provision Made against Total Assets	2.4	1.8	1.3	1.3
2.10 Total Loans (Gross) to Total Assets	53.0	55.6	61.2	61.7
2.11 Investments to Total Assets	30.8	30.4	24.9	23.7
2.12 Total Income to Total Assets	14.1	11.3	9.8	11.2
2.13 Net Interest Income to Total Assets	4.3	4.2	3.9	3.9
2.14 Operating Income to Total Assets	6.3	6.1	5.3	5.6
3. Earnings & Profitability				
3.1 Return on Equity (ROE) – After Tax	11.8	22.2	19.7	20.5
3.2 Return on Assets (ROA) – Before Tax	1.8	2.7	2.4	2.5
3.3 Return on Assets (ROA) – After Tax	1.0	1.8	1.7	1.7
3.4 Interest Income to Gross Income	86.0	83.1	85.5	85.3
3.5 Net Interest Income to Gross Income	30.8	37.7	39.4	34.9
3.6 Non-Interest Income to Total Income	14.0	16.9	14.5	14.7
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	22.8	26.6	27.9	23.9
3.8 Staff Expenses to Non-Interest Expenses	46.5	45.2	43.7	45.7
3.9 Personnel Expenses to Total Income	10.6	12.0	12.2	10.9
3.10 Provisions to Total Income	6.2	0.6	1.2	2.4
3.11 Total Cost to Total Income	78.1	71.9	73.9	74.3
3.12 Efficiency Ratio	56.3	47.4	52.3	48.8
3.13 Interest Margin	4.6	4.6	4.2	4.1
4. Liquidity				
4.1 Liquid Assets to Total Assets	35.3	31.4	26.8	27.1
4.2 Statutory Liquid Assets Ratio - DBU	39.2	36.6	32.4	30.9
5. Assets / Funding Structure				
5.1 Deposits	74.1	72.8	72.3	70.5
5.2 Borrowings	12.9	14.3	14.9	16.2
5.3 Capital to External Funds	9.3	9.5	10.0	9.9
5.4 Credit to Deposits	71.5	76.4	84.7	87.6
5.5 Credit to Deposits & Borrowings	60.9	63.9	70.2	71.2
5.6 Credit to Deposits & Borrowings & Capital	55.7	58.3	63.8	64.8

Source : Central Bank of Sri Lanka

Appendix Table 2

Financial Soundness Indicators – Licensed Commercial Banks

	2009	2010	2011	2012 September
1. Capital Adequacy				
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	15.4	15.2	15.5	14.5
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	12.9	13.0	13.4	12.5
1.3 Net Non-Performing Loans to Total Capital Funds	25.3	14.6	9.9	12.8
1.4 Debt to Capital Funds	169.1	190.5	185.5	205.8
1.5 Capital to Assets Ratio	7.9	8.0	8.5	8.4
2. Asset Quality				
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	8.2	5.1	3.5	3.7
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	10.5	7.0	6.0	5.9
2.3 Net Non-Performing Loans to Total Gross Loans	4.5	2.7	1.7	2.1
2.4 Provision Made against Gross Loans	4.7	3.2	2.2	2.0
2.5 Provision Coverage Ratio (Total)	56.9	61.8	62.6	55.1
2.6 Provision Coverage Ratio (Specific)	47.4	48.4	50.7	43.7
2.7 Sector-wise NPL to Total Sector Loans				
Agriculture and Fishing	3.7	2.7	2.3	2.1
Manufacturing	11.2	8.7	6.4	7.1
Tourism	4.9	4.4	11.7	12.7
Transport	6.3	3.7	2.6	3.1
Construction	10.3	7.1	6.0	5.8
Traders	10.9	7.5	5.3	4.1
New Economy	3.9	3.5	2.8	2.7
Financial and Business Services	4.7	2.4	1.6	1.9
Infrastructure	7.3	4.8	3.5	0.7
Other Services	6.2	3.0	1.9	4.0
Other Customer	5.9	3.3	1.7	2.6
2.8 Sectoral Distribution of Loans to Total Gross Loans				
Agriculture and Fishing	11.6	13.9	13.3	13.1
Manufacturing	15.7	13.6	12.6	10.9
Tourism	2.9	2.3	2.3	2.3
Transport	1.7	1.7	2.2	2.0
Construction	14.6	14.1	11.8	11.7
Traders	14.9	15.2	12.0	16.7
New Economy	1.3	1.0	1.0	1.1
Financial and Business Services	3.3	4.5	5.4	4.9
Infrastructure	1.0	1.1	1.1	4.7
Others Services	5.2	6.9	7.8	3.2
Other Customer	27.7	25.8	30.7	29.4
2.9 Provision Made against Total Assets	2.6	1.9	1.4	1.3
2.10 Total Loans (Gross) to Total Assets	56.1	59.3	65.1	64.9
2.11 Investments to Total Assets	24.5	25.7	20.0	19.7
2.12 Total Income to Total Assets	13.9	10.8	9.7	11.2
2.13 Net Interest Income to Total Assets	4.6	4.3	3.9	4.0
2.14 Operating Income to Total Assets	6.5	6.6	5.4	5.8
3. Earnings & Profitability				
3.1 Return on Equity (ROE) – After Tax	11.0	20.8	20.3	21.9
3.2 Return on Assets (ROA) – Before Tax	1.7	2.5	2.4	2.6
3.3 Return on Assets (ROA) – After Tax	0.9	1.6	1.7	1.8
3.4 Interest Income to Gross Income	85.8	83.8	84.5	84.3
3.5 Net Interest Income to Gross Income	32.8	40.0	40.4	35.9
3.6 Non-Interest Income to Total Income	14.2	16.2	15.5	15.7
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	24.6	29.6	29.9	24.7
3.8 Staff Expenses to Non-Interest Expenses	45.5	44.6	42.8	44.8
3.9 Personnel Expenses to Total Income	11.2	13.2	12.8	11.1
3.10 Provisions to Total Income	7.2	0.4	1.3	2.7
3.11 Total Cost to Total Income	77.6	73.4	74.0	73.1
3.12 Efficiency Ratio	59.1	50.8	53.9	48.5
3.13 Interest Margin	4.8	4.6	4.3	4.2
4. Liquidity				
4.1 Liquid Assets to Total Assets	31.9	27.0	22.9	24.0
4.2 Statutory Liquid Assets Ratio	33.0	29.4	26.2	25.8
5. Assets / Funding Structure				
5.1 Deposits	73.8	72.4	71.5	69.6
5.2 Borrowings	13.3	15.1	15.8	17.3
5.3 Capital to External Funds	9.1	9.1	9.8	9.7
5.4 Credit to Deposits	76.0	81.9	91.1	93.3
5.5 Credit to Deposits & Borrowings	64.4	67.8	74.6	74.7
5.6 Credit to Deposits & Borrowings & Capital	59.0	62.1	67.9	68.1

Source : Central Bank of Sri Lanka

Appendix Table 3

Financial Soundness Indicators – Licensed Specialised Banks

	2009	2010	2011	2012 September
1. Capital Adequacy				
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	22.0	24.4	20.0	19.4
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	23.6	25.0	21.1	21.1
1.3 Net Non-Performing Loans to Total Capital Funds	30.3	17.8	19.0	21.0
1.4 Debt to Capital Funds	120.9	97.2	105.1	104.6
1.5 Capital to Assets Ratio	8.9	10.1	9.7	9.5
2. Asset Quality				
2.1 Gross Non-Performing Loans (NPL) to Total Gross Loans (w/o Interest in Suspense)	10.4	7.9	6.8	6.7
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	12.2	9.5	8.1	7.8
2.3 Net Non-Performing Loans to Total Gross Loans	8.9	5.8	5.1	5.2
2.4 Provision Made against Gross Loans	3.1	3.1	2.2	2.0
2.5 Provision Coverage Ratio (Total)	30.2	38.2	32.7	30.0
2.6 Provision Coverage Ratio (Specific)	15.5	29.0	25.4	22.6
2.7 Sector-wise NPL to Total Sector Loans				
Agriculture & Fishing	20.0	8.8	5.6	5.1
Manufacturing	13.8	9.6	6.4	9.7
Tourism	18.1	14.7	5.8	4.4
Transport	12.3	8.6	4.9	5.8
Construction	19.5	12.8	12.4	11.9
Traders	9.5	8.0	5.0	8.9
New Economy	6.8	2.2	2.0	3.4
Financial and Business Services	3.5	2.7	0.7	0.7
Infrastructure	1.1	1.1	0.1	2.0
Other Services	8.8	8.0	6.5	8.3
Other Customer	0.6	3.2	2.0	3.0
2.8 Sectoral Distribution of Loans to Total Gross Loans				
Agriculture & Fishing	3.0	9.3	11.2	12.8
Manufacturing	9.7	8.3	7.1	7.6
Tourism	0.9	0.7	1.1	1.3
Transport	1.0	1.7	2.0	2.0
Construction	39.6	37.6	32.8	31.4
Traders	3.9	3.7	3.8	3.9
New Economy	2.1	0.3	0.2	0.1
Financial and Business Services	10.5	5.6	12.2	10.4
Infrastructure	3.9	3.1	3.3	3.2
Others Services	2.5	2.2	1.8	1.5
Other Customer	23.0	27.4	24.5	25.7
2.9 Provision Made against Total Assets	1.2	1.1	0.9	0.9
2.10 Total Loans (Gross) to Total Assets	37.4	36.7	40.4	43.0
2.11 Investments to Total Assets	54.5	55.1	50.5	48.0
2.12 Total Income to Total Assets	14.8	13.9	10.6	11.3
2.13 Net Interest Income to Total Assets	3.2	4.0	3.7	3.3
2.14 Operating Income to Total Assets	5.1	6.8	4.7	4.3
3. Earnings & Profitability				
3.1 Return on Equity (ROE) – After Tax	15.1	27.1	17.4	13.5
3.2 Return on Assets (ROA) – Before Tax	2.4	3.8	2.5	1.8
3.3 Return on Assets (ROA) – After Tax	1.4	2.6	1.7	1.3
3.4 Interest Income to Gross Income	87.0	80.1	90.2	91.3
3.5 Net Interest Income to Gross Income	21.4	28.7	34.9	29.3
3.6 Non-Interest Income to Total Income	13.0	19.9	9.8	8.7
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	14.4	14.8	18.2	19.4
3.8 Staff Expenses to Non-Interest Expenses	54.4	50.0	51.5	52.7
3.9 Personnel Expenses to Total Income	7.8	7.4	9.4	10.2
3.10 Provisions to Total Income	1.7	1.6	0.5	0.9
3.11 Total Cost to Total Income	80.0	66.2	73.6	81.4
3.12 Efficiency Ratio	40.8	31.0	41.9	50.9
3.13 Interest Margin	3.4	4.1	4.0	3.4
4. Liquidity				
4.1 Liquid Assets to Total Assets	52.4	54.0	47.7	45.2
4.2 Statutory Liquid Assets Ratio	71.1	74.3	65.4	61.0
5. Assets / Funding Structure				
5.1 Deposits	75.2	75.1	76.3	76.1
5.2 Borrowings	10.8	9.8	10.2	10.0
5.3 Capital to External Funds	10.4	11.9	11.2	11.1
5.4 Credit to Deposits	49.7	48.8	52.9	56.5
5.5 Credit to Deposits & Borrowings	43.5	43.2	46.7	49.9
5.6 Credit to Deposits & Borrowings & Capital	39.4	38.6	42.0	45.0

Source : Central Bank of Sri Lanka

Appendix Table 4

Financial Soundness Indicators – Licensed Finance Companies

	2010 *	2011 *	2012 *	2012 September
1. Capital Adequacy				
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	11.3	7.2	11.7	14.5
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	9.8	6.4	10.8	13.7
1.3 Capital Funds to Assets Ratio	9.6	7.8	10.8	12.0
1.4 Capital Funds to Deposits Liabilities	15.0	12.5	20.5	22.1
1.5 Non-Performing Loans Net of Provisions to Capital Funds	35.9	33.6	14.5	13.1
2. Asset Quality				
2.1 Non-Performing Accommodation (NPA) to Total Accommodation	10.0	8.9	5.7	6.0
2.2 Provisions to Non-Performing Accommodation	55.6	54.9	52.3	52.0
3. Earnings and Profitability				
3.1 Return on Assets (ROA) – Before Tax	0.1	2.4	4.5	4.0
3.2 Return on Assets (ROA) – After Tax	-0.7	1.0	3.3	2.5
3.3 Return on Equity (ROE) – After Tax	-7.4	13.0	30.2	24.7
3.4 Net Interest Income to Gross Income	22.2	33.1	39.3	37.9
3.5 Net Interest Income to Total Assets	4.2	5.7	6.8	7.0
3.6 Non-Interest Expenses (Operating Expenses) to Income	30.8	35.1	31.6	28.9
3.7 Staff Expenses to Non-Interest Expenses	36.6	34.4	35.5	39.4
3.8 Total Cost to Total Income	99.7	86.3	74.1	81.0
4. Liquidity				
4.1 Liquidity Assets to Total Assets	9.0	7.0	6.3	6.8
4.2 Liquidity Assets to Short Term Liabilities	14.1	11.2	12.1	12.6
5. Assets / Funding Structure				
5.1 Deposits	63.9	62.2	52.4	54.2
5.2 Loans and Advances	63.7	70.3	77.4	77.1
5.3 Investments	2.5	3.3	2.3	2.3
5.4 Credit to Deposits	99.7	112.9	147.7	142.1

* As at end of the financial year (March)

Source : Central Bank of Sri Lanka

Appendix Table 5

Financial Soundness Indicators – Specialised Leasing Companies

	2010 *	2011 *	2012 *	2012 September
1. Capital Adequacy				
1.1 Capital Funds to Total Assets	19.1	18.1	23.4	23.6
1.2 Total Borrowings to Capital Funds (Gearing) - (Times)	3.5	3.8	2.9	3.5
2. Asset Quality				
2.1 Non-Performing Accommodation (NPA) to Total Accommodation	6.0	3.8	2.5	2.4
2.2 Provisions to NPA	63.9	87.9	66.5	82.5
2.3 Total Advances to Total Assets	74.3	74.4	87.5	88.5
2.4 Total Advances to Total Borrowings	111.4	109.6	130.8	135.9
2.5 Provision Made against Total Advances	3.8	3.3	1.7	1.9
3. Liquidity				
3.1 Net Loans to Total Borrowings	105.8	104.7	127.9	132.7
3.2 Liquid Assets to Total Assets	10.2	4.2	2.6	2.9
3.3 Liquid Assets to Total Borrowings	15.3	6.1	3.9	4.5
4. Earnings and Profitability				
4.1 Net Profits Before Tax to Total Assets (ROA)	3.8	5.3	6.9	5.3
4.2 Operating Profit Before Provision to Total Assets	5.0	5.7	6.1	3.0
4.3 Profit After Tax to Capital Funds (ROE)	11.8	20.5	21.4	16.1
4.4 Interest Income to Interest Expenses	158.8	205.6	212.2	183.1
4.5 Net Interest Income to Gross Income	29.4	39.9	45.6	39.5
4.6 Net Interest Income to Total Assets	5.8	6.7	7.8	7.5
4.7 Net Interest Income to Net Profit Before Tax	154.9	127.1	112.5	142.2
4.8 Operating Cost to Net Interest Income	83.1	71.3	51.8	53.8
5. Assets / Funding Structure				
5.1 Borrowings	66.7	67.9	66.9	65.1
5.2 Investments	6.7	11.5	3.3	3.4

* As at end of the financial year (March)

Source : Central Bank of Sri Lanka