2013 Financial System Stability Review

Central Bank of Sri Lanka

Financial System Stability Review 2013

Central Bank of Sri Lanka

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Governor's Message

The Central Bank has been preparing the Financial System Stability Review (FSSR) annually since 2004, with a view to creating awareness among financial market participants as well as stakeholders of the financial sector about the developments in the financial sector, the outlook for financial stability and the policy measures that have been taken to reduce and mitigate potential risks to financial system stability. The FSSR 2013 covers developments in the financial sector; potential risks to financial system stability that may emerge as a result of evolving trends on the financial and economic landscape; and several topical issues which merit delving into by way of taking steps to improve stability of the financial sector as well as its competitiveness.

The financial system continued to remain resilient throughout 2013, providing an environment that supported the continued expansion of economic activity. Financial institutions have maintained healthy levels of capital and liquidity buffers. Easing of monetary policy from the latter part of 2012, the decline in inflation and inflation expectations, and ample liquidity in financial markets facilitated their orderly functioning. The stability of payment and settlement systems too has continued, with no disruptions in the operations of the major payment and settlement systems during the year.

Going forward, continued focus on the development of a sound, progressive and inclusive financial sector will further reinforce the resilience of the financial system. At the same time, the consolidation of banking and non-bank financial institutions, the enhancement of their capital, strengthening of their capital planning process, strong risk management and improved governance in financial institutions are also expected to enhance the dynamism and stability of the financial sector. The regulatory and supervisory framework too will be further strengthened to safeguard the stability of the financial system, including key market infrastructure.

These measures are expected to enhance the country's growth prospects, helping Sri Lanka to become a higher value-added, competitive and progressive upper middle-income country.

Ajith Nivard Cabraal

Governor

Central Bank of Sri Lanka

Acronyms and Abbreviations

APPF	Approved Private Provident Fund
ASPI	All Share Price Index
ATM	Average Time to Maturity
ATMs	Automated Teller Machines
AWCMR	Average Weighted Call Money Rate
AWDR	Average Weighted Deposit Rate
AWLR	Average Weighted Lending Rate
BIDS	Bond Information and Dissemination System
BOP	Balance of Payments
BPO	Business Process Outsourcing
CAR	Capital Adequacy Ratio
CAS	Common ATM Switch
CBGA	Central Bank Gold Agreement
CCAPS	Common Card and Payment Switch
CCP	Central Counterparty
CCPI	Colombo Consumers' Price Index
CP	Commercial Paper
CPI	Consumer Price Index
CPSS	Committee on Payment and Settlement Systems
CSE	Colombo Stock Exchange
D/SNBFI	Director/Supervision of Non-Bank Financial Institutions
EFTPOS	Electronic Fund Transfer Point of Sale
EPF	Employees' Provident Fund
ETF	Employees' Trust Fund
ETFs	Exchange-Traded Funds
ETP	Electronic Trading Platform
EU	European Union
FX	Foreign Exchange
GDP	Gross Domestic Product
GWP	Gross Written Premium
IBPA	Indonesia Bond Pricing Agency
IBSL	Insurance Board of Sri Lanka
IIS	Interest in Suspense
IMF	International Monetary Fund
IT	Information Technology
IVR	Interactive Voice Response
JGBs	Japanese Government Bonds

JREITs	Japan Real Estate Investment Trusts
KPO	Knowledge Process Outsourcing
LCB	Licensed Commercial Bank
LCs	Letters of Credit
LFC	Licensed Finance Companies
LKAS	Sri Lanka Accounting Standards
LSB	Licensed Specialised Bank
LTV	Loan to Value
MPOS	Mobile Point-of-Sale
NAV	Net Asset Value
NBMC	National Bond Market Committee
NFC	Near Field Communication
NPA	Non-Performing Accommodation
NPLs	Non-Performing Loans
OMO	Open Market Operations
PD	Primary Dealer
PER	Price Earnings Ratio
POS	Point-of-Sale
PSPF	Public Services Provident Fund
QQE	Quantitative and Qualitative Monetary Easing
ROA	Return on Assets
ROE	Return on Equity
RTGS	Real Time Gross Settlement
RWCAR	Risk Weighted Capital Adequacy Ratio
SEC	Securities and Exchange Commission
SIA	Securities Investment Account
SLAR	Statutory Liquid Asset Ratio
SLC	Specialised Leasing Companies
SLDB	Sri Lanka Development Bond
SLFRS	Sri Lanka Financial Reporting Standard
SLIPS	Sri Lanka Interbank Payment System
SRR	Statutory Reserve Ratio
SSDS	Scripless Securities Depository System
SSSS	Scripless Securities Settlement System
TLE	Terminal Line Encryption
UK	United Kingdom
USA/US	United States of America
USD	US Dollar
UT	Unit Trust
UTMC	Unit Trust Management Companies
Y-o-Y	Year-on-Year

1. Developments in the Financial Sector and an Assessment of Financial System Stability in 2013

Sri Lanka's financial system remains sound, and continues to support the expansion of domestic economic activity. In spite of slower loan growth, the banking and finance company sectors maintained their soundness at healthy levels. The insurance sector also maintained its solvency and liquidity at healthy levels during the year. Financial markets have remained liquid. The money market had excess liquidity during much of the year, which together with the easing of monetary policy by the Central Bank during this period resulted in interest rates in the money market declining. Interest rates pertaining to longer-term financial instruments were also seen declining, but at a slower pace. In the domestic foreign exchange market, the rupee depreciated *vis-à-vis* the US dollar, the pound sterling and the euro, in 2013, but appreciated against the Japanese yen, the Australian dollar and the Indian rupee. Activity in respect of equity listed on the Colombo Stock Exchange (CSE) remained buoyant and net foreign inflows into the equity market continued. Funds raised by way of debentures listed at the CSE as well as the turnover of listed debentures increased significantly during 2013. Issues of commercial paper, in value terms, meanwhile have been sustained at around the same level as in the previous year. The systemically important payment and settlement systems operated with a high degree of availability and safety, facilitating the smooth functioning of the financial system.

Domestic Macroeconomic Developments

The economy grew by 7.3 per cent in 2013, that is, at a higher rate than the growth of 6.3 per cent recorded in 2012. The stable macroeconomic conditions that prevailed in the country, with relatively low inflation, and the moderation of interest rates together with stable exchange rates supported this growth. This growth was broad-based with a strong growth of 9.9 per cent in the industry sector and a 6.4 per cent growth in the services sector. The agriculture sector grew by 4.7 per cent during the year. This sector, which grew marginally during the first half, amidst adverse weather conditions, revived strongly in the second half. In the agriculture sector, the performance of paddy, tea, minor export crops, livestock and plantation development sub sectors was notable. The continued expansion of the construction sector, which was supported by major public infrastructure programmes and an increase in private sector construction activities, contributed to the growth of the industry sector. The other sub-sectors of the industry sector: mining and quarrying, manufacturing, and electricity, gas and water, also performed well in 2013. Of the services sector, the growth momentum in the hotels and restaurant sector continued with increased tourists' arrivals while the other major sectors, wholesale and retail trade, transport and communication, and banking, insurance and real estate bettered in 2013 when compared with 2012. The economy is projected to grow at a higher rate, by 7.8 per cent, in 2014.

Chart 1.1 GDP and Sectoral Performance – Year-on-Year Growth (%)

Source: Depatment of Cencus and Statistics, Sri Lanka

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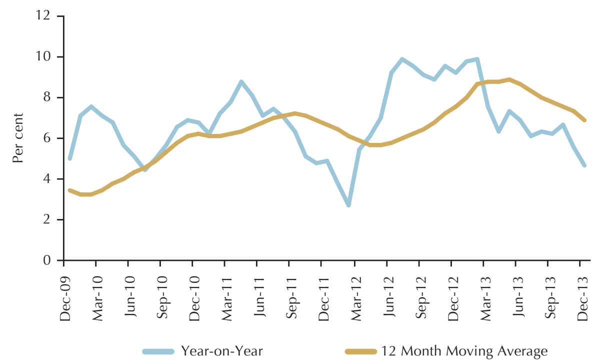
Chart 1.2 Headline Inflation as measured by the CCPI (2006/07 = 100)

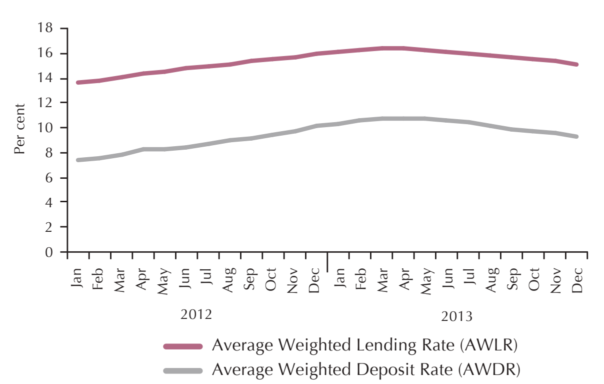


Source: Depatment of Cencus and Statistics, Sri Lanka

Inflation, as measured by the CCPI, 2006/07=100, remained at single digit levels in 2013 and decelerated further due to the lagged effect of the tight monetary policy stance maintained in 2012, the moderation of global commodity prices and the absence of any significant domestic supply-side shocks. Inflation on a year-on-year basis was 4.7 per cent by end 2013 while on an annual average basis, inflation was 6.9 per cent in 2013. The moderation of inflation and inflation expectations enabled the Central Bank to ease its monetary policy stance. Hence, market interest rates had been on a downward trend during the year.

With respect to monetary developments, broad money (M_{2b}) expanded by 16.7 per cent, year-on-year, in December 2013, compared to the growth of 17.6 per cent in December 2012. The moderation in broad money growth was accompanied by an easing of growth of credit granted to the private sector, which recorded a growth of 7.5 per cent, year-on-year, in December 2013. In comparison, credit granted to the private sector had recorded a high rate of growth of 34.5 per cent at end 2011, before decelerating to record a growth of 17.6 per cent in December 2012. Alongside the deceleration in credit obtained by the private sector, a substantial increase of around Rs.256 billion was recorded in relation to net credit obtained by the government during 2013. In 2013, the central bank's claims on the government decreased but, as a result of commercial banks' investments in government securities increasing, net credit granted to the government by the banking sector recorded an increase. The expansion of credit to public corporations however was contained at Rs. 73 billion when compared to the increase of Rs. 94 billion in 2012. Two key public corporations made interim repayments to commercial banks during the year. Net foreign assets of the banking sector meanwhile contributed to the deceleration in broad money, as net foreign assets of commercial banks contracted, partly offsetting the increase in the net foreign assets of the central bank during this period.

Chart 1.3 Market Interest Rates – Deposit and Lending Rates of Commercial Banks



Source: Central Bank of Sri Lanka

The external sector strengthened in 2013 with policy measures being adopted in 2012 to address the imbalances in the sector. Although exports, in US dollar terms, declined during the first half of 2013, by 4.6 per cent, year-on-year, exports recovered strongly in the latter half of the year, growing by 17.6 per cent, year-on-year. Altogether, in 2013, exports grew by 6.4 per cent and amounted to US dollars 10,394 million. Imports during the year meanwhile declined by 6.2 per cent and amounted to US dollars 17,989 million. Hence, the trade deficit narrowed during 2013. Meanwhile, higher earnings were recorded in relation to exports of services and workers' remittances, which helped reduce the deficit in the current account of the balance of payments in 2013. With an increase in inflows to the capital and financial accounts, the BOP recorded a surplus in 2013. As a result, gross official reserves increased to US dollars 7.5 billion by the end of the year, which was equivalent to 5 months of imports.

Government revenue as a percentage of GDP declined, exerting pressure on fiscal management in 2013, but government expenditure was contained within budgetary targets, reflecting the government's commitment to meet the budget estimate targets. Consequently, the overall budget deficit declined further to 5.9 per cent of GDP in 2013 from 6.5 per cent in 2012.

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Financial Institutions

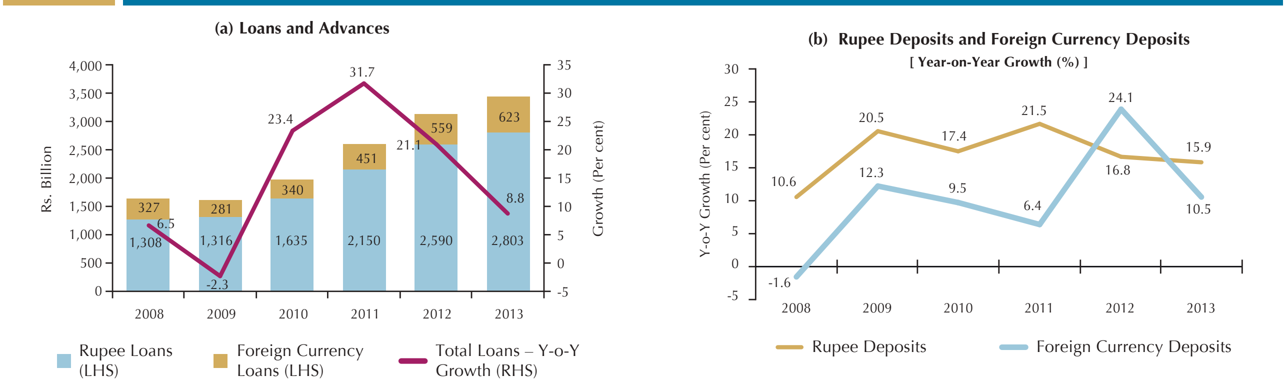
Banking Sector

The Banking sector continued to be resilient in a challenging environment. The soundness of the sector was reflected by the satisfactory levels of liquidity and capital maintained by the sector. The strengthening of the regulatory and supervisory framework for banks and the enhanced risk management measures adopted by banks enabled the banking sector to remain resilient. Assets of the banking sector increased in 2013, albeit at a slower pace when compared with the corresponding period last year, as the expansion of credit granted to the private sector moderated. Credit grew by 8.8 per cent, year-on-year, in 2013. Lag effects of the tight monetary policy stance maintained in 2012, the sharp drop in international gold prices and the consequent reduction in lending by way of pawning as well as the subdued performance of external trade particularly during the early part of the year were the factors that contributed to the moderation in loan growth during the year. Some corporations' access to foreign borrowings also had an impact on credit deceleration. An increase was seen in investments during this period. Bank profits moderated as reflected by the decline in both the Return on Assets (ROA) and the Return on Equity (ROE) and amounted to 74.6 billion in 2013 compared to 82.7 billion recorded in 2012. Several factors contributed to the decline in banking sector profits. While interest earned from credit granted is the main source of income for the banking sector, credit growth moderated in 2013. An increase in the share of high cost time deposits in total deposits; an increase in the provisions and write offs; and an increase in the share of lower yielding assets also contributed to the moderation in profits during the year.

Banks in Sri Lanka are facing relatively higher credit risk as indicated by the rising non-performing loans (NPLs). The combined effect of the weaker loan quality, particularly in the pawning portfolio, and the slower growth of loans largely contributed to the increase in the NPL ratio in the banking sector. However, the current level of NPLs will not have an adverse impact on banking sector stability given the availability of adequate resources in the form of capital. Increased NPLs were recorded mainly in relation to consumption, particularly pawning backed consumption, agriculture and fishing, construction and tourism. The provisions (specific) coverage ratio also declined due to no additional provisions being made against new NPLs which were being backed by gold where the residual risk is low. In addition to specific provisions, banks are required to maintain general provisions of 0.5 per cent for loans in the performing and special mention categories.

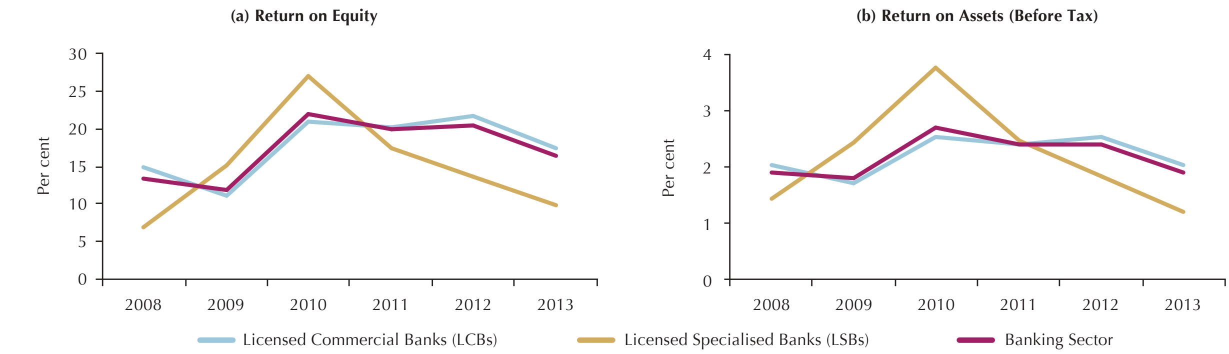
A large part of bank lending is concentrated in five key areas of economic activity. By end December 2013, trading accounted for 15.6 per cent of bank lending, while construction (14.5 per cent), agriculture and fishing (12.2 per cent), consumption (11.4 per cent) and manufacturing (11.3 per cent) also accounted for significant shares of total bank lending. Concentration of lending to a few sectors or customers would expose a bank to credit risk in the event of a crisis situation associated with one sector or a customer, affecting the

Chart 1.4 Assets and Liabilities of the Banking Sector



Source: Central Bank of Sri Lanka

Chart 1.5 Profitability Ratios of the Banking Sector



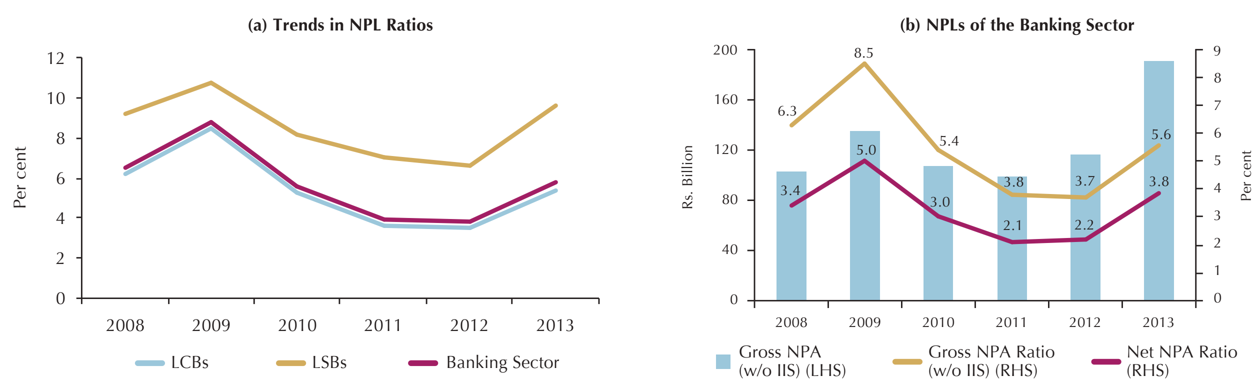
Source: Central Bank of Sri Lanka

recoverability of a large share of the loan portfolio. Hence, banks should closely monitor the potential credit risk associated with key sectors, given the high NPL ratios reported in respect of several key areas of economic activity.

Maturity mismatches have decreased, indicating lower exposure to liquidity risk. Banks' exposure to liquidity risk declined, as indicated by the narrowing of the cumulative negative gap between short-term assets and liabilities. The credit to deposit ratio of the banking sector declined, indicating that banks' need for market borrowing had lessened. With the moderation in lending activities, investments in government securities increased significantly, thereby increasing the portfolio of liquid assets of banks. As a result, banks were able to maintain a high statutory liquid asset ratio (SLAR) while their credit to deposits plus borrowings ratio declined. The SLAR of the banking sector, which acts as a buffer against a liquidity shortfall, increased to 37.7 per cent by end December 2013, which was well above the minimum requirement of 20 per cent. Although the liquidity position of the banking sector is currently comfortable, banks need to manage the mismatches in the asset liability maturity profile more effectively.

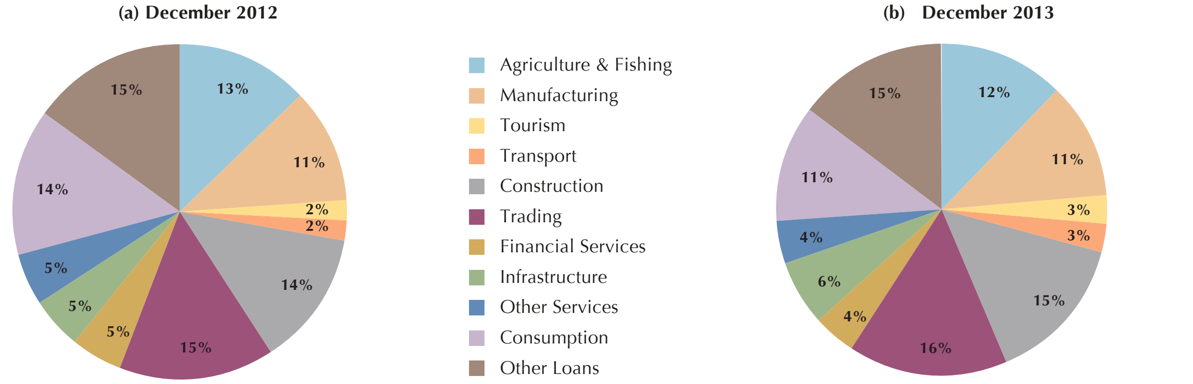
Exposure to market risk was manageable. The banking sector had considerable exposure to interest rate risk and experienced a significant reduction in their interest margin due to the decreasing trend in interest rates. However, with the moderation in interest rates, gains on trading securities increased during the period under consideration. The exposure to foreign exchange risk was low as the aggregate value of net open foreign currency positions was less than 2 per cent of the banks' regulatory capital. Moreover, the trend in exchange rates had a positive net impact on the

Chart 1.6 Non-Performing Loan Volumes and Ratios of the Banking Sector



Source: Central Bank of Sri Lanka

Chart 1.7 Credit Exposure of the Banking Sector

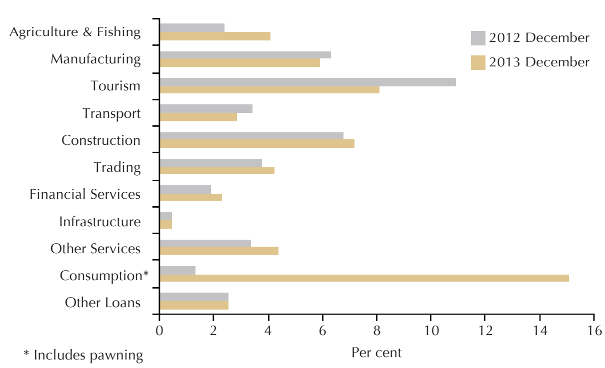


Source: Central Bank of Sri Lanka

banks' profitability through the revaluation of foreign currency assets and liabilities. The exposure to equity market risk was also negligible due to the minimal exposure to the equity market (only 3 per cent of total investments). Hence, movements in share prices at the CSE did not have a significant impact on the banking sector's financial stability.

The banking sector remains well capitalised. The overall capital funds position of the banking sector improved, enlarging the buffer available for absorbing risks. Consequently, the total capital adequacy ratio and the core capital adequacy ratio of the banking sector increased. During 2013, the Central Bank issued the Direction on the implementation of the supervisory review process under Pillar II of Basel II. With regard to the Basel III framework, the Sri Lankan banking sector is currently compliant with the new capital requirements under Basel III. By end December 2013, the banking sector operated with a common equity ratio of 13.7 per cent and a total capital ratio of 16.3 per cent, which are well above the requirements of Basel III.

Chart 1.8 Non-Performing Loans of the Banking Sector



* Includes pawning

Source: Central Bank of Sri Lanka

The Banking Sector Soundness Map[1] indicates that the banking system remained sound and stable in 2013. With bank-wise ratings on corporate governance showing a general tendency towards improvement, the management soundness indicator for the banking sector improved. An improvement was also seen in the liquidity position of the banking sector in 2013, when compared to the previous year. However, as indicated by the map, asset quality deteriorated while profitability declined during 2013 as a result of the deceleration in credit growth and an increase in non-performing loans, which also led to a deterioration in the Return on Assets (ROA), the Return on Equity (ROE) and the net interest margins in the banking sector.

A number of policy measures were introduced during the year to further strengthen the banking sector. Banks were required to classify the existing banking outlets into two categories: branches and student savings units. The definition of liquid assets was broadened to include investments in Gilt Unit Trusts,

1 Banking Soundness Map is used to assess the soundness of the banking sector. There are seven partial indicators and nineteen variables in the BSI as follows. *Capital Adequacy:* Tier 1 capital to risk weighted assets, Capital base to risk weighted assets, Net non-performing loans to capital funds, Total assets to capital funds. *Asset Quality:* Gross non-performing loans to total gross loans, Net non-performing loans to total gross loans. *Management:* Rating on corporate governance. *Profitability:* ROA, ROE, Net Interest margin. *Liquidity:* Liquid assets to total assets, Credit to (deposits + borrowings), Cumulative gap of assets and liabilities up to 3 months/cumulative liabilities up to 3 months. *Market Risk:* Cumulative gap of interest – bearing assets and liabilities up to 3 months to cumulative interest bearing assets up to 3 months, Equity to capital funds, Net open position in foreign exchange to capital funds. *Efficiency:* Operating expenses to non-interest income, Staff cost to operating expenses, (credit + deposits) to total employees.

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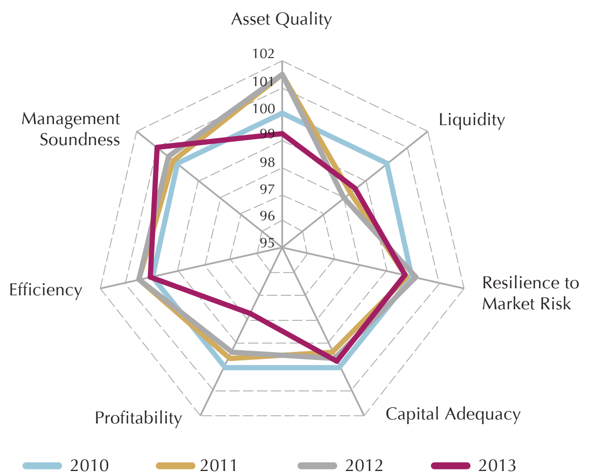
Chart 1.9 Banking Sector Soundness Map



Note: Moving away from the center denotes increasing soundness.
Base year of the indices compiled to gauge the different aspects of bank performance is 2010.

Source: Central Bank of Sri Lanka Staff Calculations

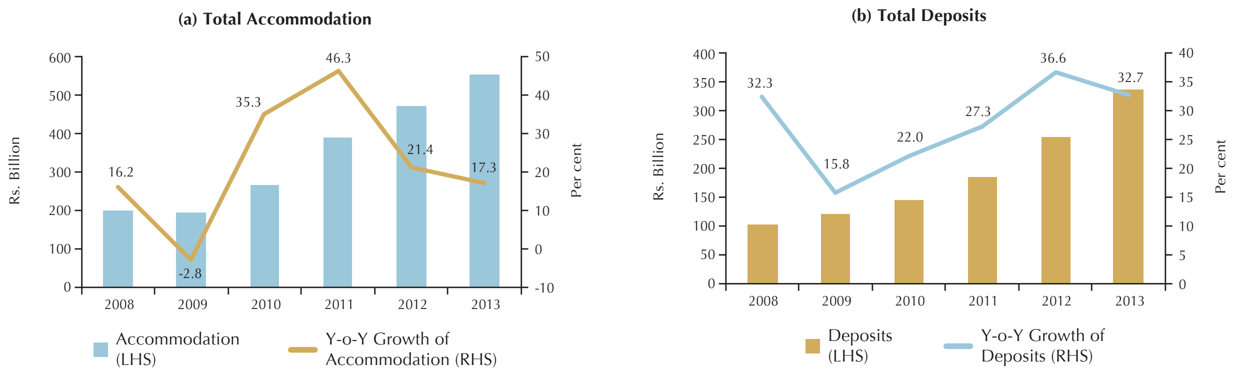
which are open ended mutual funds. Taking into account the changes in the international accounting standards as well as the suggestions and comments provided by the licensed banks and the Institute of Chartered Accountants of Sri Lanka, new formats for the preparation of annual audited financial statements and the publication of quarterly financial statements in the press, were issued. The existing direction was amended to permit banks to sell, transfer, assign or dispose of immovable assets with the prior approval of Director of Bank Supervision. Regulations were implemented with a view to improving the standard of business conduct and promoting good market practices for the effective and efficient functioning of foreign exchange trading activities; promoting the adoption of appropriate risk management standards by banks to mitigate plausible risks arising from their exposure to the stock market to prudent levels; regularizing and streamlining outsourcing of business operations of banks; and strengthening the governance and risk management polices pertaining to banks. The restriction, in the corporate governance direction, on holding directorships in more than 10 specified business entities, under the eligibility criteria for a person to be a director of a licensed bank, was withdrawn. Ceilings were imposed on penal rates of interest pertaining to advances to facilitate the expansion of economic activity.

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

Financial soundness of the LFC and SLC sector was maintained despite challenges. The growth of financial facilities provided by LFCs and SLCs slowed down, while the investment portfolio of the sector decreased marginally in 2013. The increase in the import duty applicable to vehicles and the relatively high lending rates pertaining to accommodations that prevailed during much of the period from 2012 to 2013 have largely contributed to the moderation of the growth of leasing and hire purchases in 2013. Deposit mobilisation increased significantly during this period, which could be attributed to several SLCs obtaining LFCs status. The profitability of the sector declined due to increased operational costs and provisioning requirements. Consequently, the capital levels in the sector moderated during the period under review. However, the capital adequacy ratios of the sector were well above the minimum regulatory requirements.

Asset quality of the LFC and SLC sector showed some deterioration with NPLs of the sector increasing. The NPLs of the sector increased reflecting a deterioration of the repayment ability of borrowers, partially due to the moderation in the expansion of economic activity during the early part of the year and the adverse gold price movements. In addition, the LFCs and SLCs with weak balance sheets were vulnerable to liquidity risk as market interest rates moved downwards. During the period, public confidence in LFCs and SLCs was affected due to severe liquidity constraints associated with one LFC. Meanwhile, the increase in interest cost relative to income, and lower interest income generation resulted in a decline in the interest margin of the sector. In addition, the intense competition due to the increased number of players currently in the sector and the expansion of the banking sector posed a threat to LFCs and SLCs with weak balance sheets, by way of limiting their ability to attract funds at attractive rates. Several LFCs and SLCs are operating with very high short-term assets and liability mismatches. This situation needs to be addressed by these institutions as it could have negative repercussions during challenging times. Further, the business model of some LFCs and SLCs incorporates a high cost of funding, resulting in inefficiencies.

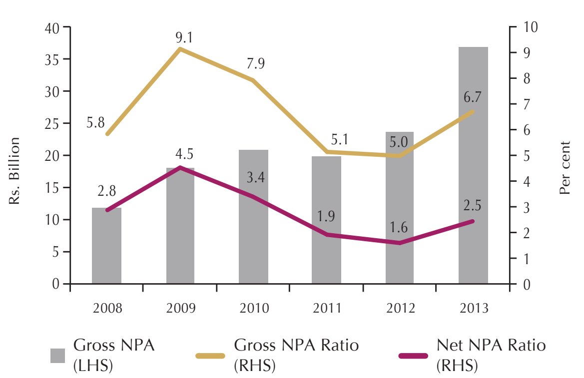
Chart 1.10 Assets and Liabilities of the LFC and SLC Sector



Source: Central Bank of Sri Lanka

Several measures were introduced to streamline the operations of LFCs. The Finance Companies (Structural Changes) Direction No.1 of 2013 was issued in June 2013 to replace the Structural Changes Direction that was in force up to then, as it was limited in scope and needed to be revised to be in line with current developments in the financial sector. Provisions in the Transfer of Assets Direction have been incorporated into the new Structural Changes Direction. Accordingly, prior approval of the Monetary Board is required to effect any changes to the name of an LFC or to its structure, by forming a new business entity such as a subsidiary or an associate company, or selling the business, for example, while prior approval of the Director, Department of Supervision of Non-Bank Financial Institutions of the Central Bank of Sri Lanka (D/SNBFI) is needed for business decisions such as outsourcing functions of an LFC, for example. In view of the adoption of Sri Lanka Accounting Standards (LKAS) 32 and 39, and Sri Lanka Financial Reporting Standard (SLFRS) 7, guidelines were issued to LFCs as per which they are required to obtain the prior approval of the D/SNBFI for the distribution of dividends. From 2012 onwards, audited profits of LFCs and SLCs are dependent on the impairment and the provisions determined in accordance with the judgements and assumptions of the management of LFCs and SLCs as per LKAS/SLFRS. Requiring prior approval of D/SNBFI for the distribution of dividends is expected to prevent LFCs and SLCs from distributing profits imprudently. With a view to ensuring that the Business revival plans pertaining to several LFCs continue to be implemented, the Central Bank continued to closely monitor the progress in this respect through off-site and on-site supervision and regular meetings held with Boards of Directors and the senior management of the relevant companies. Furthermore, several amendments have been incorporated to the disclosure requirements in the Corporate Governance Direction.

Chart 1.11 Non-Performing Loans of the LFC and SLC Sector



Source: Central Bank of Sri Lanka

Insurance Companies

The insurance sector recorded improved performance, although total gross written premiums (GWP), which grew at an accelerating pace up to mid-2011, have continued to moderate thereafter, recording a lower growth during 2013. The reduction of the registration of motor vehicles due to the measures taken in 2013 to curtail vehicle imports, that is, requiring letters of credit (LCs) opened with commercial banks for the purpose of importing specified vehicles to be covered by a minimum cash margin of 100 per cent of import value deposited with the LC opening bank at the time of opening such LCs and prohibiting banks to grant advances for the

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purpose of meeting the minimum margin requirement, has affected general insurance, particularly, the motor insurance business. Consequently, the premium income for motor insurance, which constitutes about 62 per cent of the general insurance premium, recorded a relatively moderate growth in 2013. The net premium income (GWP minus reinsurance premium) for both general insurance and long-term insurance increased in 2013. The profits of the sector increased mainly due to an increase in investment income. Total investment income of the insurance sector increased significantly in 2013. The higher growth of investment income is largely due to the notable growth of investment income in the long-term insurance sector, where a large part of the investments were in government securities and corporate debt securities. Underwriting profits (difference between the insurance premium earned and claims paid and expenses incurred during the period) of the general insurance sector also increased in 2013, mainly due to claims increasing at a lower pace than in the previous year.

The soundness of the insurance sector was maintained. In 2013, all insurance companies except three met the statutory solvency margin requirement, while all insurance companies complied with the requirement of investing 20 per cent of the technical reserves in respect of general insurance and 30 per cent of the long-term funds in government securities.

Insurance companies managed their risks adequately. In general, insurance companies hold a large proportion (33 per cent) of investments in government securities of different maturities. Investments in government securities protect them against credit risk, but as a result of these investments, they are exposed to interest rate risk, especially when there is a declining trend in interest rates. Insurance companies are exposed to some degree of market risk on account of their equity holdings, and in 2013, share prices have displayed relatively lackluster performance, exposing insurance companies to some degree of market risk during the year. Increased investments in liquid, short-term government securities and premium income growth supported insurance companies to manage their liquidity risk adequately. The reinsurance risk was well managed through reinsurance with highly reputed and rated insurance companies abroad. Insurance companies maintained around 11 per cent of their gross written premium as reinsurance premia in 2013.

Several measures were taken to strength the insurance sector. The Insurance Board of Sri Lanka (IBSL) issued guidelines and instructions to insurance companies specifying eligibility criteria that a valuer should meet in order to be able to value land and buildings in Sri Lanka for the purpose of Solvency Margin Rules for Long-Term and General Insurance Business. Moreover, capital to be maintained by insurance companies and insurance brokering companies as per the minimum capital requirement pertaining to them has been increased. Accordingly, insurance companies would be required to maintain capital at a level not less than Rs. 500 million from 2015 while insurance brokering companies would be required to maintain capital at a level not less than Rs. 2.5 million from 2014.

Primary Dealers in Government Securities

The Primary Dealer (PD) sector recorded improved performance in 2013. By end 2013, an increase was recorded in the total assets of the PDs, when compared with the level recorded a year ago. This could be attributed to the significant increase in trading securities. Total profits of the PDs for the year 2013 were higher than in the previous year. Hence, the annualized ROE and ROA of PDs increased further during 2013. Increased profitability of the PDs during this period could be attributed mainly to the substantial increase in capital and revaluation gains. The Risk Weighted Capital Adequacy Ratio (RWCAR) of the standalone PDs was also well above the minimum regulatory requirement of 8 per cent. Market risk of the PD sector decreased mainly due to the decline in yield rates in the primary and secondary markets for government securities. The overall liquidity exposure of the PD sector also declined with excess liquidity in the domestic market and the availability of contingency funding arrangements.

Unit Trusts

The Unit Trust (UT) sector has posted improved performance. The net asset value (NAV) of the UT sector has recorded a significant increase by end 2013. This could be attributed to the setting up of sixteen new funds with more investments in government securities and corporate debt securities during the year. The share of equity in the investment portfolios of unit trusts recorded a decline while the share of debt securities in the investment portfolio, particularly investments in commercial paper and debentures, increased significantly during this period, reflecting a diversification of the investment portfolios of unit trusts. Several policy initiatives were taken to encourage the development of the unit trust sector during the period under consideration. Lowering the income tax applicable to Unit Trust Management Companies (UTMC) and exempting services supplied by UTMC to unit trusts from VAT have contributed positively towards the development of the unit trust sector. Enabling investments in unit trusts to be executed directly in foreign currencies without having to channel funds through Securities Investment Accounts (SIA) meanwhile, would encourage investments in unit trusts by Sri Lankans working abroad.

Stock Brokers

Alongside the modest increase recorded by the key price indices of the CSE, namely, the All Share Price Index (ASPI) and the S&P SL 20 Index, income of the stock brokers during 2013 increased by 33 per cent, year-on-year, to Rs. 2,555 million. However, a loss before tax was recorded by the stock broker sector for 2013, as in the previous year. The total net capital of the stock brokers also declined during this period.

Superannuation Funds

The investment policy of the major superannuation funds continued to focus on earning a long-term positive real rate of return for the members whilst ensuring the safety of investments and maintaining adequate liquidity for refund payments and other expenditure. The superannuation fund sector consists of the Employees' Provident Fund (EPF), which is the largest systemically important superannuation fund in Sri Lanka, the Employees' Trust Fund (ETF), the Public Services Provident Fund (PSPF) and the 171 Approved Private Provident Funds (APPFs). The risk profiles of superannuation funds, particularly of the two major funds, that is, the EPF and the ETF, are similar and their financial positions indicate that their risks were managed adequately. The credit risk of these funds is negligible as over 90 per cent of their investments are held in government securities, which have zero default risk. The funds are exposed to interest rate risk as a result of the high concentration of investments in fixed income securities, but the interest rate risk has been minimized by investing in a variety of securities with different yields and maturities. The funds' vulnerability to liquidity risk is minimal given the steady inflow of funds through member contributions and the investment of these funds in short-term Treasury securities.

Financial Markets

Inter-Bank Call Money Market

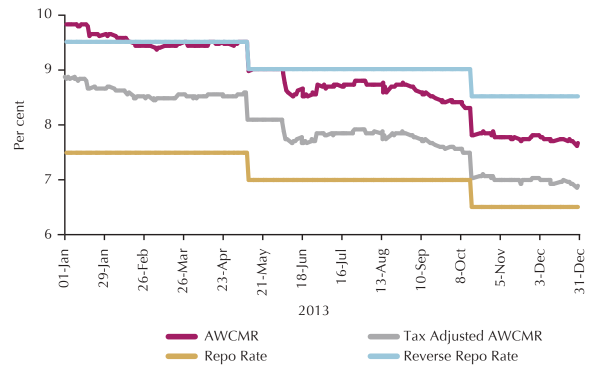
The Central Bank reduced its policy interest rates[2], *viz.*, the Repurchase rate and the Reverse Repurchase rate, by 50 basis points each, in May and October 2013, while it reduced the Statutory Reserve Ratio (SRR) by 200 basis points in July 2013. Accordingly, the Bank's Repurchase rate and Reverse Repurchase rate were at 6.50 per cent and 8.50 per cent, respectively, by end 2013, while the SRR was at 6 per cent. The reduction of the SRR, the purchase of proceeds from the foreign currency denominated bonds issued by domestic banks in international financial markets, buy-sell swap agreements, an increase in the amount granted as provisional advances to the government by the Central Bank, profits transferred to the government by the Central Bank and net forex purchases by the Central Bank in the domestic foreign exchange market meanwhile resulted in the money market having excess liquidity during much of 2013. The excess liquidity was absorbed by selling Treasury bills amounting to Rs. 128.8 billion on a permanent basis as well as through Repos conducted on term and overnight bases. On a few occasions, particularly in January and May, when market liquidity was in a deficit position, to provide rupee liquidity, the Central Bank conducted term Reverse Repo auctions in addition to the overnight Reverse Repo auctions and the Reverse Repo facilities granted through its standing facility.

The downward revision of the policy interest rates and the SRR by the Central Bank and the excess liquidity in the money market resulted in downward pressure on market interest rates. The average weighted call money rate (AWCMR) which remained within the policy rate corridor from around mid-February 2013, continued to adjust downwards in response to the

2 With effect from 2 January 2014, the Central Bank's Standing Repurchase Facility was renamed the Standing Deposit Facility and the Standing Reverse Repurchase Facility was renamed the Standing Lending Facility. Accordingly, with effect from 2 January 2014, the Central Bank's policy interest rates are the Standing Deposit Facility Rate and the Standing Lending Facility Rate.

1

Chart 1.12 Average Weighted Call Money Rate (AWCMR) and Policy Interest Rates of the Central Bank



Source: Central Bank of Sri Lanka

easing of the monetary policy stance of the Central Bank as well as other policy initiatives of the Central Bank. Changing of the reserve maintenance period and the auction process (OMO) facilitated the speedy response of the market to the easing of the monetary policy stance of the Central Bank. As per the said changes, the reserve maintenance period was extended from one week to two weeks, to facilitate stability in short-term interest rates and a potential reduction in the cost of funds of commercial banks. This measure would help increase the flexibility available to banks to manage their liquidity, limit sudden fluctuations in liquidity demand, improve efficiency in liquidity usage, and reduce *ad-hoc* fluctuations in short-term interest rates. The Central Bank also introduced short-term auctions, through which Repos and Reverse Repos with up to seven days' maturity, on the same day settlement basis, could be offered, to facilitate the revisions to the reserve maintenance period, and thereby facilitate increased stability in shor-term interest rates. With the money market becoming more active during the period under consideration, the Central Bank relaxed some administrative restrictions previously imposed, in order to encourage inter-bank lending. Accordingly, the Rs. 100 million limit on the repo standing facility on days when the Central Bank offers a reverse repo auction was withdrawn with effect from 1 June 2013.

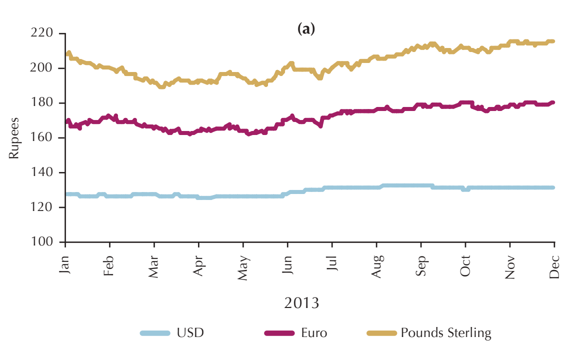
Foreign Exchange Market

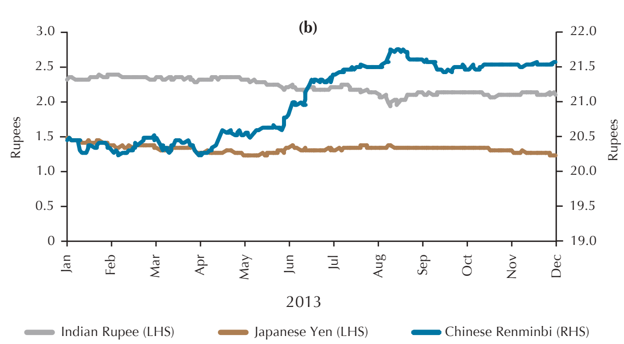
The rupee was relatively stable against major currencies in 2013. The rupee appreciated marginally during the first six months of 2013 due to foreign exchange inflows by way of investments in government securities. The exchange rate came under pressure from around mid-June 2013, due to concerns over the depreciation of currencies of emerging Asian countries against the US dollar with the expectation of the US Federal Reserve reducing its monetary stimulus, and foreign investors in government securities becoming keen in hedging their un-hedged exposures. The Sri Lanka Rupee depreciated by 2.8 per cent to Rs. 130.7530 against the US dollar by end 2013. During the year, the Central Bank intervened in the domestic foreign exchange market by buying and selling US dollars to prevent excess volatility of the exchange rate. Overall, the Central Bank was a net purchaser in the market, during the year, with net purchases amounting to US dollars 435.6 million.

Government Securities Market

Yield rates pertaining to government securities declined while average time to maturity increased during 2013. This could be attributed to the proactive public debt management strategies adopted by the Central Bank. These included diversification of

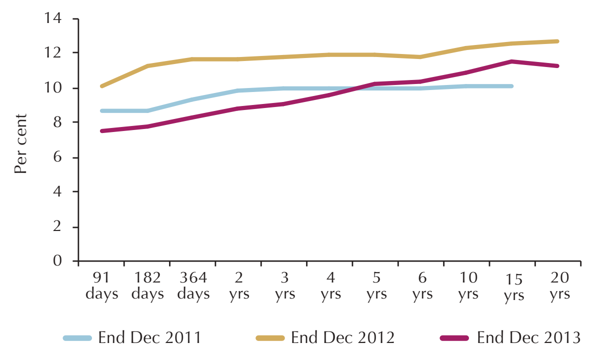
Chart 1.13 Exchange Rates: Sri Lanka Rupee *vis-à-vis* Selected Currencies





Source: Reuters

Chart 1.14 Secondary Market Yield Curve for Government Securities



Source: Central Bank of Sri Lanka

foreign investments in government securities, the establishment of stand-by funding arrangements with institutional investors in the Middle-East and sourcing of new funding in Sri Lanka Development Bonds (SLDBs). Additionally, the easing of monetary policy by the Central Bank, increased participation of foreign investors in the government securities market and the excess liquidity that prevailed in the money market during much of this period also contributed to the reduction in yield rates. Yield rates pertaining to 91 day, 182 day and 364 day Treasury bills declined by 246 basis points, 347 basis points, and 340 basis points, respectively, while those pertaining to Treasury bonds in the secondary market decreased by around 500 basis points to 200 basis points across the yield curve (2–30 years), in 2013. Treasury bill and Treasury bond holdings of foreigners increased to Rs. 477.4 billion by end 2013, from Rs. 397.8 billion at end 2012. The Average Time to Maturity (ATM) of the Treasury bills and Treasury bonds issued increased, reflecting the improved risk profile of the public debt portfolio. The ATM of the Treasury bill portfolio increased to 0.45 years by end 2013 from 0.38 years at end 2012. The ATM of Treasury bonds issued also increased to 10.24 years in 2013 from 6.86 years in 2012, mainly due to the issuance of a large volume of long dated Treasury bonds during the first nine months of 2013 and foreign investor interest in government securities with long-tenors.

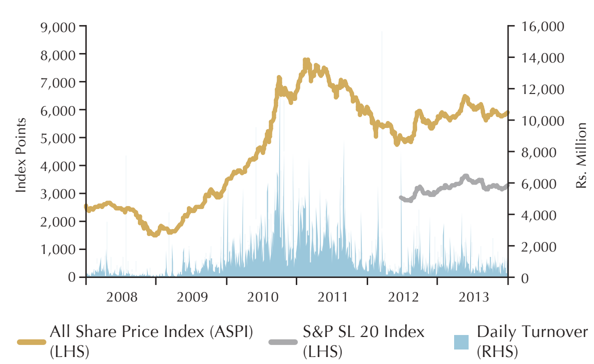
Corporate Debt Market

There has been a significant increase in debenture issues during the year. The market for debentures posted improved performance for 2013, supported by the conducive environment for economic activity. Measures taken by the government to exempt withholding tax on interest income earned from investments in listed debt have contributed to the increasing popularity of corporate bonds. There were eighty three listings of corporate debentures (excluding introductions) by twenty four corporate institutions during the year. These debentures carried both fixed and floating interest rates. Through these debenture issues, funds amounting to Rs. 69.1 billion were mobilized. In addition, the total value of Commercial Paper (CP) issued with the support of banks amounted to Rs. 28.3 billion, during the year under consideration. In the context of Sri Lanka's capital market, the corporate debt market has a long way to go as it still remains insignificant in terms of value, when compared with the listed equity market and the government securities market. The development of the corporate debt market has been constrained by the lack of liquidity, the limited number of large corporate players, the limited number of bond issues by credit-worthy corporate entities, and the high cost of issuing bonds. However, increasingly, corporate entities are looking to the corporate debt market for fund raising purposes, given the potential benefits available to debt issuers. In order to facilitate an active corporate debt market, the government is now actively promoting the corporate debt market.

Stock Market

Key indicators of performance of the Colombo Stock Exchange (CSE) such as the All Share Price Index (ASPI), the S&P SL 20 Index, market capitalisation as well as net foreign inflows indicated a modest improvement in 2013. The downward trend in domestic interest rates, foreign investments and the

Chart 1.15 Price Indices and Daily Turnover at the Colombo Stock Exchange



Source: Central Bank of Sri Lanka

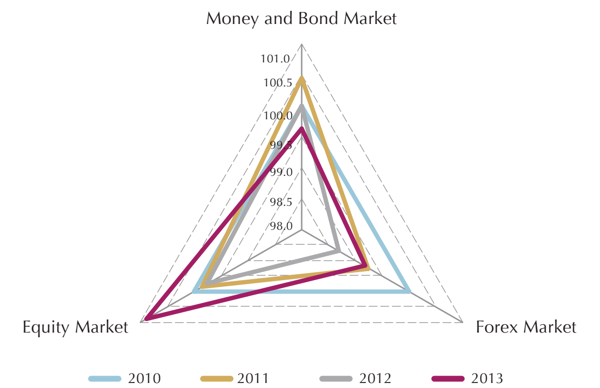
relatively favourable macroeconomic environment primarily contributed towards this improvement. The ASPI and the S&P SL 20 index of the CSE increased by 4.8 per cent and 5.8 per cent, respectively, during the year. The market Price Earnings Ratio (PER) was 15.9 by end 2013, the same level as at end 2012. Market capitalisation increased to Rs. 2.5 trillion at end December 2013 from Rs. 2.2 trillion at end December 2012, with a total of Rs. 25.6 billion being raised through nine rights issues during the year, which contributed towards the increase in market capitalisation. Foreign investment meanwhile has remained positive on a net basis during much of this period, and a net inflow of Rs. 22.9 billion, *i.e.*, US dollars 175 million was recorded by end 2013.

Although most key performance indicators of the CSE recorded growth, turnover during 2013 was lower when compared with the previous year. Daily average turnover during 2013 was Rs. 828 million, compared to Rs. 884 million during 2012. The lackluster performance of many corporate entities as reflected by the financial results posted by many of them for the second and third quarters of the year and the tepid recovery of the global economy are likely to have had a dampening effect on activity in the stock market during the year. Hence, the price indices of several sub-sectors including those for the Diversified Holdings sector, the Plantations Sector, Stores and Supplies sector, the Trading sector and the Chemicals and Pharmaceuticals sector recorded declines for 2013.

Financial Market Stability

The Financial Market Stability Map[3] indicates that financial markets remained stable over the year 2013, with the stability indices for Money and Bond Markets, the Forex Market and the Equity Market continuing to hover close to 100, the value in the base year, that is 2010. In comparison to 2012, the domestic foreign exchange market as well as the equity market

Chart 1.16 **Financial Market Stability Map**



Note: Moving away from the center denotes increasing stability.Base year of the indices for the Money and Bond Markets, the Forex Market and the Equity Market is 2010.

Source: Central Bank of Sri Lanka Staff Calculations

have shown greater stability. Given the notable decline in market interest rates and the significant increase in market liquidity, the financial market stability map indicates increased volatility in the Money and Bond Market.

Payment and Settlement Systems

The systemically important payment systems in Sri Lanka, namely, the LankaSettle System operated by the Central Bank and the Cheque Clearing System operated by LankaClear (Pvt.) Ltd. (LCPL) functioned without disruption and with a very high degree of system availability. The LankaSettle System consists of the Real Time Gross Settlement (RTGS) System, which is the only large value electronic payment system in the country, and the LankaSecure System, which is the scripless government securities settlement system. In value terms, the share of transactions settled through the RTGS System in total non cash payments accounted for 86 per cent, in 2013. The LankaSecure System consists of the Scripless Securities Settlement System (SSSS) and the Scripless Securities Depository System (SSDS) which operates on delivery versus payment basis. The total value of scripless securities held by LankaSecure as at end 2013 amounted to Rs. 3,726 billion accounting for 99.9 per cent of the total value of Treasury bills and Treasury bonds outstanding.

LCPL carried out technological and process advancements to the Cheque Clearing System which resulted in efficiency improvements. In order to extend

3 **Financial Market Stability Map** – To assess financial market stability, the performance of the following variables were considered under each market. **Money & Bond Market:** Volatility of the call money market rate, volatility of market liquidity, volatility of the secondary market 91-day Treasury bill yield, the Term spread between the secondary market 91-day Treasury bill yield and the 5-year Treasury bond yield, the Term spread between the secondary market 91-day Treasury bill yield and the 3-month SLIBOR, and the Term spread between the secondary market 91-day Treasury bill yield and the 3-month LIBOR. **Forex Market:** Volatility of LKR-USD exchange rate, FX market intervention including SWAPS, and the 3-month forward premium. **Equity Market:** Volatility of ASPI.

the benefits of such improvements to commercial bank customers, the General Direction No. 3 of 2013 relating to Service Norms and Standard Times for Accepting Cheque Deposits and Crediting Cheque Proceeds was issued, revising the standard times for accepting cheque deposits and crediting cheque proceeds stipulated by the General Direction No. 01/2007.

With the objective of providing a nation-wide common platform for electronic retail payment systems, the Central Bank continued to provide necessary assistance for the establishment of the Common Card and Payment Switch (CCAPS). The Common ATM Switch (CAS) which is the first phase of CCAPS, started live operations in July 2013. It is expected to utilize the ATM network in the country more efficiently and effectively and thereby reduce the costs incurred by financial institutions in providing ATM facilities. In order to ensure smooth operations of CAS, the Central Bank issued two directions, to LCPL and members of CAS. These directions set out certain prudential and obligatory requirements and upper limits for the fees that can be charged from customers by card issuers and the interchange fee that can be charged from card issuers by financial acquirers.

Considering practical and legal issues as well as new developments in relation to electronic retail payment systems, the Central Bank revised the relevant regulation. The Service Providers of Payment Cards Regulations, No. 01 of 2009 was rescinded and the Payment Card and Mobile Payment Systems Regulations, No. 01 of 2013 was issued to regulate and supervise activities of service providers in respect of payment cards and mobile phone based payment systems. Further, the Central Bank granted approval to a telecommunication network operator licensed by the Central Bank to operate an e-money scheme, to issue a stored value card for the transport sector, using near field communication technology. In order to ensure safe and secure payment card operations in Sri Lanka, the Central Bank mandated the adoption of the Terminal Line Encryption (TLE) technology to institutions engaged in financial acquiring. Accordingly, on the instructions of the Central Bank, all acquirers upgraded their point-of-sale terminals with TLE by 31 March 2013.

Prospects, going forward

Domestic economic activity is expected to pick up, going forward, given the recovery in global economic activity and the conducive domestic macroeconomic environment, particularly following the easing of the Central Bank's monetary policy stance recently. Measures taken to strengthen the domestic financial sector, particularly, policy measures taken to promote the consolidation of financial institutions, as well as the strengthening of the regulatory framework pertaining to the domestic financial sector would add to the strength of the economy.

1

Table 1.1 **Total Assets and Deposit Liabilities of the Financial System**

Financial Institution	Assets				Deposits			
	2012		2013 (a)		2012		2013 *(a)*	
	Rs. Bn.	Share (%)	Rs. Bn.	Share (%)	Rs. Bn.	Share (%)	Rs. Bn.	Share (%)
Central Bank of Sri Lanka (CBSL)	**1,278.8**	**14.1**	**1,246.0**	**12.1**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Institutions Regulated by the CBSL	**5,855.1**	**64.6**	**6,872.6**	**66.6**	**3,879.5**	**98.1**	**4,506.8**	**98.6**
Deposit Taking Instituions	**5,634.3**	**62.2**	**6,594.5**	**63.9**	**3,879.5**	**98.1**	**4,506.8**	**98.6**
Licensed Commercial Banks	4,355.7	48.1	5,022.2	48.7	3,061.3	77.4	3,552.4	77.7
Licensed Specialised Banks	742.5	8.2	919.3	8.9	564.1	14.3	617.1	13.5
Licensed Finance Companies	536.1	5.9	653.0	6.3	254.1	6.4	337.3	7.4
Other Financial Institutions	**220.8**	**2.4**	**278.1**	**2.7**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Primary Dealers	160.4	1.8	213.6	2.1	n.a.	n.a.	n.a.	n.a.
Specialised Leasing Companies	60.4	0.7	64.5	0.6	n.a.	n.a.	n.a.	n.a.
Institutions Not Regulated by the CBSL	**1,927.9**	**21.3**	**2,199.7**	**21.3**	**73.3**	**1.9**	**66.2**	**1.4**
Deposit Taking Institutions	**85.1**	**0.9**	**103.4**	**1.0**	**73.3**	**1.9**	**66.2**	**1.4**
Rural Banks *(b)*	77.2	0.9	94.9	0.9	68.0	1.7	60.9	1.3
Thrift and Credit Co-operative Societies *(b)*	7.9	0.1	8.5	0.1	5.3	0.1	5.3(g)	0.1
Contractual Savings Institutions	**1,753.0**	**19.3**	**1,998.3**	**19.4**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Employees' Provident Fund	1,144.4	12.6	1,300.0	12.6	n.a.	n.a.	n.a.	n.a.
Employees' Trust Fund	158.4	1.7	178.5	1.7	n.a.	n.a.	n.a.	n.a.
Approved Private Provident Funds *(c)*	110.3	1.2	123.0	1.2	n.a.	n.a.	n.a.	n.a.
Public Service Provident Fund	32.9	0.4	36.4	0.4	n.a.	n.a.	n.a.	n.a.
Insurance Companies *(d)*	307.0	3.4	360.4	3.5	n.a.	n.a.	n.a.	n.a.
Other Financial Institutions	**89.8**	**0.8**	**98.0**	**1.0**	**n.a.**	**n.a.**	n.a.	n.a.
Stock Broking Companies *(e)*	10.8	0.1	10.3	0.1	n.a.	n.a.	n.a.	n.a.
Unit Trusts / Unit Trust Management Companies *(e)*	32.4	0.4	55.8	0.5	n.a.	n.a.	n.a.	n.a.
Market Intermediaries *(e)(f)(h)*	43.9	0.3	29.5	0.3	n.a.	n.a.	n.a.	n.a.
Credit Rating Agencies *(e)*	0.2	0.0	0.3	0.0	n.a.	n.a.	n.a.	n.a.
Venture Capital Companies	2.5	0.0	2.3	0.0	n.a.	n.a.	n.a.	n.a.
Total Assets	**9,061.8**	**100.0**	**10,318.3**	**100.0**	**3,952.8**	**100.0**	**4,573.0**	**100.0**

(a) Provisional.

Source: Central Bank of Sri Lanka

(b) Registered with the Department of Co-operative Development.

(c) Registered with the Department of Labour.

(d) Regulated by the Insurance Board of Sri Lanka.

(e) Regulated by the Securities and Exchange Commission of Sri Lanka.

(f) Market Intermediaries include Underwriters, Margin Providers and Investment Managers.

(g) As at end December 2012.

(h) Excluding the assets of Licensed Banks, Licensed Finance Companies and Specialised Leasing Companies which are registered as Market Intermediaries.

n.a. – Not applicable

2. Global Developments and their Implications for the Financial Sector

Global economic activity is expected to gather momentum, going forward. World output, which slowed down in 2012, is estimated to have slowed down further in 2013, despite settling on an upward sloping growth path. The International Monetary Fund (IMF), in its World Economic Outlook (WEO) released in April 2014, has estimated global economic growth in 2013 at 3.0 per cent. Whilst expecting world output to gather momentum, going forward, economists however have highlighted risks faced by the global economy.

While the economic recovery of different regions of the world has proceeded at varied paces, the US economy, the world's largest economy, which contracted in 2008 and 2009, has continued to expand since then, supporting the global economic recovery. In 2013, the US economy expanded by 1.9 per cent, year-on-year. The expansion of the US economy has been accompanied by a gradual decline in the US unemployment rate, which is estimated to have declined to 7.4 per cent in 2013, on an annual average basis, following its gradual decline from the recent peak level of 9.6 per cent in 2010. With economic conditions improving in the USA, there has been increased speculation about the timing of the gradual withdrawal of monetary accommodation in the USA. Market speculation in this regard has continued following the announcement by the Federal Reserve in December 2013 that it would be gradually reducing the pace of its asset purchases beginning in January 2014. Hence, the risk of particularly long-term interest rates in the USA rising more sharply than desired persists, which in turn raises the risk of the hitherto seen recovery of the US economy being dampened. Issues relating to the requisite fiscal consolidation in the USA meanwhile, added to market concerns about the strength of the recovery of the US economy. In other parts of the world, bond markets have become sensitive to news of

Table 2.1 World Output

Year-over-Year, Percentage Change

	2011	2012	2013	2014*
World Output	**3.9**	**3.2**	**3.0**	**3.6**
Advanced Economies	**1.7**	**1.4**	**1.3**	**2.2**
United States	1.8	2.8	1.9	2.8
Euro Area	1.6	-0.7	-0.5	1.2
Japan	-0.5	1.4	1.5	1.4
United Kingdom	1.1	0.3	1.8	2.9
Canada	2.5	1.7	2.0	2.3
Emerging Market and Developing Economies	**6.3**	**5.0**	**4.7**	**4.9**
Commonwealth of Independent States	4.8	3.4	2.1	2.3
Russia	4.3	3.4	1.3	1.3
Emerging and Developing Asia	7.9	6.7	6.5	6.7
China	9.3	7.7	7.7	7.5
India	6.3	4.7	4.4	5.4
ASEAN-5	4.5	6.2	5.2	4.9
Latin America and the Caribbean	4.6	3.1	2.7	2.5
Brazil	2.7	1.0	2.3	1.8
Mexico	4.0	3.9	1.1	3.0
Sub-Saharan Africa	5.5	4.9	4.9	5.4
South Africa	3.5	2.5	1.9	2.3
Middle East and North Africa	3.9	4.1	2.2	3.2

* Projection

Source: Table 1, World Economic Outlook, International Monetary Fund, April 2014

Chart 2.1 Yield Rate of US Treasury Securities with a Remaining Maturity of 10 Years

Source: U.S. Department of the Treasury changes in the accommodative monetary policy stance of the USA. They have become vulnerable, given the heightened possibility of the withdrawal of funds by foreign investors who crowded into their markets with the stepping up of the quantitative easing programmes of the advanced economies.

The gradual strengthening of the US economy has helped boost economic activity in other parts of the world. Sri Lanka's exports to the USA, the largest destination for the country's exports, accounting for about a fifth of total exports, showed a gradually declining trend during the period from 2006 to 2009 but have shown an increasing trend since 2009. In 2013, Sri Lanka's exports to the USA increased significantly, particularly during the latter half of the year[1]. The growth of exports to the USA, the largest market for Sri Lanka's garment exports, which have the biggest share of around 40 per cent in the country's exports, has helped revive Sri Lanka's export performance. Improved performance of industries producing for export, in turn, would help improve the performance of the financial sector, given the significant share of the output of export oriented companies in total factory industry output.

Economic activity in the Euro Area has shown signs of strengthening. GDP of the Euro Area increased on a quarter-on-quarter basis during the last three quarters of 2013, following six consecutive declines since the last quarter of 2011. On a year-on-year basis, seasonally adjusted GDP of the Euro Area increased by 0.5 per cent in the fourth quarter of 2013, following declines in several consecutive quarters. For the year 2013 as a whole, the Euro Area recorded negative growth, that is, a growth rate of -0.4 per cent, following the contraction recorded in 2012. With respect to the member states of the Euro Area contributing to the decline in its GDP, Greece and Portugal have been burdened by sovereign debt related issues. In 2013, Greece's economy is estimated to have contracted for the sixth consecutive year, while Portugal's economy has also contracted, for the third consecutive year. The economies of Spain and the Netherlands, which have struggled with bloated financial sectors, have also contracted in 2013, following their contraction in the previous year. Italy's economy has also contracted in 2013, following its contraction in the previous year, with fiscal expenditure related issues weighing on its performance.

1 Sri Lanka's exports to the USA, which amounted to USD 2,126 million in 2012 increased to USD 2,494 million in 2013.

Germany, whose economy accounts for the largest share of more than a quarter of the Euro Area's economy, continued to expand in 2013, albeit at a modest pace. Although economic activity in Germany has been weighed down by the continuing recession in some European countries and the restrained growth of the global economy, Germany's economy expanded by 0.5 per cent in 2013 on the back of strong domestic demand. France, whose economy accounts for more than a fifth of the Euro Area's economy, also expanded by 0.3 per cent in 2013 following the zero per cent growth recorded in the previous year. Meanwhile, economic activity in the European Union, which has 28 member states including the United Kingdom (UK), compared to the 18 member states of the Euro Area, expanded in 2013, by an estimated 0.1 per cent, year-on-year. The UK, a country which accounts for more than 10 per cent of Sri Lanka's exports and is therefore the country's second largest export destination, has recorded GDP growth of 1.8 per cent for 2013, following the modest growth of 0.3 per cent recorded for 2012. Reflecting the strengthening of economic activity and the commensurate increase in consumer demand in the EU, a region which accounts for more than 30 per cent of Sri Lanka's exports, the value of merchandise goods exported to the EU from Sri Lanka increased in 2013, particularly during the latter part of the year, whereas a drop was recorded for 2012. Given the large share of the country's exports to the EU, healthy performance of exports to the EU will help maintain stability in the domestic foreign exchange market.

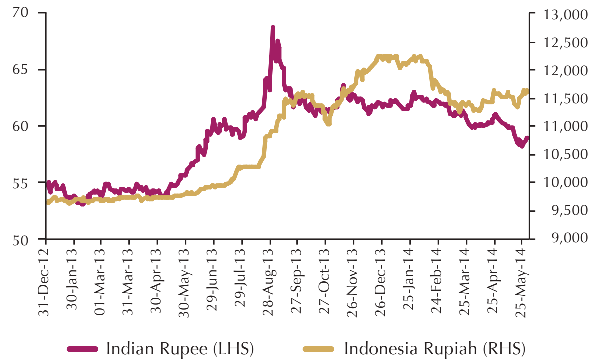
In Asia, Japan, the world's third-largest economy, has been pursuing aggressive monetary easing since December 2012. Japan's quantitative and qualitative monetary easing (QQE) operates through a virtually zero interest rate policy and purchases of financial assets by the Bank of Japan. Assets purchased by the Bank of Japan include Japanese government bonds (JGBs), exchange-traded funds (ETFs), Japan real estate investment trusts (J-REITs) as well as commercial paper (CP) and corporate bonds. QQE in Japan is aimed at its price stability target of 2 per cent introduced in January 2013, set in terms of the year-on-year rate of change in the consumer price index (CPI), with the ultimate objective of overcoming deflation and achieving sustainable economic growth. In response to these policy measures, domestic demand has picked up while the Japanese yen depreciated significantly, by more than 18 per cent against the

US dollar in 2013, supporting Japan's export oriented industries. Hence, Japan's economy strengthened and output has expanded. While Japan's economy grew by 1.5 per cent in 2013, unemployment has also been declining in Japan. Japan's unemployment rate fell to 4.2 per cent in 2013 from 5.1 per cent in 2009–2010. Japan now faces the challenge of fiscal consolidation, but Japan's economy is expected to continue its modest recovery.

With the weakening of the Japanese yen in foreign exchange markets, the Sri Lanka rupee appreciated by more than 18 per cent against the Japanese yen during 2013. Along with the appreciation of the rupee *vis-à-vis* the Japanese yen, a significant increase in vehicle imports into Sri Lanka from Japan was witnessed during the year. Hence, in contrast to the significant drop recorded for 2012 in respect of vehicle imports and the continued decline in vehicle imports during the first five months of 2013, vehicle imports increased significantly, on a year-on-year basis, from around mid-2013. Given this trend in vehicle imports, in order to prevent any undue pressure on the rupee arising from a surge in vehicle imports, the Central Bank imposed margin requirements against letters of credit (LC) opened for the importation of specified motor vehicles. Accordingly, with effect from 30 August 2013, LCs opened with commercial banks for the purpose of importing specified vehicles had to be covered by a minimum cash margin of 100 per cent of import value deposited with the LC opening banks at the time of opening such LCs. Further, banks were not allowed to grant advances for the purpose of enabling such customers to meet the minimum margin requirement. However, in view of the improvements taking place in the external sector, these margin requirements were removed subsequently, to be effective from 2 January 2014.

Alongside the gradual strengthening that has been evident in advanced economies, emerging market economies' growth has slowed down. The IMF, in its World Economic Outlook released in October 2013, highlighted the dual challenges of a slowdown in growth and tightening global financial conditions faced by emerging economies. The IMF attributes the slowing down of economic growth in emerging market economies to both cyclical factors as well as a decrease in potential output. With respect to potential output of emerging market economies, their ability to pursue an export led growth strategy has become somewhat

Chart 2.2 Currency Units per US dollar

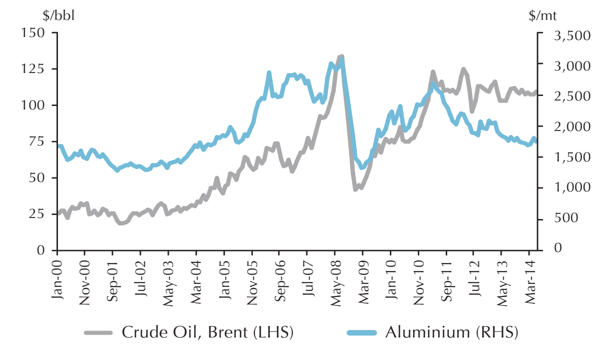


Source: Reuters

limited since the unfolding of the global financial crisis, thereby constraining their ability to expand at the pre-crisis pace. In view of the susceptibility of some emerging and developing economies given the prevailing global economic conditions, they experienced capital outflows following the announcement by the Federal Reserve in May 2013 that it would evaluate the possibility of reversing its unconventional monetary policies, quantitative easing (QE), in particular. Equity markets were seen retreating to varying degrees in several emerging economies. Such developments in turn led to a tightening of financial conditions in several emerging economies. For example, government bond yields in Brazil, Indonesia, Mexico as well as South Africa increased significantly from the levels seen during the early part of 2013. Currencies of emerging market economies also came under pressure. Indonesia, India and Brazil for example, raised their policy interest rates during 2013, thus giving support to their currencies. The depreciation of the Indian rupee in international markets meanwhile, resulted in the Sri Lanka rupee appreciating against the Indian rupee, by more than 10 per cent during 2013. Given that India accounts for nearly a fifth of Sri Lanka's imports and is therefore the largest import originating country, this appreciation is significant in relation to Sri Lanka's external trade and trade financing.

Despite the challenging environment that emerging and developing economies face, several key developments are supportive of a pick-up in economic activity in these countries. The strengthening of advanced economies will help drive export growth. Relatively low real interest rates prevalent in many countries are supportive of domestic demand. Further, in view of the lower growth of demand from emerging

Chart 2.3 **Prices of Crude Oil and Aluminium in the World Market**



Source: The World Bank

market economies, particularly China, and the still large output gaps of many advanced economies, commodity prices in the world market have subsided, as reflected by prices pertaining to oil and metals, for example. The average price of crude oil (Brent) was USD 108.86 a barrel in 2013, in comparison to the average price of USD 111.97 a barrel in 2012. With respect to metal prices, the average price of aluminium was USD 1,847 a metric ton in 2013, in comparison to the average price of USD 2,023 a metric ton in 2012.

As demand from emerging market economies, particularly China, is expected to remain subdued in 2014, price pressures are not foreseen in relation to commodities such as crude oil or metals, in 2014, except in the case of hitherto unforeseen geopolitical tensions. Given that the global economy has stabilised, as global economic activity gathers momentum gradually, pressures on prices of precious metals are also expected to ease, as institutional investors increasingly consider them less attractive "safe haven" investment alternatives.

Amongst emerging countries, India, whose GDP growth slowed down to 4 – 5 per cent in 2012 and 2013, following strong growth during much of the period since 2005, is expected to grow by over 5 per cent in 2014. China's economy meanwhile has been stabilising with credit growth declining to sustainable levels, but is expected to grow by over 7 per cent in 2014.

Taking cognizance of the origins of the crises that have engulfed some economies in recent years, stronger regulatory standards are being phased in for banks and other financial institutions globally. Key amongst these are the Basel III reforms, developed by the Basel Committee on Banking Supervision, in its continuous effort to enhance the banking regulatory framework. Basel III is a comprehensive set of reform measures aimed at strengthening the regulation, supervision and risk management of the banking sector so that it is better able to absorb shocks arising from financial and economic stress, thereby reducing the risk of spillover from the financial sector to the real economy. It builds on the International Convergence of Capital Measurement and Capital Standards document (Basel II). Basel III is to be implemented in several steps by 2019, with the goal of promoting a more resilient banking sector globally. In Sri Lanka, the Central Bank of Sri Lanka is taking the necessary measures to ensure that banks operating in Sri Lanka would be fully compliant with the Basel III regulatory framework by 2019, which will help further strengthen financial system stability in the country.

Globally, economic activity is expected to gather momentum going forward and Sri Lanka's economy is also expected to post better performance in 2014. The gradual pick-up in global economic activity will be supportive of Sri Lanka's exports while the easing of the monetary policy stance by the Central Bank of Sri Lanka and the consequent downward adjustment of market interest rates will support a further strengthening of domestic economic activity. The money market is expected to continue to have excess liquidity in the months ahead, supporting a further decline in lending rates in line with the easing of the monetary policy stance by the Central Bank. With the receipt of the proceeds from the sovereign bond issued in early 2014, liquidity in the domestic foreign exchange market has also improved further. Increased activity in relation to listed equity as well as corporate bonds is also expected given the expected strengthening of domestic economic activity.

Quantitative Easing: Unconventional Policies and their Effects on Emerging and Frontier Economies

Introduction

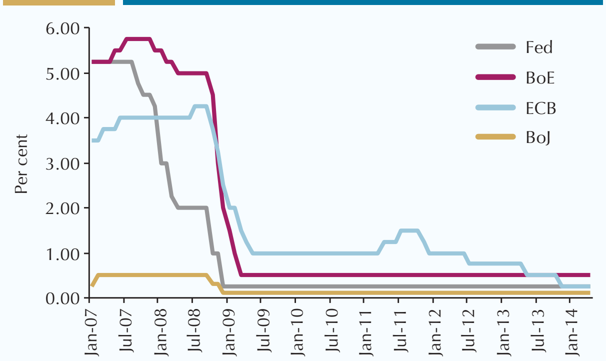
The recent global economic and financial crises witnessed central banks and monetary authorities around the world, deviating from their traditional monetary policy tool of short-term interest rates to using more unconventional, quantity based tools for the conduct of monetary policy[1]. Prior to the financial crises of 2008, the main tool used in the conduct of monetary policy was the short-term interest rate. The crises challenged the traditional conduct of monetary policy in three respects. Firstly, widespread financial disruption weakened the transmission mechanism hindering the transmission of policy rate changes along the yield curve and across asset classes. Secondly, the freezing of credit markets also hampered the conduct of traditional monetary policy. Thirdly, the severity of the recession pushed policy rates close to the "zero lower bound" level. Major central banks in advanced countries responded to the crises with unconventional monetary policy with the aim of achieving two objectives; restoring the proper functioning of financial markets and intermediaries, and providing further monetary policy accommodation at interest rates near the "zero lower bound". The restoration of the proper functioning of the financial markets and intermediation necessitated the provision of liquidity and private asset purchases while monetary policy accommodation required forward guidance and bond purchases. These policy actions undertaken by major central banks are broadly referred to as unconventional policies.

Among the unconventional policies adopted by central banks, quantitative easing (QE), was the most popular method used to influence market liquidity. QE entails the purchase of unconventional assets by a central bank thereby expanding the balance sheet of the central bank and the monetary base directly[2]. QE is defined as any policy that unusually increases the balance sheet of the central bank (Fawley and Neeley, 2013). This process enhances market liquidity, thus providing the necessary finance to revive output and employment back to the pre-crisis state. Through the purchase of assets, central banks provide direct lending to specific sectors of the market, such as distressed short-term credit markets, while also reducing long-term interest rates. By purchasing a certain type of asset with a certain maturity, a central bank can assume the risk for such period, thereby reducing the demand from investors for more compensation to hold such assets.

The four key central banks in the advanced world, the Federal Reserve of the US (Fed), European Central Bank (ECB), Bank of England (BoE) and Bank of Japan (BoJ), announced their initial large scale, outright asset purchase programmes during the period from fall 2008 to spring 2009[3]. The Fed and the BoE targeted large amounts of assets to purchase, while the ECB and the BoJ implemented policies to elastically supply loans to the market with small, targeted asset purchases being carried out.

The Fed implemented the QE process in three phases. The first phase of QE managed to quell the financial crisis from transforming into a full blown economic crisis of the magnitude of the Great Depression in the 1930s. Lehman Brothers crash in September 2008 resulted in market turmoil with the interbank market freezing up overnight. The increased perception of risk resulted in soaring risk premia coupled with illiquidity placing institutions in a

Chart B1.1 Main Policy Rates of the FED, ECB, BoE and BoJ



1 Traditionally, the main tool in the conduct of monetary policy in advanced economies has been a policy interest rate, which affects market interest rates through its direct impact on short-term interbank interest rates.

2 A central bank typically purchases Government securities in the conduct of OMO to affect liquidity. Under quantitative easing, central bank asset purchases included large amounts of securities issued by the private sector.

3 The BoJ has been utilising QE to stimulate the Japanese economy for almost two decades before the onset of the recent crises.

difficult position to seek additional funds needed for their operations. This financial market turmoil required a swift response from the monetary and fiscal authorities to provide emergency liquidity to the market to ease the pressure felt by banks and non-bank financial institutions. However, real economic activity remained sluggish with disinflationary fears in the US economy prompting the Fed to consider continuing with asset purchases. Accordingly, the second phase of the asset purchasing programme titled QE2 began in August 2010, designed to lower long-term real interest rates. Meanwhile, growth concerns in the global economy, continuing sovereign debt crisis pressures, and stagnation seen in labour markets required additional policy support, which arrived in the form of an extension to the existing QE programmes. This extension or QE3 was announced in September 2012, with an extension of the maturity extension programme that committed the Fed to buy long-term Treasuries and sell an equivalent amount of short-term Treasuries, and was nicknamed "Operation Twist". During all phases of QE, the Fed's balance sheet expanded although broader monetary aggregates did not increase sharply due to increases in the monetary base being held by banks as reserves, mostly to be used as a safe, liquid asset during times of uncertainty.

The expansion of advanced economy central bank balance sheets had a tremendous impact on emerging and frontier economies (EFEs). The causes of this effect were at least two fold: first, these advanced economies were the key sources of the world reserve currencies and investment destinations for official reserves held by EFEs; second, these advanced economies were the major portfolio and direct investors in EFEs. As such, QE in the advanced economies affected EFEs through several transmission channels, in terms of interest rate movements, investment flows, exchange rate movements, trade flows, as well as global investor confidence and expectations.

The low, near zero interest rates in advanced economies for sustained periods of time together with low interest expectations posed diminished investment prospects within advanced economies. The relatively higher interest rates and returns of EFEs, which were riding on a growth wave, thus provided an avenue for investments from advanced economies, which resulted in increased capital and other financial flows to the EFEs in search of higher returns. Widened interest rate spreads between advanced economies and the EFEs also provided additional compensation for the increased risk run by investing in EFEs.

Increased inflows resulting from QE posed several challenges to EFEs. Capital inflows prompted sharp appreciations of domestic currencies of receiving economies, at times creating external sector imbalances. Such appreciations resulted in increases in import expenditure and discouraging exports, widening trade deficits in many economies. Further, intervention by the authorities to arrest the appreciation of domestic currencies through sterilisation increased domestic liquidity, complicating liquidity management. In addition, private inflows directed towards equity, debt and asset markets inflated asset prices, leading to bubble formation. Further, these investor sentiment-driven inflows or "hot money" naturally posed a risk of reversals due to a sudden shift in such sentiments, increasing volatility in the foreign exchange and asset markets, and leading to financial instability.

Although all stakeholders of the global financial system was aware of the fact that the advanced economy central banks would eventually need to reverse QE, the prolonged nature of the QE programme along with low interest rates was taken by many as a new "norm." As such, signs of the commencement of tapering of QE in June 2013, affected the investor sentiments severely, creating turbulence in global financial markets albeit at varying degrees. The long-term yields on US Treasuries increased and international markets saw equity prices falling with hot money outflows taking place. The emerging market economies, particularly India and Indonesia, experienced increased foreign exchange outflows, leading to increased volatility in domestic markets and reversing economic gains due QE. The damage caused by such adverse investor sentiments were perhaps more than the benefits accrued to these economies during the preceding period. Such damages were particularly severe in economies where effective measures to prevent "hot money" inflows at the outset were absent.

The effects of the news of QE tapering had a minimal unexpected impact on the Sri Lankan economy. An apparent shift in investor sentiments from long tenured Treasury bonds to short tenured Treasury bills was observed. Exchange rate volatility was mitigated by prudent management and timely communiques to the markets to ease market sentiment. The Sri Lankan rupee showed greater resilience compared to most of its regional counterparts as the Sri Lankan authorities have been careful in opening up the capital account and "hot money" inflows to Sri Lanka were limited[4]. As such, Sri Lanka emerged largely unscathed from market speculation over future monetary prospects of the USA and other advanced economies.

As the Fed announced in December 2013 the gradual tapering of its QE programme commencing in January

4 In particular, since the Fed announcement in May 2013, the Indian rupee and the Indonesian rupiah depreciated against the US dollar by 10.7 per cent and 19.9 per cent, respectively, by end 2013, while, the Sri Lanka rupee depreciated only by 3.4 per cent during this period. For the year 2013 as a whole, the Indian rupee, the Indonesian Rupiah and the Sri Lanka rupee depreciated by 11.7 per cent, 20.9 per cent and 2.8 per cent, respectively.

2014, global markets remained calm unlike at the time of the announcement of its intention to taper, in May 2013. Many analysts believe that this was because of the prospects of tapering were already factored in by the markets. As for EFEs, the episode of QE as well as its gradual tapering, which is currently taking place, yet again emphasised the need to maintain sound macroeconomic fundamentals consistently as well as the need to safeguard against purely speculative hot money inflows, which could do more damage in the long run than the short-term benefits of accepting such funds.

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3. Gold as a Financial Asset and related Risks

Introduction

Traditionally gold has been considered a store of value and a safe haven which is relatively immune to inflation and financial crises. Individuals have used gold for centuries to protect their wealth. With significant consumer demand from countries like India and China, the demand for gold as a financial asset has increased significantly, with its price increasing by over 6 times since the early 21st century. The global financial crisis which unfolded in 2007 saw the gold price increasing rapidly in the subsequent years with invertors' flight to quality and safety.

An Analysis of International Gold Prices since 1950

Under the gold standard of the Bretton Woods System which was established in 1944, 44 member states fixed their exchange rates by tying their currencies to the US Dollar which was in turn pegged to gold at US Dollars 35 per ounce. Over the years, as these economies expanded, with their funding requirements increasing beyond the funding limits that could be met under the gold standard, the Bretton Woods System was abolished in 1971 and the price of gold became market determined. During the first 10 years since

Chart 3.1 Movement of Gold Prices in the World Market : 1950 – 2013

Source: Bloomberg

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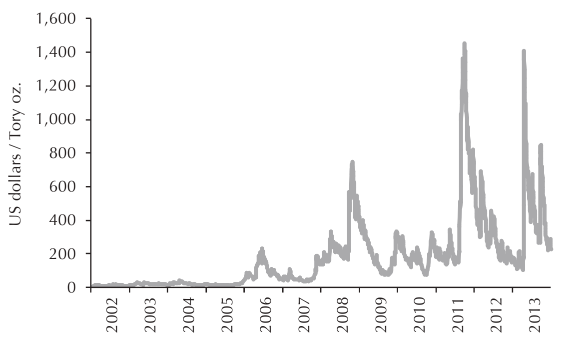
Chart 3.2 Volatility of Gold Prices in the World Market



Source: Central Bank of Sri Lanka Calcualtions

the abolition of the gold standard, the price of gold appreciated rapidly as gold was allowed to be traded freely. With high inflation and high unemployment in several major economies and several crisis events which occurred during this period, such as the oil embargo by OPEC in 1974, the Iranian revolution (1979) and the invasion of Afghanistan by the Soviet Union (1979), the price of gold increased by 2,328 per cent, reaching a high of US dollars 850 in January 1980.

During the subsequent 20 years, gold took a declining trend as inflation in major economies declined and the supply of gold was buoyed by new gold discoveries in North America and Australia. In September 1999 fifteen central banks holding gold as a part of their foreign reserves signed a collective agreement which is known as the Central Bank Gold Agreement (CBGA), to limit their gold sales following a period of uncoordinated gold sales by central banks which drove gold prices down to about US dollars 265 per ounce. The signatories to this agreement held 45 per cent of the global gold reserves. The agreement which covered a period of five years limited the collective sale of gold to 400 tonnes per year or an aggregate of 2,000 tonnes for the five year period. The signing of the agreement prompted a reversal of the declining trend in gold prices. Subsequently, two more agreements, CBGA 2 and CBGA 3 were signed with similar terms in 2004 and 2009. CBGA2 covered a period of five years and limited the collective sale of gold to 2,500 tonnes over the years from September 2004 to September 2009. Like the previous two agreements, CBGA3 also covered a period of five years from September 2009 to September 2014. The ceiling on the collective sale of gold as per this agreement was 400 tonnes per year or an aggregate of 2,000 tonnes for the five year period.

The increased demand for gold from India, China and Russia and the reduction in production of gold by about 10 per cent due to increased costs pushed gold prices upwards by about 600 per cent during the 10 year period from 2000 to 2010. The global financial crisis of 2007 affected global financial markets adversely and investors flocked to gold as a safe haven during the period of the crisis. Moreover, gold was used as a hedge against inflation, particularly during the recent episodes of booms in global commodity prices. Hence, gold prices increased sharply in world markets, reaching a high of US dollars 1,900 in September 2011.

However, since 2011, gold prices have plummeted due to several reasons. A revival of the US dollar, a rebounding of major stock markets and declining demand from Asian markets (China, India) are considered to be the major reasons for the price drop. From a peak of US dollars 1,900 per troy ounce in September 2011, gold prices dropped by 36 per cent to a low of US dollars 1,180 per troy ounce in June 2013 before recovering to US dollars 1,211 per troy ounce by end December 2013 . During 2013, gold prices declined by 28 per cent. The price forecasts made by international market analysts indicate that the price of gold would be within a range of US dollars 1,055 and 1,485 per troy ounce by end 2014.

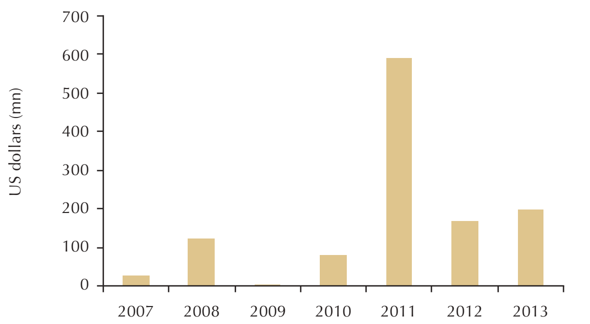
Local Gold Prices

As international prices of gold fluctuated, domestic gold prices also followed that trend, although with a lag. In 2011, on average, a 22 karat sovereign (7.787 grams) cost around Rs. 65,000, but with the decline in international gold prices, the average price of a 22 karat sovereign declined to around Rs. 51,000 in 2012. Currently, prices quoted by jewellers for a

Chart 3.3 Volume of Gold Imports

Source: Central Bank of Sri Lanka

Chart 3.4 Value of Gold Imports



Source: Central Bank of Sri Lanka

22k sovereign are around Rs. 42,000, which implies a decline of around 18 per cent during 2013. The import duty of 5 per cent, which was imposed on gold with a surcharge of 100 per cent, effective from 20 June 2013, curtailed gold imports, preventing local gold prices from declining further. However, with the revision of the tariff bands as per the national Budget for 2014, the import duty on gold was increased to 7.5 per cent while the surcharge has been removed with effect from 22 November 2013.

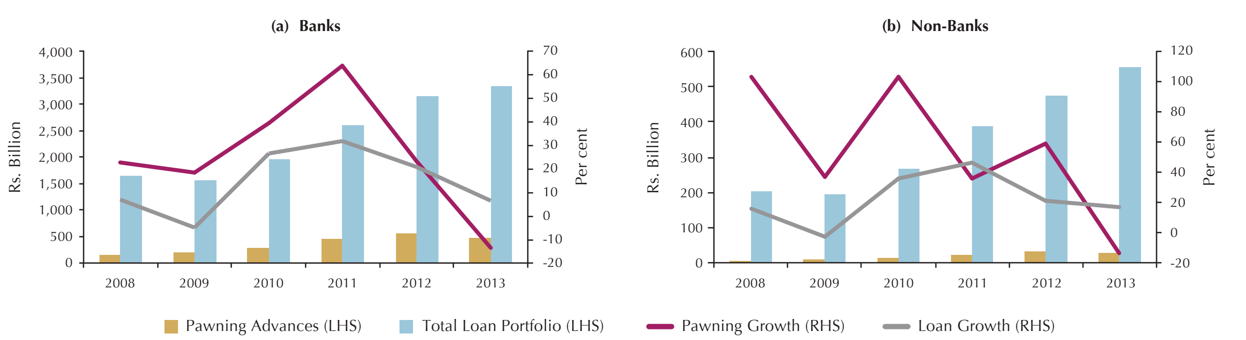
The Exposure of Banks, Finance Companies and Leasing Companies to Gold Price related Risks in Sri Lanka

Over the last few years, pawning[1] portfolios of banks, finance companies and leasing companies increased significantly. During the years when the price of gold increased continuously, the demand for pawning advances increased and several institutions expanded into this sector as per their overall expansion strategy. By end 2012, the pawning advances portfolios of banks, finance companies and leasing companies increased to Rs. 561 billion and Rs. 33 billion, respectively. However, as gold prices declined sharply in 2013 and new loans were restricted, the volumes declined to Rs. 485 billion in banks and Rs. 26 billion in finance and leasing companies by end December 2013. Consequently, pawning advances accounted for 14.5 per cent of the total lending portfolio of banks while they accounted for 4.7 per cent of the total lending portfolio of finance companies and leasing companies. However, there is wide heterogeneity in pawning exposures across individual banks as well as across individual finance companies and leasing companies. While some institutions have zero exposure to gold, several institutions carry significant exposure to gold.

In Sri Lanka, pawning advances have been used mainly in relation to consumption, agriculture or small and medium scale business. Banks, finance companies and leasing companies do not hedge their gold exposure since it is considered costly. Further, at the time pawning advances increased to peak levels in 2011, the average loan to value (LTV) ratio for banks in relation to pawning was 80 per cent while it was 85 per cent for the finance companies and leasing companies sector.

Generally, with sharply declining gold prices, there is a greater tendency amongst borrowers to abandon their pawning advances. As gold prices declined sharply in 2013, the default rates in the pawning portfolios increased, causing non-performing loans (NPL) to increase, specifically in the banking sector.

Chart 3.5 Pawning and Total Loan Portfolios of Banks, Finance Companies and Leasing Companies



Source: Central Bank of Sri Lanka

1 Pawning in Sri Lanka is based on gold and items made of gold.

3

The NPLs in relation to pawning in the banking sector increased from Rs. 4.8 billion in the year 2012 to Rs. 61.5 billion in 2013. However, banks have been able to recover a large part of the capital in relation to pawning advances granted by them, given the value and liquidity of the underlying collateral in the case of these advances, *i.e.*, gold.

Stress Tests for Gold Price and Default Shocks

Stress Tests were conducted on all banks, finance companies and leasing companies which have pawning portfolios, to ascertain the resilience of each institution to gold price shocks as well as default shocks. The resilience of banks, finance companies and leasing companies was measured by their capacity to absorb losses and their ability to maintain their capital adequacy ratios (CAR) above the minimum requirement of 10 per cent in the event of losses resulting from price shocks (measured in terms of price declines) and default shocks (measured in terms of run-off rates). Price shocks ranging from 15 per cent to 50 per cent were used for the stress tests while under each price shock, default shocks (run-off rates) of 15 per cent, 25 per cent, 50 per cent and 100 per cent were tested.

The results of the study indicated that the Banking sector was generally resilient up to a 15 per cent price shock (price decline) and a 25 per cent default rate. However, under price shocks higher than 15 per cent, several banks showed vulnerabilities if the default rates increased above 50 per cent. The vulnerability of the finance and leasing companies sector was high due to the large exposures to the gold price risk in certain companies. Most companies were in a position to absorb the price shocks provided the default shocks were below 50 per cent. The industry-wide capital deterioration in the banking sector and the finance and leasing companies sector at given price shocks and default shocks are given in the Table 3.1.

Measures taken by Banks, Finance Companies and Leasing Companies to contain the adverse impact of the decline in gold prices in international markets

A series of measures have been taken by banks as well as finance companies and leasing companies to mitigate the potential impact on their balance sheets arising from the decline in gold prices. They offered several incentives to their borrowers to reschedule their pawning advances, to minimise loan defaults. With a view to reducing non-performing loans due to their pawning business, banks have also granted a substantial amount of rebates in respect of interest payable on pawning advances. Meanwhile, provisions have been made by banks as well as finance companies and leasing companies carrying significant pawning portfolios, thereby mitigating risks faced by them due to potential losses arising from non-performing pawning advances. In the meantime, advances obtained by way of pawning by bulk borrowers such as jewellers and pawn brokers have been stopped or minimised. Banks have also introduced a separate loan scheme to settle the capital in respect of pawning advances on an instalment basis, subject to payment of interest in full. Some banks have held auctions to sell the articles of gold pawned to them. In addition, separate counters were set up in selected bank branches of some banks to sell articles of gold which could not be redeemed by

Table 3.1 Capital Deterioration of Banks, and Finance and Leasing Companies

Run-off Rate (Default Rate)	CAR deterioration (percentage points)					
	15% price shock		18% price shock		25% price shock	
	Banks	Finance & Leasing Companies	Banks	Finance & Leasing Companies	Banks	Finance & Leasing Companies
15%	0.5	0.0	0.6	0.0	0.9	0.1
25%	0.6	0.0	0.7	0.1	1.1	0.2
50%	0.7	0.0	1.0	0.1	1.8	0.4
100%	0.9	0.1	1.6	0.3	3.1	0.8

Source: Central Bank of Sri Lanka Calcualtions auctioning. Banks have had to take a haircut in selling the articles of gold pawned to them, but such sales have helped reduce losses from pawning portfolios. Hedging the gold held by banks as a result of their pawning business has been another option that some banks have availed themselves of to minimise risks faced in view of their pawning business.

Conclusion

Pawning remains a useful financial product particularly for those who are unable to offer alternative collateral as well as for those who may need money quickly in certain circumstances. Financial institutions offering pawning facilities to customers however, should ensure that the necessary prudential measures are in place which would help them remain stable even when faced with significant fluctuations in gold prices. Closely monitoring the movements of gold prices in world markets, introducing LTVs in respect of pawning, carrying out frequent reviews of the LTVs imposed taking into consideration the movements in gold prices in the world market, and carrying out stress tests in respect of pawning portfolios periodically and taking necessary prudential measures are key amongst such measures. Further, banks, finance companies and leasing companies should address the concentration risk pertaining to their loan portfolios, whenever lending to a particular sector is seen increasing rapidly.

4. Building Resilience of the Licensed Finance Companies and Specialised Leasing Companies Sector

Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) play an important role in the Sri Lankan financial system. They complement the role of licensed banks by filling gaps in the range of services offered by commercial banks whilst competing with them and forcing them to be more efficient and responsive to the needs of their customers. The LFCs and SLCs have been catering to a segment of the population that does not have easy access to the formal banking sector and has been concentrating mainly on lending based on collateralised moveable assets. The LFC and SLC sector has been offering products to relatively high risk segments in the economy, mobilising deposits and offering various financial services.

During the last decade, activities of the LFC and SLC sector have increased significantly, helping promote financial inclusion across the country. At present, LFCs and SLCs represent 7 per cent of Sri Lanka's financial system and continue to complement the banking system in financial intermediation. Thus, the role of the LFC and SLC sector will continue to be significant. Hence, building the resilience of the sector is important.

LFC and SLC Sector Expansion

During the last five years, the asset base of LFCs and SLCs recorded a compound annual growth rate of 23 per cent. At present, there are 48 LFCs and 10 SLCs providing financial access to many segments of the population.

The total asset base of the sector grew to Rs.717 billion by end 2013, driven mainly by the growth of the accommodations portfolio. Finance leases, hire purchases and other secured advances have been the core products of this sector. From the funding perspective, deposits were the major source of funding for the LFCs, while borrowings were the major source of funding for the SLCs. The funding sources have grown steadily enabling the sector to expand rapidly during the last several years. The statutory capital adequacy and liquidity ratios of the sector remain above the required minimum levels. The branch network stands at 1,060 with presence of the sector across the country, helping promote financial inclusiveness. Considering the projected economic growth, LFCs and SLCs are expected to record high growth rates and continue to be an important player in the financial sector.

Table 4.1 Growth of the LFC and SLC Sector in terms of Assets and Liabilities

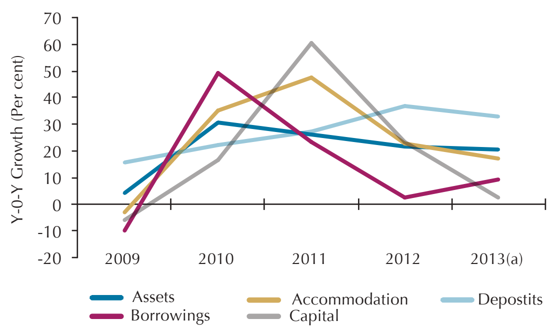
Rs. Billion

Item	2009	2010	2011	2012	2013(a)
Assets	297.3	387.8	489.8	596.6	717.6
Accommodations	196.2	265.4	388.4	471.7	553.1
Deposits	119.7	146.1	186.0	254.1	337.3
Borrowings	93.1	138.9	171.6	175.9	192.3
Capital	41.2	48.1	77.1	94.9	97.4

(a) Provisional

Source: Central Bank of Sri Lanka

Chart 4.1 Year-on-Year growth in terms of Assets and Liabilities – LFC and SLC Sector



(a) Provisional

Source: Central Bank of Sri Lanka

4

Challenges and Concerns

Often LFCs and SLCs lend on the basis of collateralized moveable assets to segments that do not have easy access to the banking sector. Despite the significant expansion of the sector, the business models of most companies in the sector have not encouraged significant diversification of products and services offered by the industry. Currently, around 80 per cent of the sector's lending portfolio hinges on finance leasing and hire purchases. Further, a number of the LFCs and SLCs are family owned business operations and they have been entrenched in systems centred around family legacies and outdated processes. A few of these companies have been subject to poor corporate governance and therefore poor integrity. The large and medium sized LFCs and SLCs meanwhile, will continue to expand further with public funds being raised by them by way of deposits or borrowings, to benefit from economies of scale, which in turn is likely to increase pressure on the smaller companies. Hence, smaller companies in the sector could find it challenging, going forward, in meeting regulatory standards in relation to capital as well as liquidity, for example, as well as remaining viable. Those financial institutions with weak balance sheets therefore will become increasingly vulnerable to domestic and external shocks. Hence, financial institutions with strong balance sheets which can benefit from economies of scale and have viable and efficient business models need to be promoted, going forward, to make this sector resilient.

In the past, a large number of LFCs and SLCs have operated with a high cost of funds as well as high interest spreads. The ability to attract domestic savings as well as obtain foreign borrowings, at rates which help them remain viable, will be key to being competitive and successful in the financial market. Relatively larger companies that benefit from economies of scale have been more successful in raising funds at rates that help them remain viable and competitive and therefore have managed to keep their non-performing assets at low levels. This again underscores the importance of amalgamation in this market segment.

Key regulatory measures implemented during the recent past

The Central Bank took several regulatory measures during the recent past in relation to LFCs and SLCs. These measures were aimed at helping them progress by building their capacities and strengthening their management. Given below are the key measures introduced.

- Introduced the Finance Business Act, No. 42 of 2011 to enhance the powers and supervisory capacity of the Central Bank.
- Increased the minimum core capital to Rs. 400 million for LFCs and Rs. 250 million for SLCs, to be effective from 2015.
- Introduced regulations in relation to corporate governance; made the board of directors responsible and accountable for the business as well as for promoting a robust risk management framework. Further, key management personnel have been assessed on their fitness and propriety, to ensure that capable and qualified officers conduct the business operations of LFCs and SLCs.
- Introduced an Information Systems Security Policy to ensure that the organization's information and databases are fully protected.
- Introduced a supervisory framework in relation to debt instruments issued by finance companies. This has encouraged LFCs to obtain long-term funding with a view to minimizing the short-term assets and liability mismatch. Further, liquidity requirements and maximum interest/coupon rates have been imposed for such debt instruments.
- Appointed a selected panel of External Auditors to carry out the external audit function of the LFCs and SLCs.
- Changed the maximum rate of interest which may be paid by a LFC for time deposits, in line with the monetary policy changes, to avoid excessive cost of funds.
- Encouraged SLCs to upgrade to LFC status, with a view to strengthening the resilience of these entities. In addition, during the last few years, LFCs and SLCs have been encouraged to merge with strong companies to improve their balance sheets.
- LFCs have been required to list on the Colombo Stock Exchange with a view to improving their transparency and accountability.
- Increased the statutory on-site examinations conducted by the Central Bank to ensure that each company is examined at least once a year.

Rationale for Consolidation

Consolidation is essential for building sufficient resilience in the LFC and SLC sector. Increasing capital and asset bases through consolidation would enable LFCs and SLCs to mobilize lower cost, long-term funds and build greater resilience to shocks. The synergies that could be achieved through consolidation meanwhile would help make available a wider array of products to customers. Diversifying the products offered and in turn, the customer base would help diversify risks, thereby helping them to become more resilient. Having a smaller number of larger and stronger firms would create an industry that is fully compliant with the Central Bank's supervisory and regulatory framework.

Over the past two decades, global financial markets have experienced a significant level of consolidation. Market-driven consolidation has not been the norm in emerging market economies and has mainly been observed in developed markets. In emerging market economies such as Malaysia and South Korea, consolidation in the financial sector has been an important reform measure taken by the respective central banks, following the financial crises faced by these countries. In countries such as Singapore, financial sector consolidation has been promoted to build strong and competitive financial institutions, which could embrace universal banking and thereby become one-stop shops for financial products.

In Sri Lanka, market driven consolidation has not taken place in the LFC and SLC sector. This phenomenon could be attributed primarily to the fact that many of the LFCs and SLCs are family owned businesses. Therefore, it is necessary that the authorities, namely, the Central Bank, drives the consolidation process in building a strong and stable LFC and SLC sector, which could cater to the future needs of the economy. Consolidation in the LFC and SLC sector is expected to yield the following benefits to the domestic economy.

a. **Large institutions dominate the sector:** During the past 5 years, the dominance of the top 20 LFCs / SLCs have increased as these companies are stable and less risky compared to smaller companies. As they become more dominant in the market, small companies could become weak and vulnerable.

Table 4.2 **Market Share of the LFC and SLC Sector**

Item	2009	2010	2011	2012	2013(a)
Assets:					
Market share of the top 20 (b)	82.6	83.6	85.3	85.0	86.3
Deposits:					
Market share of the top 20 (b)	93.7	91.6	92.8	90.0	91.4

(a) Provisional
(b) Top 20 LFCs/SLCs in terms of assets and the top 20 LFCs in terms of deposits

Source: Central Bank of Sri Lanka

b. **Certain business models are not cost effective:** With the envisaged growth of the economy, operations of the financial sector are projected to be elevated to the next phase, given the growing demand for cost effective and value added financial products, and the competitive market environment. However, most of the LFCs and SLCs have grown at their own slow pace whilst the post-war Sri Lankan economy has grown rapidly reaching higher levels in terms of income. Whilst this growth momentum in the economy is expected to continue, the LFC and SLC sector is expected to play a more supportive role by becoming more cost effective and enhancing its capacity for providing modern financial products.

c. **Strong corporate governance culture:** The financial institutions which failed in Sri Lanka in the early 1990s have revealed that the lack of corporate governance is the foremost reason for such failures. It is expected that consolidation would create an improved corporate governance culture, resulting in the effective and smooth functioning of LFCs and SLCs.

d. **Banking sector to consolidate and become stronger:** The banking sector is envisaged to be stronger in terms of size and resilience to shocks and demonstrate strength by way of performance. The banking sector will continue to strengthen in terms of capital, by consolidating to form larger banks, and therefore will be able to introduce new products and use enhanced IT platforms to be competitive in both domestic and international markets. In supplementing the banking sector, the LFC and SLC sector will be required to strengthen itself in tandem, by building into it the same dynamism, to enhance its role in the economy.

e. **Weak balance sheets face high risks:** It has been observed that LFCs and SLCs with weak balance sheets have been highly vulnerable to domestic and external shocks, resulting in them experiencing liquidity constraints, which in turn, had led some companies to even end up as distressed companies. As the domestic economy grows and becomes more integrated with the global economy, stronger LFCs and SLCs with a larger capital base will be expected to operate in the country, supporting the stability and progress of the country.

f. **High bargaining power:** Large and strong LFCs and SLCs would be able to attract foreign funding, borrow low cost funds and mobilize long-term funds. Their higher bargaining power would help them address concerns such as asset-liability mismatches, high funding costs and weak business models.

g. **Focused regulations:** The sector consists of LFCs and SLCs with various risk profiles, characteristics and management styles. This has made it difficult for the regulatory authority to impose a stringent regulatory framework as many companies would not be able to meet such compliance levels due to their structural weaknesses. Consolidation in the sector would enable the regulators to put in place a regulatory framework that ensures better performance of the sector.

Progress of the consolidation programme

As per the national budget for 2014, tax benefits would be made available to facilitate the consolidation of financial institutions. The Master Plan for the Consolidation of the Financial Sector was articulated by the Governor of the Central Bank to the relevant stakeholders on 17 January 2014. Subsequently, the Central Bank's senior management held one-on-one meetings with all boards of directors and the senior management of the local banks, LFCs and SLCs. As the next step, a framework for carrying out due diligence activities was established, and the audit firms that are eligible to audit banks, LFCs and SLCs have commenced due diligence of the relevant companies. In the meantime, the Central Bank has conducted several meetings with various other regulators and authorities, namely, the Securities and Exchange Commission of Sri Lanka, the Colombo Stock Exchange, the Ministry of Finance and Planning and the Department of Inland Revenue, to discuss regulatory matters. Further, the Central Bank's senior officials have participated in many knowledge sharing events on the subject of consolidation. In line with the Master Plan, all LFCs and SLCs submitted their plans for consolidation by 31 March 2014. While the Central Bank requires the relevant financial institutions to complete the process of consolidation by end 2014, satisfactory progress has been made in this regard in the LFC and SLC sector, so far.

Outlook

It is evident that the LFC and SLC sector has made a notable contribution towards the economic progress of the country by serving a segment of the population that is not catered to by the banking system. However, weaknesses in some institutions in this sector have made them vulnerable to shocks, endangering public confidence in the sector from time to time. Hence, going forward, it is necessary to take measures to strengthen the LFC and SLC sector. In this regard, paving the way for large and strong LFCs which can cater to the growing demands of the economy to strengthen and grow further and preventing failures in the sector, is important. Historically, the cost of funds of this sector was high due to the higher risk involved in their lending activities, when compared to banks, for example. The result was that several companies in the sector were not able to operate as a viable business. The Central Bank is promoting amalgamation of LFCs as well as SLCs with a view to reaping the benefits of economies of scale as well as economies of scope in the LFC and SLC sector, which would help these institutions to obtain funds at cost effective rates of interest and thereby lower their cost of funds. Hence, whilst improving their margins, consolidation would also enable LFCs and SLCs to better cater to segments such as the SME and microfinance sectors. Stronger financial institutions, of course, would help build a robust financial sector that would be resilient to shocks.

In line with the proposed plan for consolidation in the LFC and SLC sector, it is expected that the minimum core capital requirements for the sector would be raised further. Higher capital levels should make LFCs and SLCs more resilient, reducing the probability as well as the severity of financial crises affecting it, whilst allowing it to expand to cater to the growing financing needs of the economy. In parallel to the enhanced capital requirements, LFCs and SLCs would also be required to maintain an adequate liquidity buffer to face potential risks.

Although consolidation would involve a tedious process of integrating and rationalizing risk management, information systems, internal controls, organizational cultures and management of the relevant institutions, the resulting large LFCs and SLCs would be stronger and more diversified. Larger financial institutions however, would entail larger risks to systemic stability if they run into difficulties. The supervisory role of the Central Bank therefore is expected to intensify with frequent inspections and closer assessments while ensuring safety of the depositors. The resulting benefits from consolidation in the LFC and SLC sector to the economy would far exceed the cost and effort involved. In particular, the public would benefit from enhanced financial system stability.

5. Promoting Digitalization of Financial Transactions

Introduction

Efficient mechanisms enabling the settlement of financial transactions underlying economic activity, whether in the markets for goods and services or in the financial markets for stocks, bonds or other monetary instruments, are crucial to the development of economies. While transactions between economic agents involve payments requiring the movement of funds in a timely manner, as economies develop and economic activity becomes increasingly more sophisticated in nature, fund transfer mechanisms also have to keep pace by evolving. Globally, fund transfer mechanisms have evolved gradually in accommodating the changing needs of economic agents, from the primitive cash-less barter system to sophisticated cash-less digitalized payment methods.

Digitalization of financial transactions has offered consumers and financial intermediaries a vast range of benefits that are not available through traditional means of fund transfers. The most important advantage is the convenience in effecting financial transactions. Individuals can make payments, purchases and other fund transfers at unconventional locations 24 hours a day, 7 days a week. There is no need for a merchant location or a business to be open. As individuals can simply pull up their accounts online and make financial transactions, it helps to save time which is another important benefit of digitalized financial transactions. Once the initial set-up is completed, an individual can make financial transactions in a flash. Another benefit of digitalized financial transactions is the low cost when compared with traditional fund transfer mechanisms. Digitalization also lowers the risk of human error by reducing manual intervention for completion of a transaction once it is released by a payer. In addition to the convenience, time saving and low cost, financial intermediaries have the advantage of recording each and every financial transaction thereby easing the audit trail, mitigating risks and enhancing the efficiency of their businesses. Further, using digitalized modes of financial transactions has become more secure, as several security measures have been introduced by system developers at the initiation of the related systems, adhering to the international best practices.

Global Experience

Historically, cash and cheques have been the dominant instruments used for financial transactions. The process of digitalization of financial transactions began in the 1960s in view of the difficulties experienced and risks observed in the manual processing of financial transactions. At the initial stages of this process, the prevailing payment and settlement mechanisms, such as the cheque clearing process, were automated in order to provide a speedy mechanism to address increasing volumes of transactions. Over the years, with the evolution of information and communication technologies and rapidly changing requirements of consumers and financial intermediaries due to multifaceted economic and financial activities, a range of fund transfer channels and instruments have emerged, globally, for financial transactions. Payment cards, internet based payment facilities, Automated Teller Machines (ATMs), Electronic Fund Transfer Point of Sale (EFTPOS), Interactive Voice Response (IVR) mechanism and mobile phones are some of the modern fund transfer channels and instruments currently available in the global financial market. All these channels facilitate the completion of financial transactions digitally by debiting and crediting relevant

Chart 5.1 Number of Debit Cards per 1,000 persons (As at end of 2012)

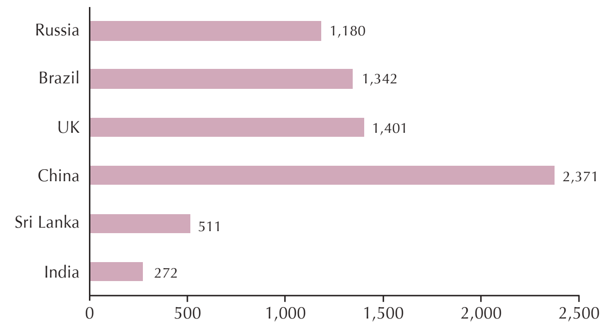
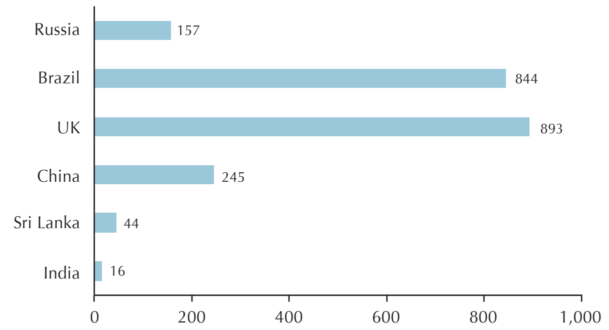


Chart 5.2 Number of Credit Cards per 1,000 persons (As at end of 2012)



Sources: Committee on Payment and Settlement Systems (CPSS) of Bank for International Settlements – Statistics on Payment, Clearing and Settlement Systems in the CPSS countries
Central Bank of Sri Lanka – Payment Bulletins

accounts through automated processing without using physical cash or paper-based payment instruments. Comparative data on payment cards, ATMs and EFTPOS terminals of selected countries for 2012 are depicted in Charts 5.1 – 5.4.

The revolutionary process of digitalization of financial transactions will continue in the future as well, leading countries to move gradually towards an increasingly digitalized, cashless society. Digitalization of financial transactions depends heavily on how efficient and robust the payment and settlement infrastructure which connects service providers, customer accounts and customers electronically, are. Therefore, many countries in the world have prioritized the development of payment and settlement infrastructure.

In examining the adoption of innovative payment products, an important fact that can be observed is the existence of many variations across different countries. For instance, in some countries, mobile phone based payment systems have been developed to address the payment needs of people who do not have access to the financial system, in order to promote financial inclusion, whilst in some advanced economies, mobile phone based payment systems have been introduced to enhance convenience in making payments at merchant outlets using technologies such as Near Field Communication (NFC).

Non-financial institutions have also shown considerable interest in offering digitalized payment products and have entered the financial services sector which was previously dominated by banks. Mobile network operators, in particular, tend to introduce mobile phone based payment and/or fund transfer systems, with a view to diversifying their business portfolios by venturing into new business where they can offer payment solutions, capitalizing on their knowledge and expertise in mobile phone technology. This tendency is more common in countries where the level of mobile phone penetration is high. However, the extent to which mobile payment services introduced

Chart 5.3 Number of persons per EFTPOS Terminal (As at end of 2012)

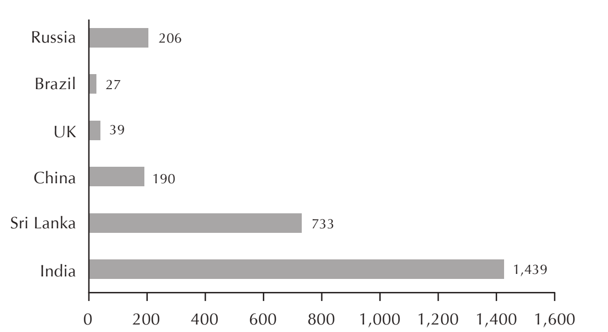
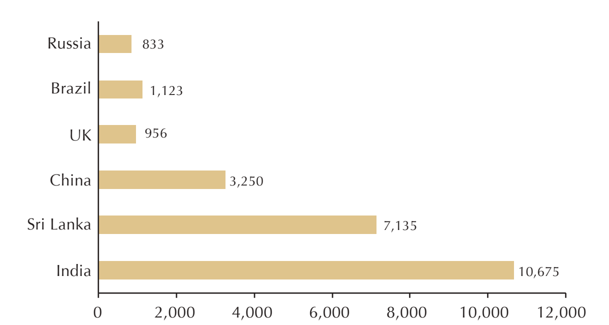


Chart 5.4 Number of persons per ATM (As at end of 2012)



Sources: Committee on Payment and Settlement Systems (CPSS) of Bank for International Settlements – Statistics on Payment, Clearing and Settlement Systems in the CPSS countries
Central Bank of Sri Lanka – Payment Bulletins

by these non-bank entities are used depends largely on the availability of a developed payment and settlement system which provides accessible, reliable and affordable services to the public. In countries where such developed national payment systems do not exist and where the percentage of the unbanked and under-banked population is relatively high, mobile phone based payment products have been keenly accepted by the public. The M-PESA system of Kenya which is a mobile phone based money transfer system is one such success story.

Given the progress made in respect of domestic fund transfer mechanisms in different parts of the world and the economic co-operation among countries, integrating digitalized payment and settlement systems at regional and global levels has increased potential and is likely to be the next step of the digitalization wave. For instance, integration of national level ATM networks at the regional level, providing easy access to travellers and migrants, is being already implemented in some countries while operators of well-developed national mobile payment systems are planning to extend those systems to other countries to promote mobile phone based remittances.

Developments in Sri Lanka

In Sri Lanka, digitalization of financial transactions began in the 1980s, alongside the economy-wide liberalisation process that was set in motion in the late 1970s. Since then, a gradual transformation of banking activities, that is, from manual processing to digitalized processing, has taken place with commercial banks introducing computerised methods for their day-to-day internal operations such as book keeping, balancing and transaction processing, with the objective of easing the workload associated with manual processing. This digitalization process was gradually extended by banks with a view to offering services of a higher quality to customers so as to provide them with greater convenience and easy-to-use mechanisms for banking. The Central Bank, as the regulator and the facilitator of the national payment system, and the National Payments Council, which is the highest decision making body in relation to payments and settlements in the country, comprising representatives of major stakeholder groups, have collectively facilitated the financial transaction digitalization process in Sri Lanka, by offering guidance and support while ensuring that digitalization of financial transactions takes place in accordance with international standards and industry best practices. Given below are the major events in relation to digitalization of financial transactions in Sri Lanka.

Evolution of Financial Transaction Digitalization in Sri Lanka

- Digitalization of financial transactions began in the 1980s, following the liberalization of the economy.
- The introduction of ATM cards in 1986 and credit cards in 1989 by commercial banks was an important landmark in the digitalization of financial transactions in Sri Lanka.
- In 1994, Sri Lanka Interbank Payment System (SLIPS) was introduced as an off-line electronic fund transfer system.
- Debit cards were introduced in Sri Lanka in 1997, facilitating the purchase of goods and services by making payments with funds held in the cardholders' bank accounts.
- Telephone/mobile phone based banking was commenced in the 1990s.
- Banks offered Internet Banking products in Sri Lanka in 1999.
- The introduction of an automated Real Time Gross Settlement System in 2003 was a landmark in respect of high value payments in Sri Lanka.
- The Cheque Imaging and Truncation System was launched in 2006 to digitalize the cheque clearing process.
- In 2010, the Central Bank commenced licensing service providers of payment cards and mobile payment systems to ensure safe and efficient retail electronic payment systems in Sri Lanka.
- SLIP System was upgraded to an on-line system with T+0 settlement facility in 2010.
- A mobile phone based e-money system was launched by a mobile network operator in 2012 to facilitate small value bulk payments using electronic money.
- Terminal Line Encryption Technology was adopted in 2013 for electronic fund transfer point-of-sales terminals to increase the security of payment card transactions.

5

Commercial banks in Sri Lanka introduced Automated Teller Machines (ATM) in the 1980s and provided ATM cards to customers as a convenient method for customers to withdraw funds from their accounts using the ATM network without visiting the bank premises. As at end 2013, there were 3,122 ATMs in the country. In view of the technological enhancements that have taken place, the ATM network presently provides not only the fund withdrawal facility, but also facilities such as cash deposits, balance inquiries, own account and pre-registered account transfers and sending funds to individuals who are not even customers of respective banks. In addition, ATM acquirers are now facilitating not-on-us[1] ATM transactions, as well. In order to reduce the cost of not-on-us transactions and maximise utilization of the available ATM infrastructure, Sri Lanka launched the Common ATM Switch (CAS) in July 2013, under the guidance of the National Payment Council.

Another landmark in the digitalization of financial transactions in Sri Lanka was the introduction of payment cards, namely, credit cards and debit cards. Credit cards were first introduced to Sri Lanka in 1989 and since then the use of credit cards has increased gradually due to the promotional activities of card issuers and the features that have been introduced to credit cards to meet various payment requirements of cardholders. As at end 2013, there were 12 credit card issuers licensed by the Central Bank operating in the country while there were 951,625 credit cards in use. Banks have also issued debit cards to their customers, enabling them to effect payments at stores using the funds in their accounts at banks, in addition to withdrawing funds through the ATM network. As at end 2013, there were 23 debit card issuers while 12,441,728 debit cards were in use in Sri Lanka.

With the introduction of payment cards to the payment system, the Electronic Fund Transfer Point of Sale (EFTPOS) mechanism was introduced in 1994 to facilitate purchasing goods and services by making payments with cards to merchants. The EFTPOS mechanism has expanded gradually throughout the country alongside the increase in the number of payment cardholders. As at end 2013, there were 27,955 active EFTPOS terminals in the country and there were 8 financial acquirers engaged in the financial acquiring business. Further, internet websites have also been created by service providers, which connect to payment gateways of banks to effect card-not-present transactions for e-commerce. With increased use of payment cards in the country, Sri Lanka also experienced fraudulent activities in relation to payment cards, such as data theft and hacking. Therefore, as a security measure, in March 2013, on the instructions of the Central Bank, all financial acquirers completed adoption of Terminal Line Encryption (TLE) technology for POS terminals in order to secure the payment card based transactions in the country.

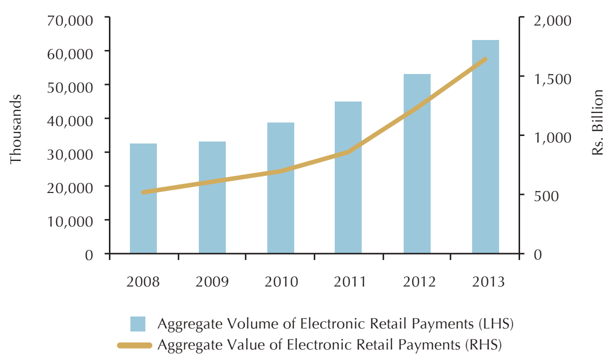
In addition to the above developments in digitalization of financial transactions, in line with global trends, telephone/mobile phone based financial transactions were also commenced in the 1990s and they have shown gradual progress over the years. At present, 10 commercial banks facilitate intra-bank transactions through mobile/phone banking. In the meantime, non-bank telecommunication operators also have introduced mobile phone-based e-money systems in Sri Lanka during the past three years.

The introduction of an automated Real Time Gross Settlement (RTGS) system for high value payments in 2003 is a landmark in the process of digitalization of financial transactions in Sri Lanka. The scripless securities settlement system for government debt securities was integrated with the RTGS system in 2004 in order to facilitate inter-bank financial transactions with regard to government securities, and the paper-based manual transaction processing and issuance of paper based government securities were discontinued. Accordingly, banks are able to effect inter-bank transactions as well as high value customer transactions through the RTGS, banks and Primary Dealers are able to transfer government securities digitally on a real-time gross basis and the Central Bank is able to maintain a central depositary system for government debt securities. The RTGS system meanwhile, has been expanded to carry out the net settlements of retail payments made through cheques, interbank payment arrangements and the CAS. The Central Bank has been operating and maintaining the RTGS system adhering to international best practices introduced by the Committee on Payment and Settlement Systems of the Bank for International Settlements.

Developments in relation to payments and settlements due to the digitalization of financial transactions

1 Not-on-us ATM Transaction means an ATM transaction made by a customer using an ATM terminal of another financial institution which is not the issuing entity of the card being used by the customer.

Chart 5.5 Electronic Retail Payments in Sri Lanka



Source: Central Bank of Sri Lanka

have changed the risk structure of the national payment system, resulting in risks associated with information security becoming a prime concern. As most digital payment products and systems are based on electronic records of funds, it is important that the requisite policies and procedures for managing risks are adopted by service providers so as to ensure reliability of the systems used and confidentiality of customer and transaction information and most importantly, to ensure that the value of the customers' funds are protected. With a view to ensuring the continued robustness of the payment and settlement systems as they become increasing more digitalized, the Central Bank has been studying the risk structures of the state-of-the-art payment and settlement systems and strengthening the applicable regulatory framework so as to ensure that the digital payment systems are stable, secure and reliable. The volumes and values of retail payment transactions effected through the electronic fund transfer mechanisms during the last 5 years are shown in Chart 5.5 which indicates a gradual shift of the Sri Lankan community towards the digital payment mechanisms.

Future Prospects

Digitalization of financial transactions is an ongoing process with continuous development of the mechanisms and the infrastructure available in a country for executing both large value and retail financial transactions. Considering the advantages of digitalization of financial transactions, which is a trend that could be observed globally, several initiatives have been taken to promote the use of electronic payment channels to settle financial transactions in Sri Lanka.

The implementation of common payment and settlement infrastructure to facilitate the timely settlement of inter-bank transactions is crucial for the development of new electronic retail payment products which offer customer convenience at a relatively low cost. Accordingly, the technologically advanced Common Card and Payment Switch (CCAPS) is being developed to facilitate inter-bank settlements in relation to electronic retail payment systems in Sri Lanka. The Common ATM Switch which is the first phase of CCAPS has already been implemented and measures would be taken to extend the switching system to facilitate point-of-sale (POS) transactions and mobile-phone based transactions in the country. With the introduction of this common infrastructure to facilitate the digitalization of financial transactions, financial institutions will be able to offer attractive electronic retail payment products.

As a measure of reducing transaction processing time while offering customer convenience, NFC technology is also being explored by payment service providers to be introduced for card-based payment systems as well as mobile payment systems. NFC-based payment products target mainly the market for low-value payments which are still dominated by cash. Financial institutions are also encouraged to issue pre-paid cards which can be used to settle retail payments and thereby reduce the use of cash in the country.

With the increasing popularity of payment cards, it has become imperative to improve the infrastructure facilities available for payment card acceptance. Mobile Point-of-Sale (MPOS) machines have been identified as the most cost-effective method of widening card acceptance infrastructure. Accordingly, financial acquirers of payment cards are showing increased interest in deploying MPOS machines, particularly in the case of small scale merchants who are unable to afford traditional point-of-sale terminals. The result would be more convenience to consumers as well as merchants, enabling them to make fund transfers digitally.

Conclusion

Digitalization of financial transactions has resulted in the introduction of many developed payment instruments while advancing many systems in the national payment and settlement system of Sri Lanka. A majority of the landmark events in the evolution of the national payment and settlement system in Sri Lanka during the last five decades are outcomes of the digitalization process. The benefits of financial transaction digitalization are not limited to the users of payment and settlement systems; the financial system and the economy as a whole has benefited from financial transaction digitalization.

The increasing use of electronic retail payment products will gradually reduce the use of cash in the economy, thereby lowering the cost of minting coins and printing bank notes. Most importantly, from an economic perspective, improvements in transaction efficiency gained through greater use of digital payment products will ultimately contribute towards fast-tracking economic growth.

For a country to reap the full benefits of financial transaction digitalization, it is important that the majority of the people use digital financial products. Therefore, measures should be taken to discourage the use of paper-based fund transfer instruments and promote the use of electronic products as alternatives. Further, to ensure a smooth shift from traditional payment systems to digital payment systems, continued measures need to be taken to enhance public confidence in the user-friendly digital payment systems and increase awareness about the digital payment systems.

6. Building a Strong and Dynamic Banking Sector

Introduction

The banking sector accounts for more than a half of the assets of the financial sector in Sri Lanka and therefore, it is the largest sub-sector within the country's financial sector. Hence, it could play a catalytic role in facilitating the development of the economy. Traditionally, banks accept deposits, lend money and offer other credit products such as credit cards and overdrafts, process payments, issue bank drafts and cheques, and offer safety deposit boxes for valuable items. However, to propel economic progress of the country, banks need to play a more dynamic role. To help raise efficiency and productivity across other sectors of the economy, banks would need to explore and embrace the opportunities afforded by new technologies whilst adapting their business models to the changing needs of the economy. To support the growth initiatives of the government as well as corporate entities, banks would need to take advantage of the opportunities afforded by the integration of financial markets worldwide, particularly in sourcing the required funds. In the meantime, it will continue to be of paramount importance that banks mitigate their risks, and remain sound and stable. A healthy, robust and stable banking sector plays a crucial role in supporting economic activity, promoting economic growth and ensuring financial stability.

Sri Lanka's banking sector facilitated the acceleration in economic growth witnessed in recent years by making available funds as well as payment facilities and other banking facilities to the diverse sectors of the economy. It did so whilst remaining resilient to adverse shocks. In the years ahead, Sri Lanka's economy is poised to reach higher levels in terms of output, with activity particularly in relation to construction, the leisure industry and emerging sectors such as the KPO and BPO sectors and the maritime sector expected to gather momentum. In propelling the growth momentum in the economy, banks would be called upon to play an increasingly more supportive role, by making available modern banking facilities as well as by funding the increasing volumes of economic activity. It is in this context that consolidation in the banking sector is important. The consolidation of financial institutions is aimed primarily at achieving economies of scale and scope. Economies of scale are particularly relevant to the financial sector today in view of the large outlays involved in adopting and upgrading information technology and related equipment necessary for providing modern financial services. With respect to the scope of activities of financial institutions, particularly in sourcing funds from international markets to support large projects such as those relating to infrastructure development, the strength of the balance sheets of financial institutions raising funds is of key importance. Taking cognizance of these factors, the Central Bank is taking the necessary steps to promote consolidation within the domestic banking sector.

The Need for a Strong and Dynamic Banking Sector

1. **Larger scale of operations to exploit opportunities**

   Larger banks, benefiting from economies of scale and providing a wider range of products and services, would be able to operate at a lower intermediation cost. Hence, they would be able to compete with large players both domestically and internationally. Further, the process of consolidation within the banking sector would be accompanied by banks

Table 6.1 Key Performance Indicators of the Banking Sector in Selected Asian Countries

Country	Return on Equity (%)	Return on Assets (%)	Net Interest Margin (%)
Sri Lanka*	16.0	1.3	3.5
India (Scheduled Commercial Banks)**	12.8	1.0	3.0
Pakistan**	14.4	1.2	3.5
Bangladesh***	8.2	0.6	2.8
Singapore***	11.8	1.1	1.6
Hong Kong***	16.7	1.4	1.4
Malaysia**	17.5	1.6	

* 4th Quarter, 2013
** End 2012
*** 2nd Quarter, 2013

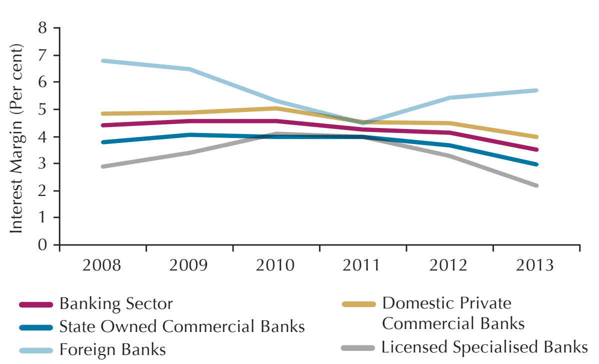
Source: Official Web Sources

enhancing their capital, and well capitalized banks will be able to be ranked high among the world's top banks and earn sound credit ratings, which will help them to be placed at the cutting edge of competitive banking.

2. **While the net interest margin could be considered a proxy for financial intermediation cost in banks, studies show that the variation in interest margins is due to bank-specific factors.** Margins tend to increase with higher riskiness of the credit portfolio, lower bank capitalisation, and smaller bank size. Concentrated market structures and the resultant lack of competition in banking systems, and institutional weaknesses constitute the key impediments that prevent financial intermediation costs from declining.

The average interest margin in the banking sector in Sri Lanka has been declining; however, the interest margin still remains above that of several Asian countries. This demonstrates that the interest margin needs to decline further.

Chart 6.1 Trends in the Interest Margin of the Banking Sector



Source: Central Bank of Sri Lanka

3. **Technology-driven banking to strengthen operational efficiency, delivery channels and risk management**

   - In diversifying and strengthening revenue streams, banks will no longer be able to continue to rely mainly on the delivery of core banking business through conventional brick and mortar structures. Investments in information technology (IT) based systems to improve banking efficiency and delivery of services will be vital. The resulting greater efficiency and outreach will help promote financial inclusion, reduce intermediation costs and thereby improve the bottom line.
   - Risk management in financial institutions must be strong to ensure their viability. Necessary investments in information systems including management information systems must therefore be made to facilitate sound risk management in banks.
   - Acquiring IT based systems can be very costly and will remain a challenge for many mid-tier banks. Banks therefore need to explore means to achieving synergy in operations so as reduce their costs of operations and increase their competitiveness.

4. **Diversifying revenue streams by embarking on new products and services**

   Fund based income continues to contribute significantly to the bottom line of banks in Sri Lanka. However, the range of fee based income generating products of banks need to be expanded, with banks undertaking other financial services such as bancassurance, investment banking activities, and private banking for wealth management, which will help enhance the fee based income of our banks whilst also enabling our banking sector to capture a share of the growing wealth management business in Asia. In this regard, a strong off-shore banking structure will provide the necessary thrust in attracting banking business from non-residents and in establishing an off-shore centre. These areas of business can leverage infrastructure developed for other banking activities thus improving the bottom-line.

5. **Diversifying funding sources to reduce risks and improve cost efficiency**

   As the economy grows and becomes more integrated with the global economy, strong banks will be expected to operate, particularly as the need for sourcing funds from overseas to fund large infrastructure projects arises. Strong banks will have the opportunity to raise capital with relatively longer tenures at competitive rates, thus reducing the vulnerability to capital flight. Mobilising funds at competitive rates will remain vital for our economy, especially to ensure the sustainability of Small and Medium Enterprises and their integration into the global supply chain.

6. **Complying with the enhanced regulatory framework to strengthen resilience**

The Basel III framework will require banks to build and maintain higher levels of capital with higher quality to meet the new requirements. The leverage ratio, which is a key reform measure under the Basel III framework, will also require banks to maintain enhanced levels of capital in relation to total assets irrespective of the level of risk undertaken. With the envisaged growth in banking assets, there will be additional pressure for banks to generate or infuse capital. While meeting the enhanced capital requirements would be challenging for mid-tier banks, consolidation in the banking sector would help them meet the more stringent requirements. Complying with the more stringent requirements of the Basel III framework meanwhile, will help boost public confidence in banks, which in turn will be an impetus to the growth of the banking sector. The domestic systemically important banks will need to maintain higher levels of capital and have in place bank resolution plans, which will enable them to minimise systemic risks if a stress situation arises.

7. **Expansion beyond domestic territories**

Expanding beyond the domestic market by establishing bank branches overseas and tapping international markets will be important in stabilising profits and diversifying risks. Such expansion will only be feasible if banks have the necessary resources such as expertise, capital and risk management systems.

8. **Addressing external vulnerabilities and spillovers**

Deleveraging in the advanced economies following the global financial crisis and the resultant contraction of balance sheets have an adverse impact on the emerging markets. In this context, banks' ability to diversify their markets, particularly in sourcing funds, will be key to expanding banking business.

9. **Sustainable pool of human resources**

Building a pool of professionals with the requisite skills in risk management and adapting the business models of banks to be in line with the emerging needs of the economy will help build up the competitiveness of banks. It is also important that banks attract and maintain a pool of skilled personnel that could cater to the emerging sectors in the economy.

10. **Strong corporate governance**

Having an appropriate mix of professionals who could lead and give strategic direction would help banks to be competitive and adopt business models that are most appropriate, taking into consideration the envisaged larger scale of banking operations and the accompanying complexity of operations. In the meantime, it is imperative that banks continue to strengthen their governance whilst taking measures to expand. Strengthening governance in the banking sector would help boost public confidence in banks whilst reducing the threat of reputation risk. Enhancing the independence of directors, disclosures in relation to capital and risk management, and strengthening the role and capacity of key management personnel would be vital to improving the health of banks.

11. **A regulatory framework on par with International Standards**

The stability and dynamism of the banking sector is influenced by the regulatory framework that is in force. Complying with a regulatory framework that is on par with international standards will benefit banks by helping them earn public confidence and compete in international markets. Undertaking intensified supervision and regulation of domestic systemically important banks, to prevent moral hazard and the costs associated with moral hazard due to them being 'too-big-to-fail' will be important following consolidation in the banking sector. Preparedness for crisis resolution and timely adoption of regulatory reforms will also be important in safeguarding the stability of financial institutions.

6

Change in the Business Models of Banks

A strong and dynamic banking sector, which could serve the growing needs of the economy by being competitive and effective will require a change in the business models of banks in Sri Lanka. The following are discussed in this regard.

A. Consolidation of the Banking Sector[1]: The banking sector needs to consolidate to improve its financial stability, its intermediation function, and access to finance. Consolidation can be in the form of mergers and acquisitions. Financial institutions should be strong in terms of capital, be competitive and efficient. The larger banks in the sector are expected to benefit from organic growth while the mid-tier banks are expected strengthen their economic viability and grow through consolidation. Meanwhile, consolidation will increase the market shares of banks, making it difficult for smaller banks to remain competitive.

According to the Banker, July 2013, the 'Top 1,000 Banks' in 2013 included 36 new entrants. Fifty per cent of the banks amongst the top 1000 banks in 2013 have strengthened their positions to enter into this group through organic growth, benefiting from the growth taking place in the emerging markets. For example, 10 banks from Latin America and 5 from South East Asia were amongst such banks. With a young population, a rising middle class and an abundance of natural resources, Latin American economies, in particular, have been benefitting from a surge in demand for commodities and have also been experiencing rapid growth, which has been driving the growth of the regional banking industry. The balance fifty per cent of the banks are from developed markets and their inclusion in the 'Top 1,000 Banks' has been largely following merger and acquisition activity or conversion into bank holding companies.

Regional Experience: Bank consolidation has been encouraged in many jurisdictions. Bank Indonesia has highlighted the importance of small banks consolidating to address their weak capital positions. The number of participants in Thailand's banking sector is due to shrink as competition and cost cutting fuels consolidation. Under the multiple license system in Vietnam, small and mid-size banks will be required to replenish capital as expansion will be inter-alia based on the strength of capital. Malaysia sees the importance of consolidation among banks to help integrate its financial system with other emerging economies and to venture into the next phase of development in the financial system. Singapore has encouraged consolidation of banks in commitment to having bigger and stronger local banks whose interests are aligned to the long-term interests of the economy, to strengthen the economic viability of small banks, and to provide Singapore with better services so as to be able to compete in the region.

B. Embarking on Universal Banking: Growth and stability of banks can be supported through a change in the banking business model. In the case of specialised banks, this change can be in the form of converting to a fully fledged licensed commercial bank, thereby not restricting the bank's operations to serving a specific economic sector or a client base. Through this, the concentration risk can be reduced. The universal banking model will permit banks to undertake commercial banking and investment banking activities thus diversifying the income sources and risks. The universal banking model has posed management challenges and has been found difficult to regulate. These structures also pose issues of conflict of interest between commercial and investment banking operations. However, with intensive supervision and new regulatory reforms in place, the risks of these structures can be addressed whilst harnessing the benefits of efficiency enhancement due to universal banking.

C. Subsidiarisation of bank branches: Subsidiarisation of bank branches entails merits given that it would then have its own capital and a board of directors. There will be a clear delineation between the assets and liabilities of the domestic bank and of its foreign parent. Subsidiarisation will clearly provide for ring fenced capital and assets to be held within the host country. Considering the importance of containing the negative externalities arising out of interconnectedness, and due to lack of effective cross border resolution regimes, subsidiarisation of bank branches is important.

1 The Master Plan for Consolidation of the Financial Sector can be accessed through the following URL:
http://www.cbsl.gov.lk/pics_n_docs/02_prs/_docs/speeches/speech_20140117e.pdf

The Way Forward: Strengthening the banking sector to spearhead growth

The main constituents of the banking sector are expected to embark on a distinct course of action in the form of consolidation and changing business models or business structures to strengthen their role in the economy.

Considering the fragmentation of the financial sector, H E the President, in presenting the national budget for 2014, enunciated tax concessions and benefits to facilitate financial sector consolidation. The Central Bank unveiled the Master Plan for Consolidation of the Financial Sector in January 2014, highlighting key aspects such as the objectives driving financial sector consolidation, anticipated outcomes of the consolidation process, and the approach to consolidation. The Master Plan sets out the following in relation to the banking sector.

- At least 5 Sri Lankan banks will have assets of Rs. 1 trillion or more, with such banks also having a strong regional presence.

- **State-owned Commercial Banks:** The presence of large and strong banks is vital to facilitating economic development and promoting stability of the financial system. The two state owned commercial banks, currently accounting for 36 per cent of the market share in terms of assets, are expected to expand their asset bases. The two banks, considering their size, interconnectedness and the role in the economy, have been identified as systemically important banks and will be subject to higher capital requirements under the Basel III International Capital norms. During the medium-term, the two banks will need to generate/infuse adequate capital to meet the expected asset expansion and higher capital requirements. The two state-owned commercial banks will be encouraged to grow and expand to have a stronger regional presence.

- **Domestic Private Banks:** The domestic private banks operating in our economy differ in terms of size and strength. To facilitate the envisaged expansion of the economy in the years ahead, larger and stronger banks would be required. Investments in information technology, for efficient delivery of services, and expertise, will be costly to small banks, thus posing challenges for such banks to remain competitive. Considering the need to maintain higher levels of capital to further strengthen resilience, and to have in place efficient delivery channels, the smaller banks will need to merge with larger banks to achieve synergy in operations. Banks which are not in a position to grow in a prudent manner will need to consolidate with other stronger banks to remain viable and enhance their role in the economy. Domestic banks which have assets amounting to less than Rs.100 billion will need to have assets worth Rs.100 billion or more, through organic growth and merger (or absorption) with other banks, finance companies or leasing companies, over a reasonable time horizon.

- **Foreign Banks:** Expanding and aligning banking operations of foreign banks with the domestic economic needs is important. Many foreign banks have been operating in Sri Lanka for over decades and are in a position to significantly grow and contribute to the economy. Further, when considering the need to reduce cross-border risk spillover to our economy, subsidiarisation of the operations of foreign banks will be beneficial.

  Going forward, new entrants will need to operate with dedicated capital for banking operations and separate Boards of Directors. The large foreign banks operating in Sri Lanka need to explore the possibility of converting to subsidiaries or adopt an alternative mechanism to safeguard their operations from spillover risks. Following the global financial crisis, similar financial reforms are being introduced in other parts of the world with a view to ring fencing operations of foreign banks to reduce the risks emanating from their parent bank/group entities.

- **Banks serving Niche Markets:** Financing micro enterprises and improving access to finance in the provinces remain important, to minimise regional disparities and strengthen the economies of the provinces. The banks catering to such segments will need to strengthen their capital positions and IT systems and build their capacity for efficient delivery of services. Banks with a regional focus, serving the niche market for micro finance, need to grow, increasing access to finance of the rural sector. Banks carrying out Islamic finance need to expand business and endeavour to develop products to raise funds for continuity of banking business.

- Banks would need to have state-of-the-art, effective IT applications. Banks will also have to substantially lower interest margins through increased efficiency and prudent management of assets and liabilities. They will also be expected to strengthen their off-shore banking operations and be able to attract funds, as well as conduct private banking on a wider scale.

- The smaller state-owned banks will be encouraged to merge with the bigger state owned banks or with one another and play a more cohesive role, since at present, these banks account for just 1.1 per cent of the market share.
- Considering the large number of non-bank financial institutions with little capital and assets, the banking sector is encouraged to acquire such institutions to further strengthen the financial sector through infusion of capital and instilling of strong risk management and corporate governance standards.
- To ensure that the consolidation process is smooth and effective, the following measures were taken by the Central Bank by way of facilitating the consolidation process.
  - Considering the importance of carrying out effective due diligence and valuation of business, the Central Bank appointed the Central Bank approved External Auditors to carry out such exercise. Further, with a view to ensuring independence of this exercise, the Central Bank stepped in to meet the related costs.
  - All licensed banks submitted their preliminary plans for consolidation and greater participation in economic activities, as required, by the end of the first quarter of 2014. Domestic licensed banks have shortlisted potential merger/acquisition counterparts and are carrying out internal evaluations of such companies.
  - Foreign banks in Sri Lanka have identified potential business areas through which they can increase participation in domestic economic activities. They would also need to pay greater attention to aspects such as expansion of the necessary skills, product development, expanding private banking and off-shore banking facilities, infrastructure financing; and support for the 5+1 Hub activities.
  - The Central Bank continues to maintain an active dialogue with key stakeholders of the financial sector consolidation process including other financial sector regulators, employee unions in the banking sector, the panel of external auditors and the public at large.
  - A special unit headed by an Assistant Governor and comprising of senior Central Bank officers from related functional areas to assist in the merger/consolidation process was established.

Challenges to be Addressed

The cost of financial intermediation remains relatively higher in Sri Lanka when compared with emerging Asian economies, for example. This is an issue that needs to be addressed in facilitating the desired acceleration in economic growth.

With a view to strengthening the domestic banking sector, the Central Bank intends raising the regulatory standards pertaining to banks' capital, in line with Basel III requirements. Given the volatilities in international financial markets however, raising additional capital at competitive interest rates in overseas markets could be challenging.

Crisis Preparedness to avoid Systemic Disruptions in the Financial Sector

Introduction

The global financial system has suffered immensely from the recent global financial crisis. The cost of the crisis in the United States of America (USA) alone has amounted approximately to a year's Gross Domestic Product (GDP), thus highlighting the importance of crisis preparedness, by way of which resolution costs can be avoided or reduced.

The first phase of crisis management would comprise intervention to contain contagion and reinstate confidence in the financial system. The second and third phases would involve handling the secondary effects of the crisis and strengthening the financial system to reduce the risk of avoiding future crises, respectively. Effective crisis management would make recovery and resolution of crisis affected financial institutions (FIs) feasible; ensure continuity of systemically important financial services, including clearing and settlement functions, by preventing severe systemic disruptions; protect depositors, and prevent exposing taxpayers to loss.

Crisis Management Tools for Financial Institutions

Probability of failure cannot be completely eliminated under any circumstances. Therefore, the focus of crisis management should be to make failures less disruptive and less costly. With that understanding, some tools that can be used in crisis management are explained below.

(i) Contingency Planning – Includes the following.

(a) Mechanisms and procedures to identify the roles and responsibilities within each relevant financial institution which would help implement clear governance arrangements to guide each of them.

(b) Action plan to enhance the resolution authority's ability to take action in a short period of time, and

(c) Plans to sustain critical financial system infrastructure and defined communication protocol which would facilitate communication with relevant institutions and affected parties.

(ii) Recovery and resolution planning

(a) Recovery Planning : Sets out the framework and options a FI can take up under severe stress to stabilise and restore its capital, liquidity and financial position needed as a going-concern. It takes into account specific circumstances of a FI and reflects the nature, complexity, interconnectedness, level of substitutability and the size of the FI. Key elements of recovery planning include measures relating to the governance framework, identification of recovery triggers and deciding on recovery options.

(b) Resolution Planning : This includes coordinated efforts of related authorities to have in place necessary tools and a detailed roadmap to address serious problems in a FI in order to maintain financial stability. Resolution plans provide means to restructure or to close down a bank, which is failing or likely to fail and whose failure would threaten financial stability and therefore, the continuity of critical functions of such FI is needed. When prompt corrective actions do not help in recovering of such FI, one or combination of the following options may be used in resolving the FI.

- Purchase and assumption – a healthy institution purchases some or all of the assets of a failed institution and assumes some or all of the liabilities, including all insured deposits.
- Bridge institution – identifying the good assets or essential functions of the bank and separating them into a new bank (bridge bank) which would be sold to another entity.
- Asset separation – transfer the bad assets of the bank into an asset management vehicle.
- Open Bank Assistance (OBA) – allows the FI to be open for full-scale or limited business on the next business day after being placed under the statutory management.
- Bail in – bank would be recapitalised with shareholders wiped out or diluted, and creditors' claims reduced or converted to shares.
- Bail out – An act of giving financial assistance by the government to save it from collapsing and liquidation.
- Liquidation – process of closing down a business, due to a reason such as insolvency, undercapitalization, unsafe/unsound practices, fraud or a combination of such reasons.

(iii) **Deposit Insurance :** As a financial safety net mechanism of the financial stability framework and as a key factor in resolution frameworks, Deposit Insurance plays a vital role in crisis management.

It is important to make use of both quantitative and qualitative triggers in recovery and resolution plans. Quantitative triggers are focused on firm-specific liquidity and capital measures, such as ratings downgrades, revenue reports, credit risk limits, equity ratios, increased collateral requirements, rise in public debt and adverse GDP forecasts. Triggers of reputational crises, difficulties in mobilizing funds at current market rates, unexpected loss of senior management, adverse court rulings and negative market press releases can be factored in qualitative triggers.

Broad Attributes of an Effective Crisis Management Framework

Based on the lessons learnt during the recent crisis, some broad attributes that can be considered a part of an effective crisis management framework of a FI are as follows:

(i) Clear assignment of responsibility for financial stability

(ii) Dynamic and responsive framework

(iii) Early identification of systemic risks

(iv) Appropriate balance between rules and judgments

(v) Accurate, relevant and timely information.

(vi) Knowledge of global interdependence and integration

(vii) Timely decision making

(viii) Identification of critical functions and critical shared services

(ix) Effective communication

Challenges for effective Crisis Management

Challenges include:

(i) Probable gap between actual vs. expected consequences

(ii) Determination of the recovery and resolution options

(iii) Agreeing on liquidity and capital triggers to activate the recovery plan

(iv) High level of planning requirement and costs associated with crisis management

(v) Obstacles to cross border resolution

(vi) Adverse impact on the business model

Progress made by Sri Lanka in Crisis Preparedness

The Central Bank of Sri Lanka has already implemented a crisis resolution framework. Its key components are as follows.

(i) The Sri Lanka Deposit Insurance Scheme (SLDIS) has been established under the provisions of the Monetary Law Act with effect from October 1, 2010 as a mandatory deposit insurance scheme for member institutions (licensed banks and licensed finance companies).

(ii) In case of emergency liquidity distress of a member institution of the SLDIS, a liquidity support system is available for member institutions under the SLDIS and the facility of lender of last resort (LOLR) is available for banks from the Central Bank.

(iii) Existing legal provisions under the Banking Act include resolution measures such as order of cease and desist from unsafe and unsound banking practices, vesting of banking business of a defaulting bank to another bank, liquidation of a distressed bank. Proposed amendments to the Banking Act will provide appropriate legal infrastructure to facilitate the appointment of new management as well as procedures for mergers and acquisitions in order to facilitate orderly resolution of distressed banks.

(iv) Existing legal provisions under the Monetary Law Act would also facilitate suspension and restriction of banking business.

(v) Existing legal provisions under the Finance Business Act would facilitate regulatory and resolution action in respect of licensed finance companies.

(vi) Intervening in appointing new Boards of Directors for distressed FIs in order to improve the financial position of such FIs and ensure the continuation of business without disrupting the financial system.

(vii) A crisis resolution framework has already been put in place by the Central Bank for banks and finance companies.

(viii) Inter-Regulatory Institutions Council of Sri Lanka (IRIC) has been formed to ensure close coorporation between financial sector regulators and strengthen financial system stability. MOUs with regulators in some jurisdictions have also been signed which will facilitate information sharing and cooperation.

(ix) Reforms in respect of capital and new requirements pertaining to liquidity under Basel III, for banks, are being discussed at present.

The way forward

Crisis preparedness requires taking proactive measures. Crisis prevention as well as recovery and resolution planning involve all key stakeholders of the financial sector.

Going forward, it would be beneficial to periodically review, and wherever possible, improve the instruments available for crisis prevention as well as crisis management. In addition, refining special requirements for local SIFIs in the case of resolution; simulation exercises to assess the feasibility of crisis management arrangements; implementation of stress testing frameworks for FIs, which would enable them to optimize their investment strategies and respond effectively in a crisis situation, would also help strengthen crisis preparedness of the financial sector.

With the participation of other stakeholders of the domestic financial system, the Central Bank continues to be engaged in the process of implementing, assessing and reviewing the measures already introduced by it so as to be better prepared to handle any crisis situation, thereby minimizing potential systemic disruptions.

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7. Recent Policy Initiatives and Developments in the Corporate Debt Market

Importance of a Developed Corporate Debt Market

Corporate debt market is a very effective alternative source of funding for the private sector. A well-developed, deep and liquid corporate debt market can also be a cheaper source of funds for the private sector and can make a significant contribution towards the country's growth prospects. The corporate debt market links the issuers having long-term financing needs with investors willing to place funds in long-term interest bearing securities. It also makes the financial market more competitive by generating market based interest rates that reflect the opportunity cost of funds at each maturity and reduces over dependence on the banking system. A well-functioning bond market offers issuers the flexibility to diversify their sources of funding and provides them with alternative sources of funds with different credit standards and varying maturities to match their specific expenditure needs. A well developed corporate bond market is particularly important for funds that have long-term liabilities such as life insurance companies and pension funds.

The complexities of banking systems and their exposure to a wide range of risks make them vulnerable during times of crisis. The Asian financial crisis of 1997-1998 underscored the limitations of even the reasonably regulated, supervised, capitalised and well managed banking systems in the region highlighting that liquidity pressures exerted during a crisis may lead to total disruption in the financial intermediation process in a country. The susceptibility of the intermediation process to disruption is high when a country's financial intermediation process is primarily dependent upon its banking system with no other effective alternative source of funding. Moreover, there is significant over reliance of the public and corporate sectors on short-term bank loans for long-term investments resulting in asset and liability maturity mismatches in the banking system.

Increased attention to Corporate Debt in Regional Markets

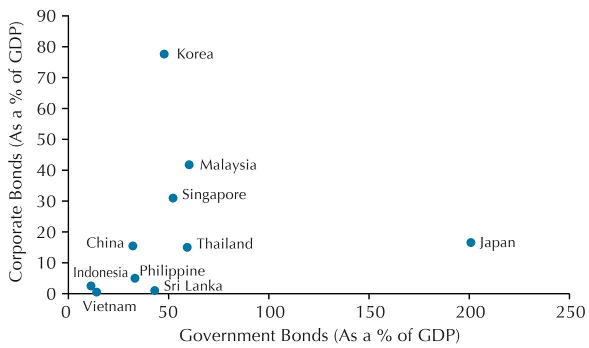
The expansion of the corporate debt market in the Asian region has received increased attention as corporate debt volumes in these markets have increased significantly during the last ten years. Subsequent to the 1997 Asian financial crisis, significant developments have taken place in corporate debt markets in Asian countries such as Korea, Malaysia, Singapore, Indonesia and Thailand.

Korea is one of the more advanced markets in Asia with a wide range of corporate debt instruments. The corporate debt market in Korea is larger than the government securities market, and accounted for 78 per cent of GDP as at end 2013. Immediately after the crisis, the corporate sector in Korea was very much in need of additional funds to be raised from the corporate debt market, since commercial banks adopted a very cautious approach to corporate lending. In response, the government raised the ceiling on an individual firm's corporate bond issuance from double to four times its equity capital, and removed all remaining restrictions on investments in domestic bonds by foreigners in December 1997.

The Malaysian corporate debt market represented 43 per cent of GDP whereas the government debt market accounted for 61 per cent of GDP as at end 2013. Malaysia introduced a Capital Market Master Plan in 2001 which was a 10 year strategic blueprint focussing on the development of the capital market.

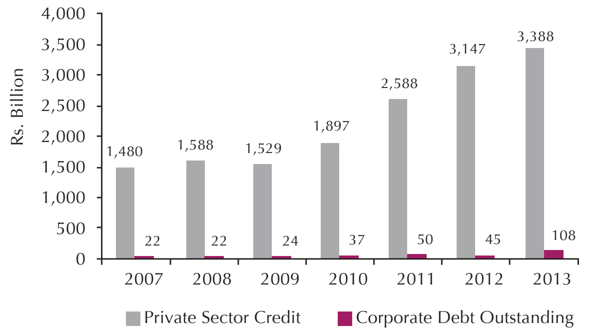
7

Chart 7.1 Comparison of Corporate Bond Markets in the Region (As at December 2013)



Source: AsianBondsOnline.adb.org (AsianBondsOnline web portal is an ASEAN+3 initiative supported by Asian Development Bank)

Chart 7.2 Private Sector Credit and Corporate Debt Outstanding



Sources: Colombo Stock Exchange
Central Bank of Sri Lanka

Thailand's corporate bond market has experienced significant growth and as at end 2013 the corporate bond market accounted for 17 per cent of GDP. For further improvement of the secondary market activities, the Bank of Thailand, in collaboration with other market participants has mapped out a multi-year action plan for the development of secondary market which focuses on improving efficiency and reducing transaction cost, increasing participant's ability to hedge risks, broadening investor base, *etc*.

Indonesia's corporate bond activities, including conventional and Islamic bond offerings, accelerated significantly beginning in 2003 and have maintained momentum since then. The Indonesia Bond Pricing Agency (IBPA) was established in July 2008 to improve transparency and ensure a fair trading environment in the bond market. The IBPA is responsible for establishing daily reference prices for government and corporate bonds, including conventional and Islamic debt issues. Hence, with the creation of the bond pricing agency, all market participants were given an equal access to price information to aid investment decisions.

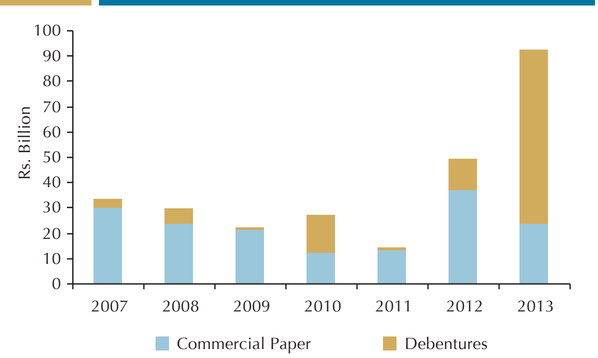
Corporate Debt Market in Sri Lanka

In Sri Lanka, the corporate sector is heavily dependent on the borrowings from financial institutions (Chart 7.2). The corporate bond market in Sri Lanka is very small accounting for only 0.8 per cent of GDP. The major factors hindering corporate bond market operations include the lack of liquidity due to the buy and hold strategy of investors, the limited number of large corporate players, the limited supply of high quality bond issues, disclosure issues, relatively high cost of issuing bonds, distorted risk reward system, the absence of a bid-ask price quotation system and the lack of awareness among investors.

An efficient bond market can play a critical role in the Sri Lankan economy, supplementing the banking system to meet the requirements of the corporate sector in respect of long-term capital investments and asset creation. There is a very high demand for funding within the corporate sector, given the number of investment projects in the pipeline after the end of the civil war. It also can provide a stable source of finance when the equity market is volatile.

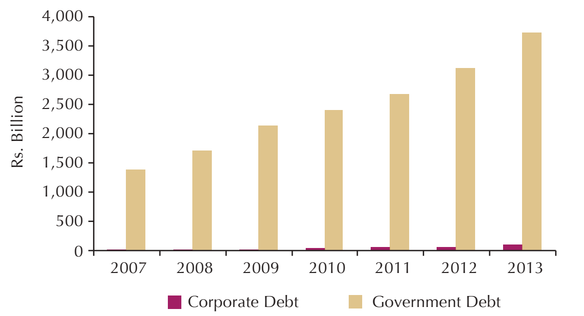
Currently, the corporate debt securities market in Sri Lanka comprises of short-term securities such as commercial paper and promissory notes and medium/ long-term securities such as debentures, fixed and floating notes and asset backed securities, namely trust certificates. There were 83 issues of debentures during 2013 which carried both fixed and floating

Chart 7.3 Value of Commercial Paper and Debentures



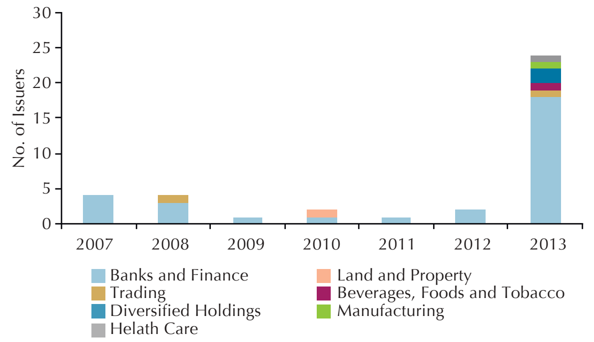
Sources: Colombo Stock Exchange
Central Bank of Sri Lanka

Chart 7.4 Corporate Debt and Government Debt



Sources: Colombo Stock Exchange
Central Bank of Sri Lanka

Chart 7.6 Issuer Profile in the Corporate Bond Market



Source: Colombo Stock Exchange

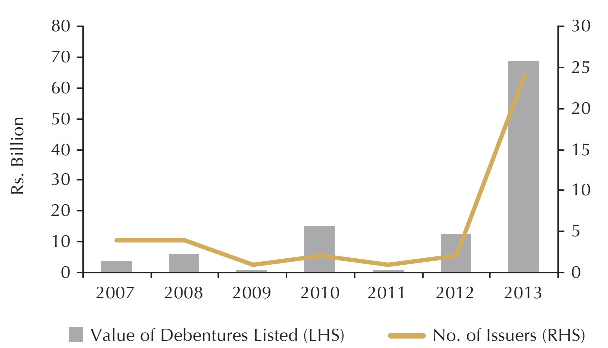
rates of interest, by way of which funds amounting to Rs. 69.1 billion were mobilised. Commercial paper and promissory note issues have become a very popular means of raising working capital in the money market. The total value of commercial paper issued with the support of banks amounted to Rs. 28.3 billion during 2013 in comparison with Rs. 36.9 billion in 2012 (Chart 7.3). The outstanding value of commercial paper amounted to Rs. 7.4 billion as at end December 2013 compared to the Rs. 10.6 billion in the corresponding period of 2012.

Although an active market exists for government bonds in Sri Lanka, the corporate bond market is still at an underdeveloped stage. Overall volumes in the corporate debt market are significantly small when compared with the government securities market (Chart 7.4).

Recent policy initiatives to develop the corporate debt market in Sri Lanka

Recognising the benefits of developing the corporate debt market, a series of measures and policy initiatives were introduced in Sri Lanka to facilitate the development of the corporate debt market. Fiscal policy measure introduced to withdraw the withholding tax on interest income from listed corporate debt as per the Budget 2013, has been successful in raising market activities significantly during the year. There were 83 issues of debentures during 2013 which carried both fixed and floating rates of interest, by way of which funds amounting to Rs. 69.1 billion were mobilised, compared to the 9 issues of debentures in the corresponding period of 2012, by way of which Rs. 12.5 billion was mobilised (Chart 7.5). As at December 2013, the corporate debt outstanding amounted to Rs. 100.8 billion compared to the Rs. 34.1 billion a year ago. The market capitalisation of corporate bonds increased gradually from Rs. 5.8 billion in 2000 to Rs. 71.2 billion as at end December 2013. However, the issuer profile in the corporate bond market shows a concentration among a few categories of market participants dominated by the financial sector including banks and non-bank financial institutions while non-financial corporations account for only a negligible number of issues in the past few years (Chart 7.6).

Chart 7.5 Debentures Listed on the Colombo Stock Exchange



Source: Colombo Stock Exchange

Capital Market Development Master Plan

The SEC and the CSE are working together in implementing a capital market development master plan to make the regulatory system more proactive, in line with international standards. This master plan intends to pursue 10 key strategies to further enhance investor confidence and develop the capital market in the country, which includes the development of the corporate debt market as one of the key strategies.

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Further, a joint committee comprising representatives from the CSE and the SEC has recently formulated a set of policies for the development of the corporate bond market. These policy measures include enhancement of the trading platform, creating a reporting platform, improving the information quality of bond market data, the establishment of a central clearing corporation and creating public awareness.

Alongside these developments, the Central Bank has initiated measures to develop market infrastructure for the government debt securities market which are expected to benefit the corporate debt market as well. The Central Bank is currently formulating a plan to introduce an e-trading facility through the Colombo Stock Exchange for all debt instruments (corporate & government) and their derivatives. Further, a Central Counterparty (CCP) arrangement for secondary market transactions in debt instruments, quoted shares, money market instruments and derivatives of such instruments is also being considered by the Central Bank together with the SEC, the CSE and LankaClear.

Primary Dealers to be Market Intermediaries

Previously only stock brokers who are members of the CSE were able to trade in listed corporate debt, although their expertise was in equity trading and not so much in fixed income securities. In order to ensure that there are adequate market intermediaries with expertise and appropriate systems infrastructure for trading in fixed income securities, Primary Dealers (PDs), who are experienced in government debt trading, were permitted to engage in corporate debt trading within some specific limits. PDs, who have a minimum capital requirement of Rs. 300 million, have been permitted to carry investment portfolios in corporate debt upto a maximum limit of 5 per cent of their investment portfolio.

Further Measures Needed to Facilitate Projected Economic Growth

The corporate bond market in Sri Lanka is projected to realize significant growth to reach US dollars 10 billion of outstanding corporate bonds by 2016. Despite earlier setbacks, the corporate bond market in Sri Lanka is ready for a rapid take off supported by the recent developments and events which have already created a very conducive environment. However, a series of more measures will need to be implemented to achieve rapid development and enhance efficiency of the bond market. A financial sector with a deep, well developed and liquid bond market will be more resilient to financial crises than a sector that relies mainly on bank financing. Hence, the rapid development of the corporate debt market will be essential to strengthening the stability of the financial sector. Further, the projected growth of the economy could be robustly supported by a stable financial sector.

Develop a benchmark yield curve. Developing a long-term, market determined and liquid yield curve for government securities, as a benchmark yield curve, is crucial for the development of the corporate bond market. Absence of a risk free term structure of interest rates makes it difficult to price the credit risk of instruments issued by the private sector.

Enhance trading efficiency in the market. Introducing an Electronic Trading Platform (ETP) has already been identified in several policy proposals aimed at developing the corporate debt market. An ETP, with its combination of electronic trading and centralised price dissemination, can provide bond traders a more complete and efficient platform for cost competitive trade executions. It can also lead to more effective price discovery and greater access by a wider range of investors, including retail investors. Bursa Malaysia introduced an ETP in 2008 for the Malaysian bond market to boost transparency and liquidity as well as increase efficiency in bond trading.

Establish a corporate bond index. Indices can be an important contributory factor in the development of the corporate bond market as it creates greater visibility, enables fund managers to track their performance against the index and promotes greater liquidity. Further, a corporate bond index may drive issuers to address any gaps and impediments that prevent their bonds being included in the index. Corporate bond indices are a characteristic of most developed capital markets.

Broaden and diversify the investor base. A broad investor base will accrue several advantages to the development of the bond market, through enhanced market stability, promoting financial innovation and contributing to expanding liquidity. Accordingly, measures need to be taken to develop a group of private institutional investors such as pension funds and mutual funds. To encourage wider foreign institutional investor participation, policies should focus on addressing regulatory obstacles, the cost of access, taxation and issues relating to capital controls. Active participation by foreign investors can provide greater exposure to international practices and standards and will enhance confidence in the local bond market.

Encourage the development of risk management instruments. Investing in corporate bonds exposes investors to market, credit and liquidity risks. The existence of risk management instruments such as forward, futures, swap, and option markets can help protect intermediaries against adverse market movements, interest rate risk and other risks inherent in corporate bond markets. This can be achieved by improving the product design of these instruments to meet the needs of users and by introducing product specialists to areas such as addressing tax issues and investment restrictions.

Promote trading and price transparency. Sri Lanka should have in place a trade reporting framework in the OTC market. This may include providing a centralised information dissemination system to ensure there is an effective price discovery process which would facilitate greater trading activities. In Malaysia, Bond Information and Dissemination System (BIDS) was introduced in 1997 to enhance the transparency of bond information. Similarly in Indonesia, The Indonesia Bond Pricing Agency (IBPA) was established in July 2008 to improve transparency and ensure a fair trading environment in the bond market. With the creation of a bond pricing agency, all market participants are given equal access to price information to aid investment decisions.

Enhance the quality and timeliness of disclosures by issuers. A framework that encourages the disclosure of clear, comprehensive and accurate information by issuers on a timely basis is essential for an efficient bond market. Developing a standardized template with a prescribed minimum content in the disclosure document will enhance the overall quality and timeliness of information disseminated to investors.

Maintain a database on bond information. A comprehensive database that captures trading activities in the primary and secondary markets would be useful to investors as well as regulators in supervising the market.

Establish a high level committee to facilitate the development of the corporate bond market. In Thailand, a Domestic Bond Market Development Steering Committee was established to promote the development of the domestic bond market, which is chaired by the Finance Minister and comprises high-level representatives from both the public and private sectors. An important milestone in the broader bond market development in Malaysia was the creation of the National Bond Market Committee (NBMC) in 1999. Its members comprised of senior representatives from the Ministry of Finance, Bank Negara Malaysia, Securities Commission, Bursa Malaysia and the Registrar of Companies. Establishment of a similar high level committee would be useful to steer the rapid development of the Sri Lankan bond market.

The development of the corporate bond market will be an incremental process that takes place over several years. In developing a well-functioning corporate debt market in Sri Lanka, much progress has been made during the recent past, but several issues and challenges remain. While the reforms proposed above could be implemented gradually, these will lay the foundation for strong and diversified financial markets that would underpin the sustainable growth of the financial sector and the economy.

8. Challenges and Prospects for 2014 and Beyond

The financial sector has to play a key role in supporting the economic growth target of over 7.5 per cent in 2014 amidst optimistic developments in the external and domestic economies. Although the global economic recovery is still sluggish, most of the major advanced economies are on a higher growth path, contributing to the projected increase in global growth to 3.6 per cent in 2014 from 3.0 per cent in 2013. Emerging and developing economies are also expected to grow by 4.9 per cent in 2014 compared to the 4.7 per cent growth in 2013, with continuous strong growth expected in developing Asia. On the domestic front, healthy economic growth is expected to continue, supported by the moderation in both inflation and interest rates.

The continued moderation of interest rates is expected to stimulate credit growth in 2014. Subsequent to the precautionary policy measures taken by the Central Bank to arrest excessive credit growth, which was above 30 per cent in 2011 and early 2012, credit growth moderated significantly in 2012 and 2013. Easing of monetary policy twice in 2013 as well as early in 2014 and the decline in inflation and inflation expectations have enabled a declining trend in interest rates. While a low interest rate regime is conducive to credit facilitation, it can have many implications for the financial sector. In particular, insurance companies and pension funds would find it increasingly challenging to earn a satisfactorily high yield for their policy holders and members.

Going forward, competition in the financial sector is likely to intensify, particularly with larger and more efficient financial institutions emerging along with consolidation in the financial sector. Increased competition, in turn, is likely to pressurise profit margins in the sector. Hence, improving operational efficiency will be increasingly important to banks and other financial institutions to improve their profitability. Their strategies and business processes will therefore need to focus on improving efficiency. In this regard, it is important that the branch networks of financial institutions operate as optimal delivery channels, helping raise their efficiency as well as effectiveness. Business processes would also have to be improved, taking advantage of enabling technologies, to increase productivity in the financial sector. In the meantime, aligning human resources in the financial sector with the business opportunities of the sector and developing the human resources within the sector will continue to be central to the sector playing a catalytic role in the economy. The use of outsourcing opportunities meanwhile, could facilitate the effective use of human resources within the sector.

The funding structure of the banking sector is expected to change as a result of the recent orientation towards local debt and equity markets and foreign borrowings. Tax concessions provided as per the 2013 budget to investors in corporate debt securities have been taken advantage of by banks and finance companies by issuing debentures. Several more debenture issues are expected to follow. Further, Sri Lankan banks are expected to explore more opportunities to raise funds from international markets. It is anticipated that the concentration of bank funds in customer deposits would decline as a result of the foreign borrowings as well as domestic borrowings.

Understanding evolving market needs and maintaining a customer centric focus is important to improving productivity of financial institutions. As technology evolves rapidly, the banking system has the opportunity to incorporate into their products appropriate benefits of new technology, mainly in the areas of mobile payments, mobile banking and customer identification using biometric data. Improving product quality facilitates not only access to increased market share, but can also be an effective risk management tool preventing frauds and malpractices. Banks would also need to align their business models with the changes in funding structures of the customers. With increasingly large scale infrastructure development projects being proposed for the country, banks will have to seek more affordable and diverse sources of funding and consider business partnerships with other local or foreign entities to facilitate such large scale financing. On the other end of the product spectrum are products designed to meet financing requirements of micro, small and medium sized enterprises which are being increasingly promoted to enhance financial accessibility and inclusion.

Improving soundness and resilience of the financial sector is important as the sector is expected to expand rapidly. Enhancement of capital, strengthening capital planning processes, strong risk management and governance practices and improved quality of management information systems are expected to strengthen the financial sector. Licensed commercial banks and licensed specialised banks are required to enhance their capital levels subject to a minimum core capital of Rs. 10 billion and Rs. 5 billion, respectively, for the existing banks, from 01st January 2016, and for new banks, from 01st January 2015. Implementation of the Pillar 2 of Basel II – Supervisory Review Process will contribute to improved integrated risk management in the banking sector. Currently, existing licensed finance companies have a minimum capital requirement of Rs. 300 million, while for new companies it is Rs. 400 million and from 2015 all the companies are required to meet the minimum capital requirement of Rs. 400 million.

Strengthening of regulation and supervision focused on identifying potential risks and vulnerabilities will help enhance the ability of the financial system to withstand potential shocks. Statutory examinations of all banks and finance companies will be conducted annually. The supervisory and regulatory framework will be strengthened in line with Basle Core Principles and other international best practices. A consolidated supervision framework incorporating both micro-prudential and macro-prudential supervision as well as close interaction with other regulators will be implemented.

Improved governance in LFCs and SLCs is expected to improve public confidence in the sector. The LFC sector will be closely monitored and regulation of the sector will be strengthened specifically in the areas of governance, risk management, liquidity management and business processes. Minimum core capital of LFCs will be increased up to Rs. 1 billion and Rs. 1.5 billion by 01st January 2016 and 01st January 2018, respectively, and penalties will be introduced for non-compliances. Caps will be introduced on remuneration and other emoluments and deposit caps linked to overall performance and compliance levels of each LFC will be imposed. These and many other regulatory measures are expected to be implemented in the near future.

Measures aimed at enhancing the soundness of the Insurance sector will be taken. Minimum capital requirements have been increased for insurance companies and insurance brokering companies with effect from 2014 and 2015, respectively. The regulatory framework pertaining to the insurance sector will be strengthened with the introduction of a risk based supervision system for insurance companies.

Development of domestic capital markets is considered an important step towards Sri Lanka achieving the status of a financial hub. Measures proposed by way of the national budgets for 2013 and 2014 to promote the development of the infrastructure network of stock brokers and encourage the issue of listed corporate debt have been successful. With the proposed introduction of an e-trading platform for corporate debt securities and a central counterparty system, the corporate debt market is expected to expand and deepen further.

As assets of the banking and non-banking sectors are expected to expand significantly in the years approaching, consolidation will be necessary to ensure stability. Amidst the expected rapid growth, it is necessary to ensure that financial institutions remain strong and well capitalized. Consolidation in the financial sector will increase efficiency and stability in the sector. Generally, large scale financial institutions enjoy economies of scale benefits and operational and cost efficiencies and hence higher profitability. With the enhancement of the minimum capital requirements for banks, LFCs and SLCs and the need to meet the minimum liquidity requirements, the smaller and weaker institutions would be encouraged to consolidate for survival as well as to enable them to compete with the large institutions. Already, several SLCs have migrated to LFC status in order to enhance their funding sources by way of deposits, in addition to borrowings through debt instruments. In this context, it is expected that the remaining SLCs would also migrate to LFC status or be amalgamated with other financial institutions. The way ahead towards upper middle-income country status could pose challenges to small or weak institutions as competition for funding sources intensify. Therefore, such companies are expected to consolidate, bringing stability to the sector whilst deriving the benefits from economies of scale and synergies

Prospects for capital markets are expected to improve in an environment of declining interest rates, targeted incentives and focussed market development plans. In a scenario of lower interest rates to boost economic growth, capital markets would be in a position to attract investors from traditional deposits. Further, several tax incentives granted to encourage investors in corporate debt securities have already been successful in bringing about significant levels of market activity in this sector. Several new corporate debentures have been lined up for issue in the next few months, providing a much needed boost to the corporate debt market. In addition, the SEC and the CSE are working together in implementing a capital market development master plan to make the regulatory system more proactive in line with international standards. This master plan incorporates 10 key strategies to further enhance investor confidence and develop the capital market in the country.

Financial market infrastructure is to be expanded and strengthened using advanced technologies. An e-trading platform is to be established to facilitate secondary market activities in relation to government and corporate debt securities, a Central Counterparty System is to be established to facilitate clearing and settlement of equity and debt securities while mitigating settlement risks. Payment and settlement infrastructure is expected to advance further towards an environment of digitalised transactions where electronic payment systems such as e-money, e-payments and mobile payments systems are made available to carry out a wider range of retail transactions. Arrangements will be made to establish a national platform for electronic retail payments where the final settlements will be effected through the Real Time Gross Settlement System. In addition, measures by way of putting in place effective security systems and a strong regulatory framework will be taken to ensure the security and reliability of financial market infrastructure.

Appendix Table 1

Financial Soundness Indicators of the Banking Sector

	2009	2010	2011	2012	2013 (a)
1. Capital Adequacy					
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	16.1	16.2	16.0	16.4	16.3
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	14.1	14.3	14.4	14.7	13.7
1.3 Net Non-Performing Loans to Total Capital Funds	26.2	15.2	11.5	12.5	23.2
1.4 Debt to Capital Funds	160.1	172.0	171.4	184.5	207.4
1.5 Capital to Assets Ratio	8.1	8.3	8.7	8.6	8.2
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	3.7	5.6
2.2 Gross Non-Performing Loans (NPL) to Total Gross Loans (with Interest in Suspense)	10.7	7.3	6.2	5.7	7.7
2.3 Net Non-Performing Loans to Total Gross Loans	4.0	2.3	1.6	1.7	3.3
2.4 Provision Made against Gross Loans	4.4	3.1	2.1	1.9	2.2
2.5 Provision Coverage Ratio (Total)	53.0	58.1	57.1	53.4	40.4
2.6 Provision Coverage Ratio (Specific)	42.8	45.3	46.0	41.4	32.5
2.7 Sector-wise NPL to Total Sector Loans					
Agriculture and Fishing	4.2	3.0	2.6	2.4	4.1
Manufacturing	15.4	8.9	6.1	6.3	5.9
Tourism	5.3	4.5	11.3	10.9	8.1
Transport	6.6	4.1	2.8	3.7	2.8
Construction	12.3	8.5	7.7	6.9	7.2
Traders	11.0	7.5	5.3	3.9	4.2
New Economy	4.4	3.5	2.8	3.3	7.6
Financial and Business Services	4.5	2.4	1.5	1.9	2.3
Infrastructure	5.0	4.1	1.0	0.6	0.5
Other Services	6.3	3.1	2.2	3.6	3.3
Other Customer	5.4	3.1	1.7	2.2	8.6
2.8 Sectoral Distribution of Loans to Total Gross Loans					
Agriculture and Fishing	10.8	13.5	13.1	13.1	12.3
Manufacturing	15.1	12.9	12.0	10.8	11.4
Tourism	2.7	2.2	2.2	2.4	2.8
Transport	1.6	1.7	2.2	1.8	2.8
Construction	17.1	16.5	13.9	13.4	14.5
Traders	13.8	13.8	11.4	15.2	15.6
New Economy	1.3	0.9	0.9	1.2	1.1
Financial and Business Services	3.9	4.7	6.1	4.8	4.2
Infrastructure	1.3	1.4	3.4	5.1	6.3
Other Services	4.9	6.4	6.8	3.3	3.1
Other Customer	27.4	26.1	28.0	28.9	26.0
2.9 Provision Made against Total Assets	2.4	1.8	1.3	1.2	1.3
2.10 Total Loans (Gross) to Total Assets	53.0	55.6	61.2	61.8	57.7
2.11 Investments to Total Assets	30.8	30.4	24.9	23.9	28.5
2.12 Total Income to Total Assets	14.1	11.2	9.8	11.3	11.4
2.13 Net Interest Income to Total Assets	4.3	4.2	3.9	3.9	3.3
2.14 Operating Income to Total Assets	6.3	6.1	5.3	5.4	4.7
3. Earnings & Profitability					
3.1 Return on Equity (ROE) – After Tax	11.8	22.0	19.8	20.3	16.0
3.2 Return on Assets (ROA) – Before Tax	1.8	2.7	2.4	2.4	1.9
3.3 Return on Assets (ROA) – After Tax	1.0	1.8	1.7	1.7	1.3
3.4 Interest Income to Total Income	86.0	83.1	85.5	86.3	87.3
3.5 Net Interest Income to Total Income	30.8	37.7	39.4	34.3	29.0
3.6 Non-Interest Income to Total Income	14.0	16.9	14.5	13.7	12.7
3.7 Non-Interest Expenses (Operating Expenses) to Total Income	22.8	26.6	28.1	23.2	21.0
3.8 Staff Expenses to Non-Interest Expenses	46.5	45.2	44.2	45.8	44.9
3.9 Personnel Expenses to Total Income	10.6	12.0	12.4	10.6	9.4
3.10 Provisions to Total Income	6.2	0.6	1.2	2.5	3.9
3.11 Total Cost to Total Income	78.0	72.0	74.1	75.2	79.3
3.12 Efficiency Ratio	56.3	47.2	52.7	49.4	53.4
3.13 Interest Margin	4.6	4.6	4.2	4.1	3.5
4. Liquidity					
4.1 Liquid Assets to Total Assets	35.2	31.1	26.8	26.6	31.9
4.2 Statutory Liquid Assets Ratio – DBU	39.2	36.6	32.4	31.3	37.7
4.3 Loans to Deposits Ratio	71.5	76.4	84.7	86.9	82.2
5. Market Risk					
5.1 Foreign Currency Net Open Position (NOP) to Capital Funds*	(0.8)	0.2	(1.6)	0.2	0.7
6. Assets / Funding Structure					
6.1 Deposits	74.1	72.8	72.3	71.1	70.2
6.2 Borrowings	12.9	14.3	14.9	15.8	17.1
6.3 Capital to External Funds	9.3	9.5	10.0	9.9	9.4
6.4 Credit to Deposits & Borrowings	60.9	63.9	70.1	71.1	66.1
6.5 Credit to Deposits & Borrowings & Capital	55.7	58.3	63.8	64.7	60.4

(a) Provisional
* Only for Commercial Banks

Source: Central Bank of Sri Lanka

Appendix Table 2

Composition of Assets and Liabilities of the Banking Sector

Item	2009		2010		2011		2012		2013 (a)	
	Rs.Bn	% of Total	Rs.Bn	% of Total	Rs.Bn	% of Total	Rs.Bn	% of Total	Rs.Bn	% of Total
Loans	1,596	53.0	1,975	55.6	2,601	61.2	3,149	61.8	3,427	57.7
Investments	929	30.8	1,081	30.4	1,057	24.9	1,218	23.9	1,695	28.5
Others	488	16.2	494	13.9	594	14.0	731	14.3	820	13.8
Total Assets	**3,013**	**100.0**	**3,551**	**100.0**	**4,252**	**100.0**	**5,098**	**100.0**	**5,941**	**100.0**
Deposits	2,232	74.1	2,586	72.8	3,073	72.3	3,625	71.1	4,170	70.2
Borrowings	389	12.9	507	14.3	635	14.9	804	15.8	1,015	17.1
Capital Funds	243	8.1	295	8.3	371	8.7	436	8.6	490	8.2
Others	149	4.9	163	4.6	173	4.1	233	4.6	267	4.5
Total Liabilities	**3,013**	**100.0**	**3,551**	**100.0**	**4,252**	**100.0**	**5,098**	**100.0**	**5,941**	**100.0**

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 3

Income and Expenditure of the Banking Sector

Item	2009		2010		2011		2012		2013 (a)	
	Rs.Bn	As a % of Avg. Assets	Rs.Bn	As a % of Avg. Assets	Rs.Bn	As a % of Avg. Assets	Rs.Bn	As a % of Avg. Assets	Rs.Bn	As a % of Avg. Assets
Total Interest Income	364	13	330	10	358	9	496	10	591	11
Total Interest Expenses	234	8	180	5	193	5	298	6	395	7
Net Interest Income	**130**	**5**	**150**	**5**	**165**	**4**	**197**	**4**	**196**	**4**
Foreign Exchange Income	12	0	12	0	15	0	27	1	16	0
Non-Interest Expenses	97	3	106	3	117	3	134	3	142	3
Staff Cost	52	2	55	2	60	2	69	1	70	1
Loan Loss Provisions	22	1	(6)	(0)	(3)	(0)	6	0	18	0
Profit Before Tax (after VAT)	52	2	90	3	94	2	117	2	105	2
Profit After Tax	**27**	**1**	**59**	**2**	**66**	**2**	**83**	**2**	**75**	**1**

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 4

Banking Sector Network

Item	2010		2011		2012		2013	
	No. of Institutions	No. of Banking Outlets	No. of Institutions	No. of Banking Outlets	No. of Institutions	No. of Banking Outlets	No. of Institutions	No. of Banking Outlets
Licensed Commercial Banks (LCBs)								
State Banks	2	1,198	2	1,272	2	1,331	2	1,356
Private Domestic Banks	9	962	10	1,120	10	1,179	10	1,226
Foreign Banks	11	216	12	220	12	220	12	221
Licensed Specialised Banks (LSBs)								
State Banks	6	499	6	515	6	528	6	534
Private Banks	3	101	3	109	3	109	3	111
Total	**31**	**2,976**	**33**	**3,236**	**33**	**3,367**	**33**	**3,448**

Source: Central Bank of Sri Lanka

Appendix Table 5

Financial Soundness Indicators of the LFC and SLC Sector

	2009	2010	2011	2012	2013 (a)
1. Capital Adequacy					
1.1 Regulatory Capital to Risk Weighted Assets (RWCAR)	n.a.	n.a.	14.4	16.0	14.8
1.2 Tier 1 Capital / Risk Weighted Assets (Tier 1 RWCAR)	n.a.	n.a.	15.3	15.4	13.7
1.3 Capital Funds to Total Assets	13.4	11.1	13.1	14.5	13.2
1.4 Debt to Capital Funds (Borrowings other than Deposits)	234.2	321.6	267.7	203.8	203.0
1.5 Investment Properties to Capital Funds	n.a.	11.3	8.2	7.7	8.0
1.6 Net Non-Performing Advances to Capital	22.2	21.0	11.7	8.9	14.4
2. Asset Quality					
2.1 Gross Non-Performing Advances to Total Advances	9.1	7.9	5.1	5.0	6.7
2.2 Net Non-Performing Advances to Total Advances	4.5	3.4	1.9	1.6	2.5
2.3 Required Bad Debts Provision to Total Advances	4.7	4.3	3.0	2.6	2.9
2.4 Provision made against Total Advances	4.7	4.8	2.8	2.8	3.8
2.5 Provision Coverage Ratio (Specific Provisions to NPA)	35.9	42.9	45.2	45.0	45.2
2.6 Provision Coverage Ratio (Total Provisions to NPA)	51.4	60.3	55.4	55.2	56.0
3. Liquidity					
3.1 Liquid Assets to Total Assets	6.3	3.8	4.6	5.6	8.0
3.2 Liquid Assets to External Funds	8.9	5.2	6.2	7.7	10.9
4. Earnings					
4.1 Return on Assets (Annualized)	0.7	2.8	5.6	3.3	1.7
4.2 Return on Equity (Annualized)	(0.5)	11.5	31.6	15.9	6.7
4.3 Interest Income to Interest Expenses	134.8	178.3	193.7	176.6	160.2
4.4 Net Interest Income to Profit After Tax	(2,520.0)	477.6	173.2	270.5	572.7
4.5 Operating Cost to Net Interest Income	127.8	86.8	79.0	74.7	89.1
4.6 Net Interest Income to Gross Assets	4.2	6.0	6.7	6.8	6.1
4.7 Net Interest Income to Interest Income	25.8	43.9	48.4	43.4	37.6
4.8 Non-Interest Income to Total Cost	17.0	24.5	28.2	16.1	15.3
4.9 Efficiency Ratio (Operating Cost)	74.9	56.9	51.9	56.2	64.1
4.10 Cost to Income Ratio	90.6	76.5	71.7	77.9	83.6
5. Assets / Funding Structure					
5.1 Borrowings	31.3	35.8	35.0	29.5	26.8
5.2 Investments	3.8	6.5	2.8	2.6	2.2
6. Lending					
6.1 Total Accommodation Growth	(2.8)	35.3	46.3	21.4	17.3

(a) Provisional
n.a. – not available

Source: Central Bank of Sri Lanka

Appendix Table 6

Composition of Assets and Liabilities of the LFC and SLC Sector

Item	2009		2010		2011		2012		2013 (a)	
	Rs.Bn	% of Total	Rs.Bn	% of Total	Rs.Bn	% of Total	Rs.Bn	% of Total	Rs.Bn	% of Total
Accommodation	196	66	265	68	388	79	472	79	553	77
Investments	20	4	25	6	14	3	15	3	16	2
Other Assets	82	30	97	25	88	18	110	18	149	21
Total Assets	**297**	**100**	**388**	**100**	**490**	**100**	**597**	**100**	**718**	**100**
Capital Elements	41	14	48	12	77	16	95	16	97	14
Deposits	120	40	146	38	186	38	254	43	337	47
Borrowings	93	31	139	36	172	35	176	29	192	27
Other Liabilities	43	14	55	14	55	11	72	12	91	13
Total Liabilities	**297**	**100**	**388**	**100**	**490**	**100**	**597**	**100**	**718**	**100**

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 7

Income and Expenditure of the LFC and SLC Sector

Item	2009		2010		2011		2012		2013 (a)	
	Rs.Bn	As a % of Avg. Assets	Rs.Bn	As a % of Avg. Assets	Rs.Bn	As a % of Avg. Assets	Rs.Bn	As a % of Avg. Assets	Rs.Bn	As a % of Avg. Assets
Interest Income	48.8	17	53.3	16	68.0	16	92.9	17	117.3	18
Interest Expenses	36.2	13	29.9	9	35.1	8	52.6	10	73.2	11
Net Interest Income	12.6	4	23.4	7	32.9	8	40.3	7	44.1	7
Non-Interest Income	8.9	3	12.3	4	17.2	4	13.3	2	17.2	3
Non-Interest Expenses	16.1	6	20.3	6	26.0	6	30.1	6	39.3	6
Profit Before Tax	1.9	1	10.8	3	25.6	6	22.7	4	13.8	2
Profit After Tax	(0.5)	0	4.9	2	19.0	4	14.9	3	7.7	1

(a) Provisional

Source: Central Bank of Sri Lanka

Appendix Table 8

Branch Distribution of the LFC and SLC Sector

Province	2010	2011	2012	2013
Western	192	265	316	344
Southern	76	91	112	119
Sabaragamuwa	45	59	76	78
North Western	61	67	99	112
Central	62	82	107	118
Uva	33	43	52	51
North Central	45	55	69	75
Eastern	54	60	78	87
Northern	32	44	63	76
Total	**600**	**766**	**972**	**1,060**

Source: Central Bank of Sri Lanka

Appendix Table 9

Market Share of the LFC and SLC Sector (in terms of the total assets)

Asset Category	2010		2011		2012		2013 (a)	
	Gross Total Assets (Rs.Bn)	Share (%)	Gross Total Assets (Rs.Bn)	Share (%)	Gross Total Assets (Rs.Bn)	Share (%)	Gross Total Assets (Rs.Bn)	Share (%)
Small (Assets < Rs. 1 Bn)	7.4	2	6.5	1	7.8	1	6.8	1
Medium (Assets between Rs. 1 Bn - Rs. 5 Bn)	74.4	19	54.9	11	56.9	10	48.7	7
Large (Assets > Rs. 5 Bn)	306.1	79	428.6	87	531.7	89	662.1	92
All Companies	**387.9**	**100**	**489.9**	**100**	**596.6**	**100**	**717.6**	**100**

(a) Provisional

Appendix Table 10

Selected Data and Key Financial Soundness Indicators of Insurance Companies

	2009	2010	2011	2012	2013 (a)
Total Assets (Rs.bn)	183.1	222.2	265.8	321.8	363.8
Total Income (Rs.bn) (b)	**76.35**	**104.3**	**103.1**	**110.7**	**123.5**
Gross Premium Income (Rs.bn)	57.25	68.5	80.4	87.2	94.5
Investment Income (Rs.bn)	19.1	35.8	22.7	23.5	29.0
Profit Before Tax (Rs.bn) (b)	4.99	16.6	12.3	12.1	13.5
Indicators					
Solvency Margin Ratio (%)					
– Long-Term Insurance	4.9	5.1	6.5	7.2	8.9
– General Insurance	2.8	2.6	2.0	2.4	2.6
Retention Ratio (%)					
– Long-Term Insurance	96.4	97.0	96.2	96.2	96.0
– General Insurance	72.7	75.5	78.9	82.5	83.5
Claims Ratio (%)					
– Long-Term Insurance	43.6	38.3	31.0	37.2	46.2
– General Insurance	63.2	61.6	63.8	61.8	58.7
Combined Operating Ratio (%)					
– Long-Term Insurance	69.7	60.4	74.2	82.7	93.7
– General Insurance	91.0	75.4	101.8	100.3	101.7
Return on Assets (ROA) (%)					
– Long-Term Insurance	2.4	2.6	5.0	3.3	3.1
– General Insurance	4.0	18.1	5.1	5.3	5.1
Return on Equity (ROE) (%) – General Insurance	9.0	36.9	10.2	9.9	9.1
Underwriting Ratio (%) – General Insurance	21.0	32.0	19.1	20.5	20.8

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

Source: Insurance Board of Sri Lanka

Appendix Table 11

Selected Data and Indicators of Primary Dealers

	2009	2010	2011	2012	2013 (a)
Total Assets (Rs.mn)	99,810	127,248	132,711	160,082	213,633
Total Portfolio (Rs.mn)	96,607	125,024	130,750	159,397	209,627
Trading Securities (Rs.mn)	54,015	74,339	88,586	87,057	145,949
Investment Securities (Rs.mn)	17,616	36,813	22,944	49,674	46,211
Reverse Repo (Rs.mn)	24,976	13,872	19,221	18,804	15,357
Available For Sale	–	–	–	3,862	2,110
Equity and Liabilities (Rs.mn)	99,810	127,248	132,711	160,082	213,633
Total Capital (Rs.mn) (a)	9,958	4,636	4,730	5,478	6,750
Repo (Rs.mn)	73,032	75,297	85,260	104,150	127,769
Profit before Tax (Rs.mn)	6,215	4,916	1,513	2,913	8,099
Profit after Tax (Rs.mn)	4,594	4,594	1,116	2,541	7,524
Return on Assets (ROA) (%)	6.2	3.9	1.1	1.8	4.0
Return on Equity (ROE) (%) (b)	46.4	34.1	0.3	17.7	34.4
Risk Weighted Capital Adequacy Ratio (%) (b)	22.4	20.4	18.9	22.1	18.4
Leverage (Times) (b)	7.4	8.1	8.3	7.5	7.5
Dealing	7,982,339	7,950,922	8,951,533	10,406,840	14,554,616
Primary Market Dealings	1,522,649	1,508,645	1,767,521	2,576,323	2,252,438
Secondary Market Dealings	6,459,690	6,442,277	7,184,012	7,830,517	12,302,178

(a) Provisional
(b) Standalone PDs only

Source: Central Bank of Sri Lanka

Appendix Table 12

Unit Trust Sector – Selected Data

Item	2009	2010	2011	2012	2013 (a)
Total Assets (Rs.mn)	10,004	22,176	22,674	31,088	54,323
Net Asset Value – NAV (Rs. mn)	9,952	22,060	22,547	30,890	54,448
Investments in Equities (Rs. mn)	6,036	11,743	9,549	8,841	9,486
Investments in Equities as a % of NAV	61	53	42	29	17
Total No. of Unit Holders	23,116	24,640	23,403	27,253	29,940
No. of Units in Issues (mn)	564	1,159	1,286	2,227	4,103
No. of Unit Trusts	18	21	24	37	53

(a) Provisional

Source: Unit Trust Association of Sri Lanka

Appendix Table 13

Stock Brokers – Selected Data

Item	2009	2010	2011	2012	2013 (a)
Turnover (b)	1,994	6,599	5,710	1,920	2,555
Net profit before tax (b)	823	3,661	2,362	(558)	(711)
Total Assets	6,429	13,210	11,257	10,782	10,266
Total Liabilities	3,827	6,973	4,596	4,308	4,463
Net Capital	2,076	4,468	3,347	4,927	4,742

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

Source: Securities and Exchange Commission of Sri Lanka

Appendix Table 14

Major Superannuation Funds – Key Information

	2009		2010		2011		2012		2013 (a)	
	EPF	ETF	EPF	ETF	EPF	ETF	EPF	ETF	EPF	ETF
No. of Accounts (mn)	12.8	8.9	13.4	9.3	14.0	9.8	14.6	10.0	15.0	10.0
o/w, Active Accounts (mn)	2.1	2.1	2.1	2.1	2.2	2.2	2.3	2.2	2.4	2.2
Total Contributions (Rs. bn)	48.7	8.7	54.8	9.8	61.9	11.1	70.2	12.7	80.5	14.4
Total Refunds (Rs. bn)	31.9	6.4	34.9	6.4	47.3	7.8	48.7	8.6	50.2	9.6
Total Assets (Rs. bn)	772.0	107.3	899.7	125.9	1,018.0	142.4	1,144.4	158.3	1,300.0	178.5
Total Investment Portfolio (Rs. bn)	738.1	101.0	867.1	118.9	985.6	134.1	1,105.5	149.7	1,257.3	168.0
o/w, Government Securities (%)	97.1	91.4	94.1	90.5	91.3	90.1	93.6	89.3	92.5	88.9
Gross Income (Rs. bn)	109.8	14.5	121.3	15.5	116.0	15.5	121.4	13.5	136.7	16.5

(a) Provisional

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

Glossary

A

Acquisitions	The purchase of (some portion of) one company by another; could be the purchase of assets, a definable segment of another entity or the purchase of an entire company.
Agency Mortgage-backed Securities	Mortgage-backed securities issued by government-sponsored enterprises.

B

Balance of Payments (BOP)	A statement that summarizes an economy's transactions with the rest of the world for a specified time period. Encompasses all transactions between a country's residents and its non-residents involving goods, services, income, current transfers, acquisition of financial assets and incurrence of financial liabilities. The balance of payments classifies these transactions into three accounts; namely, the current account, the capital account and the financial account. The current account shows flows of goods, services, primary income and secondary income between residents and non-residents. The capital account shows credit and debit entries for non-produced non-financial assets and capital transfers between residents and non-residents and represent only a small portion the BOP. The financial account shows the net acquisition and disposal of financial assets and liabilities. The sum of the balances of the current and capital accounts represents the net lending (surplus) or net borrowing (deficit) by the economy. This is conceptually equal to the net balance in the financial account.
Bancassurance	An arrangement in which a bank and an insurance company form a partnership so that the insurance company can sell its products to the bank's client base.
Bid-ask Price Quotation System	A system which enables buyers and sellers to quote their buying and selling prices. Bid is the highest price a prospective buyer is prepared to pay and ask is the lowest price acceptable to a prospective seller for trading of a unit of given security.
Bond Yields	Return an investor would earn for a bond purchased. Usually, the longer the term of a bond, the higher the interest rate that's paid to the holder, compensating for the inflation risk involved in having money tied up for a long time.
Business Process Outsourcing	The contracting out of a particular business function to an outside company in order to reduce costs.

C

Capital	Used to generate wealth through investments. Includes financial assets, factories, machinery and equipment owned by business. Besides being used in production, capital can be rented out for a monthly or annual fee to create wealth.
Cheque Imaging and Truncation System (CITS)	"Cheque Imaging and Truncation System" means an image based cheque clearing facility where the image of the physical cheque is captured and converted to a digital form and such captured image is presented to a clearing house for clearing.

Commercial Paper	An unsecured, short-term debt instrument issued by a corporation to raise funds for their own use, which is characterized by a single payment at maturity.
Compound Annual Growth Rate	The rate at which it would have grown if it grew at an even rate compounded annually.
Concentration Risk	Excessive credit exposure to a single borrower or to a connected group of borrowers.
Consumer Price Index	An indicator of inflation that measures the percentage change in the cost of a representative "basket" of products and services bought by the average household in a specified area.
Contingency	A condition or situation, the ultimate outcome of which, gain or loss, will be confirmed only on the occurrence or non-occurrence of one or more uncertain future events.
Core Capital	Core Capital = Equity + Disclosed Reserves
Corporate Bonds	Medium or long-term securities of private sector companies which obligate the issuer to pay interest and redeem the principal at maturity.
Corporate Governance	The system of principles, policies, procedures and clearly defined responsibilities and accountabilities used by stakeholders to overcome the conflicts of interest inherent in companies.
Credit Card	"Credit Card" means, a payment card which involves a line of credit granted by the issuer to the cardholder where the credit utilized can be settled in full or in part on or before a specified date. The issuer may charge interest or other charges on any amount not settled on the specified date.
Credit Ratings	A measure of the ability of an individual, organization or country to repay debt. These are usually issued by a credit rating agency or a credit bureau.
Credit Risk	The risk of financial loss if a customer or counterparty fails to meet a payment obligation under a contract.
Creditworthiness	The perceived ability of the borrower to pay what is owed on the borrowing in a timely manner. In the case of a company, represents the ability of the company to withstand adverse impacts on its cash flows.

D

Debentures	A debenture is a long-term fixed income security for which the issuer promises to pay the holder a periodic interest at a specified rate on the principal amount, and to repay the principal amount at maturity or at any other pre-determined time.
Debit Card	"Debit Card" means, a payment card that may be used to withdraw cash and/or execute payments for purchase of goods and services, by directly debiting from the credit balance of the cardholder's account.
Delivery *versus* Payment (DVP)	A settlement system which stipulates that cash payment must be made prior to or simultaneously with the delivery of the security.
Depreciation	The monetary value of an asset decreases over time due to use, wear and tear or obsolescence.
Derivatives	A financial instrument whose value depends on the value of some underlying asset or factor (Eg. Stock price, interest rate or exchange rate).

E

E-commerce	Business conducted over an electronic network, typically the internet.
Economies of Scale	Lead to a falling long run average cost as output increases. In reference to mergers, it is the savings achieved through the consolidation of operations and elimination of duplicate resources.
Electronic Funds Transfer at Point of Sale (EFTPOS)	If payment cards are used at a retail location, it is referred to as a point of sale. The payment information is captured either by paper vouchers or by electronic terminals, which in some cases are designed also to transmit the information. Where this is so, the arrangement may be referred to as "electronic funds transfer at the point of sale" (EFTPOS).
E-money	A digital equivalent of cash, stored on an electronic device or remotely at a server
Employees' Provident Fund (EPF)	Established under EPF Act, No. 15 of 1958 where the Monetary Board as the custodian of the Fund is vested with the responsibility of receiving contributions from employers, investing excess funds, maintaining proper accounts and paying benefits to members.
Employees' Trust Fund (ETF)	Established on 1st March 1981 under the provisions of ETF Act, No. 46 of 1980. The Fund is administrated by the Employees' Trust Fund Board and at present the ETF Board is functioning under the Ministry of Finance.
Encryption	The use of cryptographic algorithms to encode clear text data (plaintext) into ciphertext to prevent unauthorized observation.
Equity Ratio	A financial ratio indicating the relative proportion of equity used to finance a company's assets. Equity Ratio = Total Shareholder's equity / Total Assets
E-trading	A method of trading securities (such as stocks, and bonds), foreign exchange or financial derivatives electronically.
Euro Area	The Eurozone officially called the euro area, is an economic and monetary union (EMU) of 18 European Union (EU) member states that have adopted the euro (€) as their common currency and sole legal tender.
Exchange-Traded Funds (ETFs)	Exchange Traded Funds (ETF) are investment funds, traded on an exchange, that invest in a basket of securities or other assets that generally seek to track the performance of a specified index or benchmark.

F

Finance lease	A contract whereby a lessor (seller) conveys to the lessee (buyer) the right to use an asset for rent over an agreed period of time which is sufficient to amortize the capital outlay of the lessor. The lessor retains ownership of the asset but transfers substantially all the risks and rewards of ownership to the lessee.
Financial instrument	A financial instrument is any contract that gives rise to both a financial asset in one entity and a financial liability or equity instrument in another entity.
Fiscal consolidation	A policy aimed at reducing government deficits and debt accumulation.

G

Gross Domestic Product (GDP)	Monetary value of all the finished goods and services produced within a country's borders in a specific time period.
GDP per capita	Gross Domestic Product (GDP), divided by the number of people in the country.
Gilt-edged securities	High-grade bond issued by a national government or an established and stable firm with a long record of consistent earnings, and ability to pay its obligations on time and in full.
Gilt Unit Trusts	A unit trust whose investments are confined to gilt-edged securities only.
Government Securities	Bonds, bills, and other debt instruments sold by a government, to finance its borrowings.
Gross Written Premium	Premium which an insurer is contractually entitled to receive from the insured in relation to contracts of insurance, before any reinsurance is taken into account. Not all premiums written will necessarily be treated as income in the current financial year, because some of them could relate to insurance cover for a subsequent period.

H

Hedging	Making an investment to reduce the risk of adverse price movements of an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

I

Immovable Assets	Land and other assets that cannot be moved without destroying or altering, the original status of the asset. e.g., buildings.
Impairment	– Impairment is a permanent decline in the value of an asset which results in a reduction in its recoverable amount below its carrying amount. – Impairment is a reduction in the recoverable amount of a fixed asset (or goodwill) below its carrying amount.
Inflation	Increase in general price level of goods and services in an economy over a period of time.
Interest Margin	The difference between the interest income generated by banks or other financial institutions and the amount of interest paid out (for example, to depositors), relative to the amount of their (interest-earning) assets.
Interest Spread	The difference in borrowing and lending rates of financial institutions, (such as banks) in nominal terms.

K

Key Management Personnel (KMP)	People including directors of the entity, having authority and responsibility for planning, directing, and controlling the activities of an entity, either directly or indirectly.
Knowledge Process Outsourcing	A form of outsourcing where knowledge and information related work is carried out by a different company or subsidiary within the same organization to save costs or resources.

L

LankaSecure Comprises of the Scripless Securities Settlement System (SSSS) and Central Depository System (CDS). LankaSecure facilitates the issue of Government securities and Central Bank securities in electronic or scripless form and settlement of trades of such scripless securities on a Delivery versus Payment (DvP) basis.

Letters of Credit (LC) A document issued by a financial institution, or a similar party, assuring payment to a seller of goods and/or services provided certain documents have been presented to the bank.

Leverage Ratio The Rationale and objective for enforcing the leverage ratio are to (a) constrain the build-up of leverage in the banking sector, helping avoid destabilizing delivering processes which can damage the broader financial system and the economy; and (b) reinforce the risk based requirements with a simple, non-risk based "backstop" measure.

The Basel III leverage ratio is defined as the Capital Measure (the numerator) divided by the Exposure Measure (the denominator), with this ratio expressed as a percentage. The basis of calculation is the average of the three month-end leverage ratios over a quarter.

The Capital Measure for the leverage ratio is the Tier 1 capital, calculated as per the risk-based capital framework under Basel III. A bank's total Exposure Measure is the sum of the following exposures: (a) on-balance sheet exposures, (b) derivative exposures, (c) securities financing transaction exposures, and (d) other off-balance sheet exposures.

Liquid Assets Term used to describe an asset that can be quickly converted to cash at a price close to fair market value.

Liquidity Ratios Financial ratios measuring the company's ability to meet its short-term obligations. Generally, the higher the value of the ratio, the larger the margin of safety that the company possesses to cover short-term obligations.

M

Market Capitalization Market value of a company's issued share capital. Calculated as;

The number of shares in issue × current price of those shares on the stock market.

Market Risk Market risk can be defined as the risk of losses in on and off-balance sheet positions arising from adverse movements in market prices such as interest rates, exchange rates, equity prices and commodity prices.

Maturity The period of time for which a financial instrument remains outstanding. Maturity refers to a finite time period at the end of which the financial instrument will cease to exist and the principal is repaid with interest.

Maturity Mismatches The tendency of a business to mismatch its balance sheet by possessing more short-term liabilities than short-term assets and having more assets than liabilities for medium and long-term obligations.

Microfinance Microfinance institutions (MFIs) provide financial services to low-income, economically active, borrowers who seek relatively small amounts to finance their businesses, manage emergencies, acquire assets, or smooth consumption. MFIs are a heterogeneous group that includes different types of institutions such as banks, non-bank financial institutions (NBFIs), non-government organizations (NGOs), credit unions, and cooperatives. With respect to their legal status, some are regulated while others are unregulated. MFIs include 'for profit' as well as 'non-profit' institutions.

Middle Income Trap	The "middle-income trap" is the phenomenon of hitherto rapidly growing economies stagnating at middle-income levels and failing to graduate into the ranks of high-income countries.
Monetary Policy	One of the core objectives of the Central Bank of Sri Lanka is economic and price stability. The Central Bank formulates and implements its monetary policy, *i.e.,* actions to influence the cost and availability of money, to attain this objective. The Monetary Law Act (MLA), the legislation under which the Central Bank has been established and operates, has provided a wide range of instruments for monetary management. At present, the monetary policy framework of the country places greater reliance on market based policy instruments and the use of market forces to achieve the desired objectives.
Mortgage Backed Security	A type of asset-backed security that is secured by a mortgage or collection of mortgages.
Mutual Funds	An investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets.

N

Near Field Communication	A technology for smartphones and similar devices to establish radio communication with each other by touching them together or bringing them into proximity, usually no more than a few inches.
Niche Markets	A subset of the market on which a specific product is focusing.
Non-Performing Loans (NPL)	A loan is classified as non-performing as specified in the Directions issued under the provisions of the Banking Act, No. 30 of 1988 when payments of interest and/or principal have been in arrears, *i.e.*, for more than 3 months or more, or based on the potential risk.

O

Off-shore	Located or based outside of one's national boundaries. The term offshore is used to describe foreign banks, corporations, investments and deposits.
Open Market Operations	Buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system. Purchases inject money into the banking system and stimulate growth while sales of securities do the opposite.
Organic Growth	The process of business expansion due to increasing overall customer base, increased output per customer or representative, new sales, or any combination of the above, as opposed to mergers and acquisitions, which are examples of inorganic growth.

P

Penal Rates of Interest	In money lending, penal interest is punitive interest charged by a lender from a borrower if instalments are not paid according to the loan terms.
Per Capita Income	A measure of the amount of money that is being earned per person in a certain area. Income per capita can apply to the average per person income for a city, region or country and is used as a means of evaluating the living conditions and quality of life in different areas. It can be calculated for a country by dividing the country's national income by its population.

Point-of-Sale Terminal	This term refers to the use of payment cards at a retail location (point of sale). The payment information is captured either by paper vouchers or by electronic terminals.
Price Earnings Ratio (P/E Ratio)	A valuation ratio of a company's current price per share compared to its earnings per share. Price to Earnings Ratio = Market Price per Share / Earnings per Share
Primary Dealers	A firm that buys government securities directly from a government, with the intention of reselling them to others, thus acting as a market maker of government securities.
Provision Coverage Ratio	Ratio of provisions made against the non-performing loans.
Public Service Provident Fund (PSPF)	Established for the grant of benefits to every non-pensionable employee in the service of the Government whose salary is payable at a monthly rate

R

Real Rate of Return	Annual percentage return realized on an investment, which is adjusted for changes in prices due to inflation.
Real Time Gross Settlement (RTGS) System	A computer based fund settlement system which processes and settles each payment instruction individually and irrevocably on real time basis using funds in the participants' RTGS Settlement Accounts in the RTGS system.
Repurchase Agreements (Repo)	Arrangements which involve the sale, for cash, of securities (usually government securities) at a specified price with a commitment to repurchase the same or similar securities at a fixed price on a specified future date. The difference between the sale price and the repurchase price is the interest income. The agreement is called reverse repo when viewed from the perspective of the securities buyer. A repo is similar to a loan that is collateralized by the securities underlying the agreement. Most repos are very short-term money market instruments.
Return on Assets (ROA)	A financial ratio that shows the percentage of profit that a company earns in relation to its overall resources (total assets). ROA (after tax) = Net profit after tax / Total assets (or Average Total assets)
Return on Equity (ROE)	The amount of net income returned as a percentage of shareholders equity. It reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. ROE = Net profit after tax / Shareholder's equity (or Average Shareholder's equity)
Rights Issue	An invitation from a company to their existing shareholders to buy new shares usually for less than the prevailing share price, to raise additional capital.
Risk-Weighted Assets	Risk-weighted assets are a bank's on-balance sheet and off-balance sheet assets or exposures, weighted according to risk.

S

Scripless Securities	Securities trading where only book entries represent the security holding and settlement, and no physical certificate is issued or exchanged.

Central Depository System (CDS) — Title registry as well as the custodian for Government securities. The ownership of securities is recorded to the beneficiary level in the CDS.

Securities Investment Accounts (SIA) — A special account designated for eligible investors resident outside Sri Lanka to route funds to invest in permitted investments. Authorized dealers are permitted to open and maintain SIA in the Domestic Banking Unit of a licensed commercial bank in the name of the investor resident outside Sri Lanka, subject to the terms and conditions stipulated in the relevant Direction issued by the Central Bank of Sri Lanka.

SME — Small and Medium-sized Enterprises. The main factors determining whether a company is SME are the number of employees and either turnover or balance sheet total.

Solvency Margin Requirement — The difference between the value of admissible assets and the value of liabilities, required to be maintained by any insurer who carries on insurance business. Amongst the admissible assets are government securities and listed shares. In the case of general insurance business, the minimum solvency margin shall not be less than the highest of the following: (a) Rs. 50 million or (b) 20% of the net written premium or (c) 40% of the average net outstanding claims in the three years immediately preceding the current year. In the case of long-term insurance, the minimum solvency margin shall not be less than five per centum of the value of the policy liabilities.

Statutory Liquid Asset Ratio (SLAR) — The ratio of liquid assets as determined under the provisions of the Banking Act, No. 30 of 1988 maintained by licensed banks as a per centum of the total liabilities or deposits as the case may be.

Statutory Reserve Ratio (SRR) — The proportion of rupee deposit liabilities that commercial banks are required to maintain as a deposit with the Central Bank, subject to an allowance for vault cash balances of more than two per cent but not exceeding four per cent of deposit liability, which could be deducted from the requirement.

Statutory Solvency Margin Requirement — Risk associated with the insurance-related liabilities. Calculated on the basis of the insurance fund and the risk policies total for each insurance sector.

Subsidiary — A company that is partly or completely owned by another company, which holds a controlling interest in the subsidiary company.

Swaps — A derivative in which counterparties exchange cash flows of one party's financial instrument for those of the other party's financial instrument.

An agreement between two parties to exchange a series of future cash flows.

T

Trade Deficit — The difference between the monetary value of exports and imports of output in an economy over a certain period, measured in the currency of that economy. A negative balance is referred to as a trade deficit or, informally, a trade gap.

Trading Securities — Securities held by a company with the intention of trading them in the short-term for a profit. Also known as the held for trading securities.

U

Unit Trust — A Unit Trust is a pool of funds collected from a number of investors who share a common financial goal. Funds collected from the investors are invested in various financial assets such as shares, treasury bills, treasury bonds, debentures and other securities. The income earned from these investments and the capital appreciation is shared by its unit holders in proportion to the number of units owned by them.

V

Value Added Tax (VAT)	Introduced by the Value Added Tax Act, No.14 of 2002 and is in force from 1st August, 2002. VAT Act replaced the Goods and Services Tax (GST) which was an almost similar tax on the consumption of goods and services. The goods imported into Sri Lanka and goods and services supplied within the territorial limits of Sri Lanka are the subject matter of this tax. It is a multi-stage tax levied on the incremental value at every stage in the production and distribution chain of Goods and Services. The tax is borne by the final or the ultimate consumer of Goods or Services. It is an indirect tax and the Government will receive at the end, through all the intermediary suppliers in the chain of production and distribution, an amount equal to the amount paid by the final consumer.

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