Chapter 8

FINANCIAL SECTOR DEVELOPMENTS AND SYSTEM STABILITY

8.1 Overview

The financial sector expanded significantly and remained resilient, strengthening the capacity to support economic activity. Financial sector institutions sustained their strong performance in 2006 in terms of key financial indicators and the range of products and services offered. Several policy initiatives were taken during the year to enhance access to finance, mainly in the Agriculture sector and in the small and medium enterprises (SMEs) sector. Financial infrastructure was strengthened and improved by introducing several legal enactments, broadening prudential regulations to augment supervisory capabilities and by introducing “state of the art” technology to mitigate systemic risks.

The Central Bank continued to strengthen the supervisory and regulatory framework of banks and non-bank financial institutions by introducing necessary legislation and amending legislation to enable reforms. The Central Bank intensified the regulation and supervision of specialised leasing companies in 2006. In view of the rapid growth in credit, several prudential measures were introduced during the year. The preparation for the implementation of Basel II Capital Adequacy Framework was facilitated by issuing guidelines to banks for the parallel computation of the capital charge. To promote the integrity of, and confidence in the financial system and recognising the risks posed by money laundering and terrorist financing, Sri Lanka introduced comprehensive laws to combat these emerging threats. Amendments were also made to the Monetary Law Act and Banking Act.

The Central Bank took further measures in 2006 to improve the efficiency and regulatory framework of the payment and settlement systems. The Cheque Imaging and Truncation (CIT) System was introduced in 2006 to expedite the clearing of retail and low value payments on a country-wide basis. To ensure that participants of the LankaSettle and LankaClear systems have effective Business Continuity Plans (BCPs), the Central Bank issued guidelines to financial institutions outlining the BCP minimum standards. A National Payments Council was established, comprising of representatives of all major stakeholders to facilitate the formulation of a national payments policy for the country and to take forward the modernisation of the payments and settlements infrastructure. The payments and settlements system was further strengthened by the introduction of a law to deter illegal and hazardous practices relating to payment devices.

Table 8.1 Total Assets of the Financial System

	2005 (a) Rs. bn	2005 (a) Share in Total %	2006 (b) Rs. bn	2006 (b) Share in Total %
Banking Sector	2,208.4	70.1	2,625.8	70.8
Central Bank	440.6	14.0	495.1	13.3
Licensed Commercial Banks (c)	1,448.9	46.0	1,774.3	47.9
Licensed Specialised Banks	318.9	10.1	356.4	9.6
Non Bank Deposit Taking Financial Institutions	119.2	3.8	145.8	3.9
Registered Finance Companies	87.5	2.8	113.1	3.0
Co-operative Rural Banks	26.5	0.8	27.8	0.8
Thrift and Credit Co-op. Societies	5.2	0.2	4.9	0.1
Other Specialised Financial Institutions	129.3	4.1	155.8	4.2
Primary Dealers	45.9	1.5	50.9	1.4
Specialised Leasing Companies	53.3	1.7	66.8	1.9
Merchant Banks	24.0	0.8	31.3	0.8
Unit Trusts	4.6	0.1	5.4	0.1
Venture Capital Companies	1.5	0.0	1.4	0.0
Contractual Savings Institutions	693.8	22.0	778.8	21.0
Employees' Provident Fund	424.0	13.5	492.1	13.3
Employees' Trust Fund	58.6	1.9	66.8	1.8
Private Provident Funds	106.2	3.4	112.6	3.0
Insurance Companies	105.0	3.3	107.3	2.9
Total	3,150.7	100.0	3,706.2	100.0

(a) Revised
(b) Provisional
(c) Consolidated assets of both DBUs and OBUs of LCBs

Source : Central Bank of Sri Lanka

Financial system stability strengthened further in 2006 following the continued enhancement of regulatory and supervisory measures over the key financial institutions and major payment and settlements systems, and improved risk management. Although the improvement in the financial system stability is reflected in several key financial performance indicators, the potential sources of vulnerability, which may affect the financial system, are the build-up of inflationary pressures, high credit growth leading to an impairment of credit quality, rising debt service burden and the widening current account deficit due to high oil prices. Nevertheless, the gradual tightening of monetary policy to contain inflationary pressures, additional prudential measures taken to deter high credit growth, government's effort for fiscal consolidation and improvements to prudential regulations as enunciated in the "Road Map : Monetary and Financial Sector Policies for 2007 and beyond" would help mitigate and contain the adverse effects of these risks.

8.2 Developments in Financial Institutions

Activities of financial institutions further expanded during 2006. The total assets of the financial institutions increased by 18 per cent, reaching Rs. 3,706 billion which is 1.3 times the GDP. Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs), which accounted for 57.4 per cent of the total assets of the financial system, continued to hold a dominant position in the financial sector. LCBs contributed to 58.6 per cent of the asset growth of the financial system.

The Central Bank of Sri Lanka

Total assets of the Central Bank increased by 12.4 per cent in 2006 with the increase in both net foreign assets (NFA) and net domestic assets (NDA). The increase in NFA was largely due to the purchases of foreign currency proceeds received by the government.

NDA of the Central Bank increased with the increased Treasury bill holdings and provisional advances to the government. The Central Bank sterilised a considerable amount of rupee liquidity that arose due to the foreign currency purchases, through outright sales of the Bank's Treasury bill holdings to reduce its expansionary impact on the money supply. However, the Bank's Treasury bill holdings at end 2006 were higher by Rs.30 billion compared to the end 2005 level, thereby leading to the increase in NDA.

On the liability side, the total currency issue of the Central Bank increased by 18.7 per cent (Rs.24.8 billion), reflecting increased transaction demand for currency. Along with the growth in deposit liabilities of commercial banks, the deposits of commercial banks held with the Central Bank for statutory reserve purposes increased by 26 per cent (Rs. 17 billion).

Licensed Commercial Banks (LCBs)

The performance of LCBs improved further in 2006 in terms of growth of assets, expansion in delivery channels, improvement in risk management, risk absorption capacity and use of information technology. The LCBs, numbering 23, operated through a network of 1,530 branches, and 1,986 other service outlets. Supporting this network there were 1,127 automated teller machines (ATMs) and 8,753 electronic fund transfer facilities at the point of sale (EFTPOS) machines, which contributed towards greater accessibility of banking services. The total number of credit cards in use increased from 637,326 in 2005 to 811,289 in 2006. There were 16 banks providing fully fledged internet banking facilities with many banks utilising the developments in information and communication technologies to offer innovative banking services. The use of innovative service delivery mechanisms such as postal network and mobile phones to deliver financial and payment related services were witnessed during the year.

The regulatory framework covering the LCBs was strengthened and improved to promote risk management, greater market discipline and to mitigate potential sources of risks. Several prudential measures and guidelines were issued covering market risk, provisioning requirements, and capital adequacy within the Basel II framework to enhance the resilience of the banking sector. LCBs also took several initiatives in this regard, especially in the areas of credit and operational risks through the launch of special loan recovery drives, infusion of new capital, establishment of Disaster Recovery Sites (DRS), formulation of Business Continuity Plans (BCPs) and improvement in technical capacities of staff in the use of advanced risk management techniques.

Developments in the Structure of LCBs: The total assets of LCBs increased further, supported by higher expansion of credit with the continued expansion of economic activities and attractive lending rates in real terms. Within the banking sector, the domestic private LCBs recorded a 22.2 per cent growth of assets, while the state owned LCBs recorded an asset growth of 15.3 per cent. The contribution of domestic private LCBs and state owned LCBs to the total growth in assets was 45.3 per cent and 30.6 per cent, respectively. Meanwhile, assets of foreign LCBs grew at a rate of 24.2 per cent. In terms of contributions of various sources to the growth in assets, loans and advances accounted for about 70 per cent in 2006 compared to 50 per cent in 2005.

Table 8.2 Distribution of Banks and Bank Branches

Category	End 2005 (a)	End 2006 (b)
Licensed Commercial Banks (LCBs)		
I. Total No.of LCBs	22	23
Domestic banks	11	11
Foreign banks	11	12
II. Total No.of LCB Branches and Other Outlets	3,112	3,516
Branches (c)	1,417	1,530
Domestic Bank Branches	1,380	1,491
Main Branches	1,106	1,166
Kachcheri Branches	22	22
Extension/Pay Offices/Service Counters	241	290
Overseas Branches	11	13
Foreign Bank Branches and Other Outlets	37	39
Branches (d)	30	31
Other Outlets	7	8
Pawning Centres	194	186
Student Savings Units	1,501	1,800
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	14	14
Regional Development Banks	6	6
National Savings Bank	1	1
Long-term Lending Institutions	2	2
Housing Finance Institutions	3	2
Private Savings and Development Banks	2	3
II. Total No. of LSB Branches and Other Outlets	404	415
Branches	369	376
Regional Development Banks	197	201
National Savings Bank	114	114
Long-term Lending Institutions	11	11
Housing Finance Institutions	27	28
Private Savings and Development Banks	20	22
Other outlets	35	39
Total No. of Bank Branches and Other Outlets	3,516	3,931

(a) Revised
(b) Provisional
(c) Includes Head Offices. Excludes Pawning Centres and Student Savings Units.
(d) Includes extension offices and sub branches

Source : Central Bank of Sri Lanka

The overall growth in loans and advances was mainly fuelled by expansion of credit by state banks and the domestic private LCBs. Of the 31 per cent growth in loans and advances, 49 per cent and 43 per cent were contributed by the state owned LCBs and domestic private LCBs, respectively. State owned LCBs recorded the highest growth in loans and advances of 44 per cent followed by foreign LCBs with a growth of 25 per cent.

Increased interest margins, improved cost efficiency and a rise in foreign exchange income contributed to a healthy growth in profits in the LCB sector. Profits before tax grew by 34 per cent to Rs. 30 billion with the net interest income increasing by 17 per cent in 2006 relative to 2 per cent increase in 2005. Domestic private LCBs contributed to 58 per cent of the growth in profit of the sector. The profitability in terms of return on assets (ROA) and return on equity (ROE) improved over the previous year and stood at 1.8 per cent and 18.5 per cent, respectively, at end 2006.

Sources and Uses of Funds of LCBs: The composition of sources of funding of LCBs displayed a shift with an increase

Table 8.3 Assets and Liabilities of Licensed Commercial Banks (a)

Rs.million

	End 2005	End 2006	Change 2005 Amount	Change 2005 %	Change 2006 Amount	Change 2006 %
Assets						
Liquid Assets	333,877	333,536	58,121	21.1	(341)	(0.1)
Cash on Hand	18,366	22,220	2,127	13.1	3,854	21.0
Due from Central Bank	69,880	87,023	15,216	27.8	17,143	24.5
Foreign Currency Denominated Assets	137,020	115,126	18,343	15.5	(21,894)	(16.0)
Treasury Bills	39,562	49,195	1,328	3.5	9,633	24.3
Treasury Bonds (b) (c)	53,099	43,203	21,170	66.3	(9,896)	(18.6)
Commercial Bills	15,950	16,769	(63)	(0.4)	819	5.1
Loans and Overdrafts	778,088	1,006,571	143,437	22.6	228,484	29.4
Loans	612,516	785,276	112,913	22.6	172,760	28.2
Overdrafts	165,572	221,295	30,524	22.6	55,724	33.7
Fixed and other Assets (c)	162,018	173,072	22,892	16.5	11,054	6.8
Liabilities						
Capital Accounts	110,928	136,835	33,708	43.7	25,906	23.4
Total Deposits	1,002,381	1,181,977	159,449	18.9	179,595	17.9
Demand Deposits	145,082	161,137	34,181	30.8	16,055	11.1
Time & Savings Deposits	857,300	1,020,840	125,268	17.1	163,540	19.1
Borrowings	71,757	127,429	30,229	72.8	55,672	77.6
Local Borrowings	60,246	104,694	26,300	77.5	44,448	73.8
Foreign Borrowings	11,511	22,735	3,929	51.8	11,224	97.5
Other Liabilities	261,155	325,381	61,416	30.7	64,226	24.6
Total Assets/Liabilities	1,446,222	1,771,621	284,802	24.5	325,399	22.5

(a) Includes assets/liabilities of National Development Bank which merged with NDB Bank Ltd. with effect from August 2005.

(b) With effect from 18 May 1998 Treasury bonds are considered as a part of the liquid assets of commercial banks.

(c) Restructuring bonds worth Rs.19,392.6 million, which were issued by the government to the two state banks, have been converted to Treasury bonds upon their maturity in October 2006. This amount, which previously appeared under Other Assets has been included in Treasury Bonds since October 2006.

Source: Central Bank of Sri Lanka.

in borrowings and a decline in deposits. While the contribution of borrowings increased to 12.2 per cent from 7.8 per cent in 2005, the contribution of deposits declined from 74.4 per cent in 2005 to 70.2 per cent. Total deposits growth in 2006 was 15.6 per cent, which is a reflection of the higher disposable income of households following the continued expansion in economic activities and liquidity in the system.

The share of capital funds in the total resource base of LCBs improved marginally in 2006 in comparison to 2005. Consequently, the share of borrowings and capital funds in the total resources also increased to 20.0 per cent from 15.5 per cent in 2005. However, of the three main funding sources, borrowings recorded a significant growth.

Reflecting the high credit expansion, an increased level of resource utilisation in respect of loans and advances was witnessed during the year. Of the total resources mobilised through deposits, capital, borrowings and other sources, Rs. 229.3 billion was absorbed by increase in loans and advances, representing over 70 per cent of the total resources mobilised during the year. The share of loans in the total funding base increased to 57.8 per cent at end 2006 relative to 34.9 per cent at end 2005, while the share of investments dropped to 12 per cent from 16 per cent during the same period.

Purpose-wise distribution of credit continued to be dominated by trading, housing and consumption activities. The share of credit for trading activities including domestic and international trade declined during the year and reached 29.1 per cent by end 2006, despite the 12.5 per cent growth in credit for such purposes. Meanwhile, the share of credit absorbed by housing and construction and consumption activities increased to 16.2 per cent and 19.4 per cent and grew by 41 per cent each by end 2006. In the consumption category, loans granted for purchase of consumer goods accounted for the bulk of the increase, while in the credit for housing activities, the residential housing sector contributed to the largest share.

An increase in credit card business was recorded in the backdrop of the increased disposable income and attractive incentive packages offered by banks. Credit provided through credit cards by ten banks increased by 41 per cent to Rs 21.1 billion, amidst fierce competition among credit card services offering banks. However, the share of credit card loans in the total loan portfolio of LCBs was about 1.7 per cent. Due to the unsecured nature of such lending, interest rates on credit card loans ranged between 21 -42 per cent. Although there appears to be a rapid increase in credit card business, the level of penetration of credit cards among the population is still relatively low compared to many

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cent mainly due to the contraction in interest margin and a reduction in capital gains. Total deposits and borrowings increased by 8.4 per cent and 35 per cent, respectively. The total number of LSBs remained unchanged at 14 by end 2006 with the entry of Lankaputhra Development Bank and the merger of NDB Housing Bank with the National Development Bank of Sri Lanka Ltd. The branch network of LSBs increased to 409 at end 2006.

Lending by LSBs was concentrated in the housing, industrial and financial sectors. These three sectors accounted for 65 per cent of the loans approved during the year. Due to the existence of banks catering mainly to the housing sector, lending by LSBs was concentrated in the housing sector. Investments in the form of government securities accounted for about 42 per cent of LSBs' total assets. The total outstanding loans and deposits of LSBs at end 2006 were Rs. 137 billion and Rs. 250 billion, respectively. Meanwhile, profit before tax of the sector decreased to Rs. 6.2 billion from Rs. 7.4 billion in 2005.

Registered Finance Companies (RFCs)

Activities of RFCs expanded further and their financial soundness improved supported by increased profitability, capital levels, asset quality and improvements in compliance with prudential regulations. The total assets of RFCs grew by around 29 per cent to Rs. 113 billion as at in 2006. This largely reflected an expansion in financial accommodation, particularly in the form of leasing and hire purchase facilities, provided by RFCs. The deposit liabilities of RFCs accounted for 3.7 per cent of the total deposit liabilities of major deposit-taking institutions regulated by the Central Bank as at end 2006. RFCs continued their business operations concentrating mainly on leasing, hire purchases and real estate activities. The total number of RFCs increased to 29, with the entry of a new RFC in 2006.

Loans and advances granted by RFCs grew by 29 per cent in 2006. The lending rates charged by RFCs were higher than those charged by LCBs and LSBs due to accommodation of less creditworthy customers by RFCs. Leasing and hire purchase facilities, accounted for 50 per cent of total assets and 70 per cent of total loans in 2006. As the leasing and hire purchase facilities are heavily concentrated on purchase of vehicles, a need for diversification is increasingly being felt. The share of loans granted for real estate activities remained at around 10 per cent of total accommodation and this level of exposure is not considered as threatening to the stability of the sector.

Deposits, which continued to be the dominant funding source, represented 52 per cent of total resources of RFCs. The RFCs in general were in compliance with the Finance Companies (Capital Funds) Direction No. 1 of 2003 in terms of which capital funds shall not be less than 10 per cent of the deposit liabilities. The other major sources of funds were bank borrowings (16 per cent) and capital funds (15 per cent).

Table 8.5 Sectoral Distribution of Loans Approved by Licensed Specialised Banks (a)

Rs.million

	2005(b)	2006 (c)
Total Loans Approved During the year	52,182	51,716
Agriculture	1,478	1,101
Industry	10,793	4,548
Tourism	521	777
Commercial	6,472	5,907
Financial	11,092	13,877
Housing	12,718	15,239
Redemption of Debt	56	243
Other Loans	9,051	10,023
Loans Disbursed (d)	56,052	69,564
Total Loans Disbursed as a Percentage of Total Loans Approved	107	135

(a) Excludes Regional Development Banks, but includes National Housing Development Authority. Operations of the NDB Bank cover only up to July 2005 and NDB Housing Bank was amalgamated with NDB Bank Since August 2006.
(b) Revised
(c) Provisional
(d) Includes loans approved in previous years but disbursed during the period under review.

Source : Central Bank of Sri Lanka

A substantial increase in profitability of RFCs was recorded in 2006. Net profits amounted to Rs. 2.3 billion in 2006, registering an increase of 14.3 per cent over the previous year. The majority of the RFCs operated profitably. This reflected that there is further scope for growth in the sector.

Other Financial Institutions

Primary Dealers (PDs): The PDs recovered from the setback experienced in the previous year and recorded increases in profits, assets and capital levels in 2006, despite the rising interest rate environment. In general, PDs cut down their portfolios and activities in both primary and secondary markets, even though, some PDs, especially the state sector PDs managed to increase their trading portfolios during the latter part of the year. However, with the continuous rise in interest rates, the investor preference shifted mostly towards the shorter end of the market. Total assets of PDs increased by Rs. 5 billion to Rs. 51 billion in 2006.

Most of the financial performance indicators of PDs showed an improvement in 2006. The net profit before tax of PDs increased to Rs. 550 million in 2006 from Rs.370 million in 2005. The return on equity (ROE) increased to 11 per cent from 8 per cent, while the return on assets (ROA) increased marginally to 1 per cent. The capital base of PDs also increased.

The PD system was stable in spite of the volatility in interest rates in the domestic market. Stress testing analysis shows that the PD industry would lose only 2.3 per cent of capital (Rs. 121 million) if the interest rate moved up by 100 bps from its level as at end 2006. PDs have shifted their portfolios towards the securities with shorter maturities, due to risk of holding of medium and long term Treasury bonds in a rising interest rate scenario.

Bloomberg bond trading platform (E-Bond trader) was introduced in 2006 allowing PDs to trade without brokerage. However, usage of this facility was reduced towards the end of the year, as the rising interest rates scenario was not conducive to trading in Treasury Bonds.

All PDs were cautious to operate in both the primary as well as the secondary market throughout the year, as the increase in interest rates diluted their trading ability as well as their financial condition. As a result, trading portfolios of most PDs were curtailed significantly to mitigate "mark to market" losses and capital losses. The income of PDs was mainly confined to margin income as PDs preferred to operate in the repo market rather than in the outright market.

Specialised Leasing Companies (SLCs): Specialised leasing companies recorded an improved performance in 2006 in terms of profitability, capital, asset quality and compliance with prudential regulations. The number of SLCs stood at 20 as at end 2006. Of these, 7 companies accounted for 83 per cent of the total assets of SLCs. The total assets of SLCs increased by 25 per cent to Rs.67 billion, while total finance leases increased by 11 per cent to Rs. 29 billion.

As SLCs are not permitted to accept deposits from the public, they were mainly dependent on bank borrowings or funds obtained through the issue of debt securities. As the definition of "deposit" introduced in the Banking (Amendment) Act No. 2 of 2005 is comprehensive, it includes borrowings obtained through the issue of debt instruments on a regular basis. Therefore, at the request of SLCs, the Central Bank has recommended an amendment to the Finance Leasing Act No. 56 of 2000 to permit SLCs to mobilise funds through the issue of debt instruments. The industry average of gearing ratio (debt to capital) of SLCs stood at approximately 4 : 1 against the permitted maximum ratio of 10 : 1, at present, indicating a sound financial position.

A high concentration of the leasing portfolio of SLCs is in respect of vehicle financing, which accounts for 81 per cent. However, the risks associated with possible defaults are mitigated to a large extent, by the nature of finance leases, where the vehicle itself is considered as the security for the accommodation and SLCs have absolute ownership of such vehicles. This concentration is not considered as a major risk to the industry as vehicles financed are used for purposes such as public transport, goods transport and personal use by a diverse clientele. However, attention is being given to encourage the SLCs to diversify their leasing portfolios by providing facilities for purchase of capital equipment such as machinery.

Merchant Banks: Merchant-banking activities continued to boost during 2006 with total asset of the sector increasing from Rs. 24.0 billion in 2005 to Rs.31.4 billion. Profit before tax in the industry was Rs. 350 million in 2006, compared to Rs.183 million in the previous year. Leasing, investment in financial instruments and lending activities have mainly contributed to the progress in the merchant banking industry.

Unit Trusts: The performance of unit trust industry improved in line with the boosting of Colombo bourse activities and growth in the economy. The total assets of the unit trusts significantly increased by 18.6 per cent to Rs. 5.4 billion compared to Rs.4.5 billion in the previous year. The net asset value of unit trusts grew by 19.1 per cent supported by an appreciation of the value of investments and an increase in number of units in issue. The equity portfolio was the main instrument of the investments of unit trusts and accounted for about 69 per cent of the total investments. While the share of investments in Treasury bills and Re-purchase agreements had dropped, investments in Treasury bonds had increased during the year.

Venture Capital Firms (VCFs) : The primary business of VCFs is to provide equity capital for high-risk investments, mainly new ventures launched by entrepreneurs, which usually promise high returns. There was a marginal decline in activities of VCFs as a result of the stock market boom during the year, which turned investments in venture capitals less attractive.

Table 8.6 Specialised Leasing Companies Sectoral Classification of Leasing Facilities

Rs.million

Sector	During 2005 (a)	During 2006 (b)
Agriculture	1,397.7	1,577.7
Industry	2,515.4	2,269.6
Trade	7,615.7	8,518.1
Transportation	4,766.8	3,918.5
Construction	1,150.6	1,294.0
Services	6,438.9	8,196.8
Others	3,050.0	3,668.6
Total	26,935.1	29,443.3

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

Contractual Savings Institutions

Superannuation Funds: The total assets of superannuation funds comprising the Employees' Provident Fund (EPF), the Employees' Trust Fund (ETF), the Public Sector Provident Fund (PSPF), the Contributory Pension Fund (CPF) and the Private Provident Funds (PPFs) grew by 14.0 per cent to Rs. 671.5 billion during 2006, which represented 18.2 per cent of financial system assets at end of the year.

The EPF, the major retirement benefit fund in the country for private sector employees, expanded with an increase in net contributions and investment income. The total assets of the EPF, which account for about 72 per cent of the superannuation funds in the country, grew by 14.9 per cent to Rs. 492 billion at the end of 2006. The total investment portfolio of the EPF consisted mainly of government securities (96.8 per cent). The EPF earned a gross income of Rs.46.4 billion for the year, recording a return of 12.22 per cent. An effective rate of return of 10.2 per cent was declared on member balances in 2006, which is higher than the annual weighted average deposit rate of 6.8 per cent in 2006.

The ETF, the employer contributory retirement benefit scheme in the country, also recorded an increase in its asset base, with higher net contributions and investment income. The total assets of the ETF increased by 14 per cent to Rs.67 billion, while total contributions increased by 20 per cent to Rs.6 billion in 2006. The total outstanding member balances in the ETF rose by 15 per cent to Rs.66 billion at the end of 2006. Total investments stood at Rs.64 billion at the end of 2006 and was heavily concentrated in government securities (93 per cent).

The asset base of the PSPF and the CPF was Rs. 16 billion in 2006. In addition, there were 88 approved private provident funds, in operation in 2006 with total assets amounting to Rs. 95 billion.

Even though around two million active member accounts are covered by the EPF and the ETF each, there are over three million informal sector workers who are not covered by any social security scheme. The Central Bank will actively explore the possibility of introducing a unified voluntary contributory social security scheme to cover this deprived segment of the work force.

Insurance Companies: The insurance industry recorded significant growth in terms of premia, profits and assets in 2006. With the amalgamation of the National Insurance Corporation with Janashakthi Insurance Company, and the establishment of Ceylinco Takaful Insurance Company, the number of insurance companies engaged in both life and general insurance in Sri Lanka remained at 15 at end 2006, the same number as the previous year. The insurance companies together accounted for 2.9 per cent of the total assets of the financial system, and grew by 2.1 per cent to Rs.107.3 billion during 2006. The industry was heavily concentrated with over 72 per cent of the assets with the two largest firms. Insurance penetration i.e., the ratio of total gross premia to GDP remained unchanged at 1.3 per cent in 2006 as well, while insurance density i.e., per capita premium increased from Rs.1,543 in 2005 to Rs.1,804 in 2006.

8.3 Developments in Financial Markets

Inter-Bank Call Money Market

Reflecting the tighter liquidity position, the volume of inter-bank transactions increased from Rs. 310 billion during the first quarter to Rs. 610 billion in the last quarter 2006. Correspondingly, the daily average inter-bank call money market volume increased gradually from Rs. 5 billion during first quarter to around Rs. 10 billion during last quarter of the year.

The structural rigidities are apparent in the call money market as a result of the high concentration of liquidity among a few banks and the tax differentials associated with inter bank call money market transactions in comparison to government securities transactions.

Domestic Foreign Exchange Market

The level of activity in the inter-bank foreign exchange market increased substantially during 2006 reflecting higher international trade and remittances flows. During the year, the Central Bank permitted commercial banks to offer rupee based cross currency options to domestic corporate clients to expand the activities in the foreign exchange market. The customer market, which consists of foreign exchange sales and purchases to and from customers by commercial banks, recorded the highest volume of transactions since the floating of the rupee.

The Central Bank encouraged domestic commercial banks to develop oil hedging instruments to facilitate the oil importing companies entering into hedging to mitigate the impact of rising oil prices and to reduce volatility in the foreign exchange market. The introduction of hedging instruments would further develop the domestic foreign exchange market.

Government Securities Market

Rupee Denominated Debt: The government continued to raise funds through rupee denominated instruments, namely Treasury bonds, Treasury bills and Rupee Loans to meet a part of its budgetary requirements. In view of the rising interest rate environment and inflationary expectations, the market preference was towards short-term maturities.

Total issues of Treasury bills in the primary market increased in 2006 compared to 2005. The government issued Treasury bills amounting to Rs.628 billion in gross terms. In net terms, there were new issues of Rs.24 billion, through the auction system. Of the total gross issues, 64 per cent were for 91-day Treasury bills which resulted in an additional liquidity pressure on the money market.

A total of Rs. 310 billion was issued through the Treasury bond programme. Of the total, a sum of Rs. 43 billion was issued through auctions and Rs.267 billion through direct placements. This includes Rs.6 billion Index linked bonds issued by the government as a direct placement.

US Dollar Denominated Debt: Sri Lanka Development Bonds (SLDBs) were issued through three auctions in June, August and September 2006. All three auctions were well over-subscribed and a total of USD 580 million was raised with two year (USD 320 million) and three year (USD 260 million) maturities. The interest rates for these bond issues were six month LIBOR plus a margin of 132 basis points for 2-year tenure and 141 basis points for 3-year tenure. The Sri Lanka Nation Building Bond (SLNBB), a new sovereign debt instrument was introduced by the government in February and US dollars 2.5 million was raised by end 2006. A foreign commercial borrowing through a syndicated loan amounting to USD 100 million with the tenure of 3 years and at a variable interest rate of six month LIBOR + 75 basis points was obtained to mitigate the pressure on domestic debt securities market and to stabilise the interest rate structure.

Table 8.7 Money Market Operations 2004 - 2006

Rs.million

		Call Money Market	Primary Treasury Bill Market			
		Total Lending/ Borrowings	Amount Issued	Amount Purchased		
				Central Bank	Commercial Banks	Others
2004	1st Qtr	183,377	103,970	29,917	48,904	25,149
	2nd Qtr	372,607	104,683	20,000	62,929	21,754
	3rd Qtr	350,969	136,022	35,550	72,623	27,849
	4th Qtr	456,537	125,298	47,790	58,468	19,040
2005	1st Qtr	310,678	98,810	29,923	45,349	23,538
	2nd Qtr	230,345	108,231	27,943	63,213	17,075
	3rd Qtr	283,380	147,252	35,209	72,568	39,475
	4th Qtr	232,835	131,476	13,034	77,927	39,515
2006	1st Qtr	311,359	147,481	16,796	72,639	58,046
	2nd Qtr	453,677	144,412	29,592	65,314	49,506
	3rd Qtr	455,027	152,254	47,755	58,985	45,514
	4th Qtr	609,438	183,719	71,581	62,743	49,395

Source : Central Bank of Sri Lanka

New developments: The government securities market was liberalised partially and foreign investors were permitted to purchase up to 5 per cent of rupee denominated Treasury bonds from November 2006. This measure was introduced to further open the capital account transactions and to develop the capital market by broadening the investor base and increasing the competition in the bond market.

Corporate Debt Securities Market

Commercial Papers: Commercial Paper (CP) market activities increased significantly in 2006 and this could be due to the abolition of the withholding tax on interest income during 2005 and increased economic activities. Total amount of funds raised through CPs increased more than twofold to Rs.23.5 billion during the year of 2006, in comparison to Rs. 10.9 billion during 2005. Interest rates applicable to CPs increased to a range of 10.80-16.95 per cent by end 2006, compared to 8.90-14.25 per cent in 2005. 95 per cent of the total value of issued CPs was of less than 3 months maturity and the total outstanding value of CPs as at end of the year amounted to Rs.3.4 billion.

Corporate Bonds: Activities in the corporate debt market improved in 2006. Seylan Bank Ltd and DFCC Bank made two new issues of unsecured subordinated redeemable debentures in 2006. The total funds mobilised through corporate bonds have increased significantly to Rs. 2,257 million in 2006, compared to Rs.350 million in 2005. The activities of debt securities trading at the Colombo Stock Exchange were comparatively low. The corporate debt turnover with a total turnover amounting to Rs.405 million, showed a positive growth of 96 per cent over the previous year.

Share Market

The Colombo Stocks Exchange (CSE) recorded a significant growth, particularly during the latter part of the year. The All Share Price Index (ASPI) and the Milanka Price Index (MPI) rose by 42 per cent and 51 per cent respectively in 2006. Market capitalisation increased by 43 per cent and reached Rs.835 billion, which is about 30 per cent of GDP. The main contributory sectors to the improvement were Telecommunications, Diversified Holdings and Bank, Finance and Insurance, which account for 65 per cent of market capitalisation.

The robust performance of the share market was due to the improved performance of listed companies, due to strong corporate earnings. The price earnings ratio for the market, as a whole, increased to 14 at end 2006, from 12.4 at end 2005, indicating market expectations on further improvements. Negative real interest rates on many products including fixed income securities due to high inflation too had a positive impact on the equity market investment in 2006. Net foreign purchases amounted to Rs.5.4 billion in 2006, indicating the increased participation of foreign investors, while the continuing interest of domestic investors also was apparent with their 67 per cent share in total turnover. Primary market activity was subdued during the year, with only two initial public offerings (IPOs). The total amount of funds raised from the share market through new issues and rights issues amounted to Rs.5.2 billion.

Five companies were admitted to the CSE as new trading members in equity and debt securities in 2006, bringing the total number of trading members to 20. The companies have been issued licences as Stock Brokers and Dealers by the Securities and Exchange Commission.

The number of companies listed at the CSE has hovered around the present level of 237 for over a decade, as new listings have been rare during recent years. This remains an impediment to the growth of CSE and needs to be addressed in order to expedite capital market developments.

8.4 Development Finance and Access to Finance

Development Finance

The expansion of development finance and rural financial sector institutions continued in 2006 with the increase in the number of branches of banks including Regional Development Banks. The Central Bank introduced the Tea Development Project Revolving Fund (TDPRF) and the Second Perennial Crop Development Project Revolving Fund credit schemes in 2006 to continue support to the tea and perennial crop sectors. The Central Bank continued to operate 3 different credit schemes designed exclusively for tsunami victims namely Sushanana, Small Business Revival Project (SBRP) and Jeevana Shakthi Programme. Under these three schemes, 13,652 loans amounting to Rs. 5.9 billion were facilitated during 2006. Out of this 57 per cent was disbursed within the Southern province, and the rest in the Eastern, Northern and Western provinces.

Preliminary work was completed with respect to two new credit lines, which will be operational from 2007 for tsunami reconstruction. These credit lines are the Construction Sector Development Project credit line funded by the Government of France, which will provide refinance for loans granted to construction firms undertaking government projects for post-tsunami construction and the European Investment Bank (EIB) credit line (Contract B) which is specifically meant for providing credit to medium scale enterprises directly affected by the tsunami. The Central Bank is to act as the apex institution for this component of the EIB credit line.

The National Development Trust Fund (NDTF) which is an apex institution for disbursement of micro finance continued to act as a conduit for two tsunami related ADB funded credit schemes, namely the Rural Financial Sector Development Programme (RFSDP- reallocated for a tsunami emergency credit line) and the Tsunami Affected Area Rehabilitation Programme (TAARP). The total funds disbursed for tsunami affected districts under these programmes in 2005 and 2006 were Rs. 904 million. These funds were available at a concessionary interest rate of 6 per cent. The NDTF also continued credit delivery through its partner organisations in the other districts inclusive of the North and East.

A number of other projects continued to be in operation during the year. The Small Farmer and Landless Credit Project (SFLCP), The Poverty Alleviation Micro Finance Project (PAMP), and short-term cultivation loans under the New Comprehensive Rural Credit Scheme (NCRCS) were further continued to provide financial facilities during the year. As evident with findings of follow-up surveys, a significant fraction of the beneficiaries of funds under these projects have been able to break free from poverty.

Table 8.8 Share Market Performance

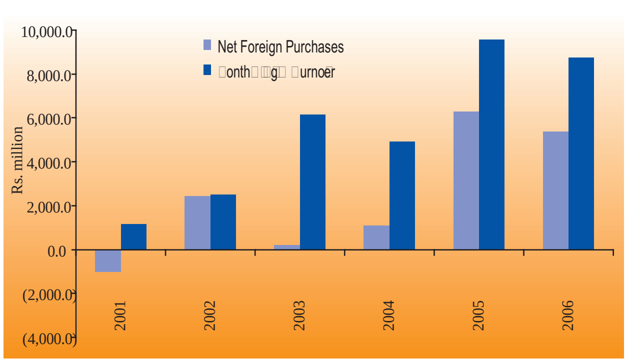
	2005	2006
All Share Price Index (a)	1,922.2	2,722.4
Year-on-year change (%)	27.6	41.6
Milanka Price Index (a)	2,451.1	3,711.8
Year-on-year change (%)	18.2	51.4
Market Capitalisation (Rs.bn.)(a)	584	835
As a percentage of GDP (%)	24.7	30.0
Market Price Earnings Ratio (a)	12.4	14.0
Turnover to Market Capitalisation (%)	19.6	12.6
Value of Shares Traded (Rs.mn.)	114,599	105,154
Number of Shares Traded (mn.)	5128	3,912
Number of Companies Traded	242	232
Number of Companies Listed	239	237
Introductions (b)	3	1
Number of Initial Public Offers/Offers for Sale (b)	3	2
Number of Rights Issues	18	16
Amount Raised through Rights Issues (Rs.mn.)	3,783	4,705

(a) End of the year

(b) There are 3 methods to obtain a listing: i.e an introduction where no public issue is required, an offer for sale where already existing shares are issued to the public and an offer for subscription where new shares are issued to the public.

Source : Colombo Stock Exchange

Chart 8.2



Enhancement of Access to Finance

During the year several measures were taken to increase access to finance. Central Bank approval was obtained to open 120 new branches of LCBs and LSBs. Of these, 56 branches were opened outside the Western Province. Approval was also obtained to relocate 120 bank branches. In 2006, licences were granted to Lankaputra Development Bank and to Sri Lanka Savings Bank to operate as LSBs and to ICICI Bank Ltd. to operate as an LCB. Outreach of existing micro-finance schemes were also widened during the year.

The Budget for 2006 proposed to amend banking regulations to make it mandatory that credit extended to agriculture, including processing be increased to 10 per cent of the credit during the next three years. A survey was undertaken to assess the current position of lending to the agriculture sector as banks lend for various purposes connected with the agriculture sector directly and indirectly under various schemes. The survey indicates that, of the 37 licensed banks, 28 banks have granted loans to agriculture in excess of the 3 per cent limit proposed for 2007. Furthermore, the share of agriculture credit was above 5 per cent in 22 banks, while the share of agriculture credit in 14 banks was above 10 per cent. The formulation of an appropriate definition of activities that constitute the agriculture sector and other modalities relating to the implementation of a requirement of a minimum percentage of loans to be extended to the agriculture sector by banks are under consideration.

8.5 Financial Infrastructure

Payment and Settlement Systems

As a safe and efficient infrastructure for payments and settlements is vital for the proper functioning and stability of the financial system, the Central Bank took further measures to strengthen the payments and settlement systems and to improve oversight of the systems, thereby minimising the risks involved. In terms of the Payments and Settlements Systems Act No.28 of 2005 which came into effect during 2006, the Central Bank performs three key functions with respect to the payment and settlement system; overseeing the payment, clearing and settlement systems, operating systemically important payment and settlement systems and formulating a national payments policy and developing the payment systems.

The Central Bank continued to operate LankaSettle, the systemically important high value payment and securities settlement system. The LankaSettle system has two components i.e., the Real Time Gross Settlement (RTGS) system, which processes large value and time critical payments, and the LankaSecure system, the Scripless Securities Settlement (SSS) System, which handles the settlement of securities transactions on a Delivery versus Payment basis (DvP). Both, the RTGS and SSS system availability was at 99.78 per cent during 2006.

Table 8.9 Non-Cash Payments: Volume and Value of Transactions

Payment Systems	2005 (a)		2006 (b)	
	Volume ('000)	Value (Rs. bn.)	Volume ('000)	Value (Rs. bn.)
Large Value Payment Systems	150	17,543	175	18,110
RTGS System	150	17,543	175	18,110
Retail Value Payment Systems	58,078	3,654	67,560	4,174
Main Cheque Clearing System	40,068	3,385	44,343	3,823
Rupee Draft Clearing System	n.a	6	n.a	4
Regional Cheque Clearing Systems	1,376	64	510(c)	25(c)
Sri Lanka Interbank Payment System (SLIPS)	3,097	87	4,165	121
Credit Cards	12,352	42	16,391	55
Debit Cards	419	1	516	1
Internet Banking	688	52	1,316	101
Phone Banking	78	5	319	33
Postal Instruments	n.a	12	n.a	11
Total	58,228	21,197	67,735	22,284
US Dollar Cheque Clearing System	106	16	98	21

a.Revised
b.Provisional
c.Data up to 10th May 2006 as the regional clearing system terminated after CIT commenced on 11th May

Source : Central Bank of Sri Lanka