8 FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

The financial sector expanded whilst remaining stable despite challenging market conditions both globally and domestically, and continued to support the growth momentum in the economy. Amidst the expansion, the risk absorption capacity of the financial sector improved with higher capital levels, adequate liquidity buffers and healthy earnings. Further, the supervisory and regulatory framework was strengthened and banks were directed to manage risks in an integrated manner while the financial safety nets in place also helped build confidence in the financial sector and promote financial system soundness. The ceiling on credit which was imposed early in the year, helped moderate the expansion of credit. As monetary conditions tightened, the net interest margins in the banking sector declined marginally. Nevertheless, profitability of the banking sector has surpassed that of the previous year along with an increase in both interest income and non-interest income. Moreover, by raising funds abroad, the banking sector diversified its sources of funding, which would further strengthen its balance sheets. During the year, the branch network of banks, finance companies and leasing companies as well as the insurance sector expanded further, increasing access to finance. Measures were taken requiring banks to open SME centres to ensure greater access to financing for SMEs. The legal and operational framework for microfinance that is expected to come into force would help expand the availability of financing for micro enterprises. Performance of the insurance sector improved during the year as reflected by the higher gross premia, healthy profitability, and higher solvency margins while the strengthening of the regulatory framework pertaining to insurance companies will help promote financial system soundness.

Although financial markets were volatile during the early part of 2012, the policy measures taken were able to restore stability in financial markets during the latter part of the year. With the tightening of monetary policy to prevent the build-up of demand pressures and the liquidity constraints that prevailed intermittently, there was upward pressure on deposit and lending rates during much of the year. However, the tax adjusted average weighted call money rate has remained within the policy interest rate corridor, despite volatility seen during the first half of the year.

Although there was volatility in exchange rates vis-a-vis the rupee during the early part of the year, the measures taken to reduce imports along with foreign currency inflows have contributed towards stabilizing the domestic foreign exchange market and raising the level of international reserves. Despite continued foreign investor purchases in the stock market, its downward trend continued through much of the year although a limited turnaround was seen during the last quarter of the year.

Continued strengthening of the supervisory and regulatory framework governing the financial sector has ensured that a sound and conducive environment for effective financial intermediation prevails. In order to further strengthen the risk assessment and capital planning processes of banks and ensure that they are in line with international best practices, the Central Bank issued a Consultation Paper on the supervisory review process, in accordance with Pillar II of Basel II. Financial reporting by financial institutions will improve with the application of the accounting standards introduced in 2012, which are in line with international financial reporting standards. A panel of external auditors was appointed for finance companies and leasing companies, to ensure that the audits of finance companies and leasing companies meet the required standards. A direction was issued to leasing companies requiring them to strengthen their corporate governance provisions relating to fitness and propriety of directors and the senior management. The payment and settlement system operated with a high degree of availability and safety. The Central Bank continued its efforts to promote mobile phone based e-payment systems as they provide secure and cost effective means of making small value payments. Measures were also taken to improve contingency planning of the key institutions in the financial system so as to ensure customer protection.

The financial sector is expected to remain stable, underpinned by adequate capital, healthy earnings and an effective regulatory and risk management framework. Further efforts will be directed toward raising efficiency of the financial sector and enhancing financial system stability so as to enable the economy to move to a higher growth path. A series of tax incentives granted is expected to spur the growth of the capital market, in particular the corporate bond market. The announced measures to further liberalise exchange control regulations permitting corporate entities to borrow abroad with greater ease would accelerate the deepening of the domestic financial system and promote its integration with the global financial system. However, risks arising due to global developments need to be monitored, given their implications for market sentiment and capital flows. To promote greater harmonisation with international regulatory standards, and increase the resilience of the banking sector by enhancing

Table 8.1 Total Assets of the Major Financial Institutions

	2011 (a)		2012 (b)	
	Rs. bn	Share in Total (%)	Rs. bn	Share in Total (%)
Banking Sector	**5,375.6**	**69.7**	**6,381.4**	**70.6**
Central Bank	1,123.4	14.6	1,279.7	14.2
Licensed Commercial Banks	3,578.5	46.4	4,359.2	48.2
Licensed Specialised Banks	673.7	8.7	742.5	8.2
Other Deposit Taking Financial Institutions	**427.1**	**5.5**	**621.2**	**6.9**
Licensed Finance Companies	352.1	4.6	536.1	5.9
Co-operative Rural Banks	67.6	0.9	77.2	0.9
Thrift and Credit Co-op. Societies	7.4	0.1	7.9	0.1
Specialised Financial Institutions	**338.8**	**4.4**	**282.8**	**3.1**
Specialised Leasing Companies	137.8	1.8	60.5	0.7
Primary Dealers	132.7	1.7	132.7	1.5
Stock Broking Companies	11.3	0.1	10.8	0.1
Unit Trusts / Unit Trust Management Companies	23.7	0.3	32.4	0.4
Market Intermediaries (c)	31.2	0.4	43.9	0.5
Venture Capital Companies	2.1	0.0	2.5	0.0
Contractual Savings Institutions	**1,570.8**	**20.4**	**1,750.2**	**19.4**
Insurance Companies	265.4	3.4	304.6	3.4
Employees' Provident Fund	1,018.0	13.2	1,144.0	12.7
Employees' Trust Fund	142.4	1.8	158.4	1.8
Approved Private Provident Funds	115.1	1.5	110.3	1.2
Public Service Provident Fund	29.9	0.4	32.9	0.4
Total	**7,712.3**	**100.0**	**9,035.6**	**100.0**

(a) Revised
(b) Provisional
(c) Includes Underwriters, Investment Managers and Margin Providers

Source : Central Bank of Sri Lanka

capital in terms of quantity and quality, and raising the level of liquid assets maintained, the Central Bank will take measures to implement Basel III standards on a staggered basis. The Bank will also continue to develop macro-prudential approaches to regulation, which would complement the supervision of individual institutions, to pre-emptively address systemic risks as well as contagion risks to financial system stability and enhance the ability of the financial sector to withstand macroeconomic shocks.

8.2 Performance of Financial Institutions

Banking Sector

The banking sector remained stable and its assets expanded while credit growth, which was high in 2011, moderated during 2012. The banking sector continued to maintain its dominant role in the financial sector with its assets increasing from 55.1 per cent of the total assets of the financial sector in 2011 to 56.4 per cent by end 2012. The effectiveness of the regulatory policy measures adopted as well as the measures adopted to strengthen risk management was reflected in the moderation in credit expansion, prudent diversification of lending, healthy levels of profitability, liquidity and capital, and the maintenance of risks, including credit risk, market risk, liquidity risk, and operational risk, at manageable levels. As a consequence, the stability of the banking sector was reinforced.

Business Expansion

Outreach: The banking sector continued to perform its role of financial intermediation while further expanding the range of products and services offered as well as its outreach. By end 2012, 33 banks comprising 21 domestic banks (including 09 licensed specialised banks) and 12 branches of foreign banks continued operations while expanding the banking network and introducing new diverse banking solutions to attract new customers. The banking network expanded with 190 banking outlets and 153 automated teller machines (ATMs) being added to the network during 2012. Of these, 168 branches and 86 ATMs were established outside the Western Province. Accordingly, by end 2012, the banking sector was operating with 6,374 banking outlets and 2,390 ATMs.

Table 8.2 Distribution of Banks and Bank Branches

Category	End 2011(a)	End 2012(b)
Licensed Commercial Banks (LCBs)		
I. Total No.of LCBs	24	24
Domestic banks	12	12
Foreign banks	12	12
II.Total No.of LCB Branches and Other Outlets	5,397	5,574
Branches	1,616	1,676
Domestic Bank Branches	1,567	1,627
Foreign Bank Branches	49	49
Extension Offices	989	1,041
Domestic Banks	818	870
Foreign Banks	171	171
Student Savings Units and Other Outlets	2,792	2,857
Automated Teller Machines	2,079	2,232
Licensed Specialised Banks (LSBs)		
I. Total No. of LSBs	9	9
Regional Development Bank	1	1
National Level Savings Banks	2	2
Long-term Lending Institutions	2	2
Housing Finance Institutions	2	2
Private Savings and Development Banks	2	2
II. Total No. of LSB Branches and Other Outlets	787	800
Branches	515	527
Regional Development Bank	235	240
National Level Savings Banks	179	185
Long-term Lending Institutions	25	25
Housing Finance Institutions	30	31
Private Savings and Development Banks	46	46
Extension Offices	84	85
Student Savings Units and Other Outlets	188	188
Automated Teller Machines	158	158
Total No. of Bank Branches and Other Outlets	6,184	6,374
Total No. of Automated Teller Machines (ATM's)	2,237	2,390
Total No. of Electronic Fund Transfer Facilities at Point of Sale Machines (EFTPOS)	27,073	27,689
Banking Density: No.of Bank Branches Per 100,000 Persons	10.2	10.8

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

Assets and Liabilities

Assets: The growth in assets of the banking sector during 2012 remained unchanged at 20 per cent. Owing to the imposition of a ceiling on credit growth, loans and advances increased only by 21 per cent during the year, while investments and short-term placements (included in other assets) recovered from the slow growth that prevailed during 2011. Despite the slower growth, the share of loans and advances increased marginally from 61.2 per cent to 61.6 per cent by end 2012, while the share of investments declined from 24.9 per cent to 23.5 per cent by end 2012.

The increase in lending during 2012 was concentrated in four major economic sectors, namely, trading (19 per cent), agriculture (14 per cent), infrastructure (14 per cent) and construction (12 per cent). Lending to the manufacturing and consumption sectors increased by Rs. 33 billion and Rs. 82 billion, respectively, in 2012, compared to the increase of Rs. 55 billion and Rs. 139 billion, respectively, during 2011.

Liabilities: Deposits continued to be the main funding source in the banking sector, despite the marginal decline from 72 per cent of total liabilities as at end 2011 to 71 per cent by end 2012 due to the lower growth in deposits. The resultant funding gap was bridged with borrowings which increased by 27 per cent during 2012 compared to the growth of 25 per cent in 2011. Accordingly, the share of borrowings in funding sources increased from 15 per cent as at end 2011 to 16 per cent by end 2012. The increase in borrowings was the result of an increase in borrowings in foreign currency (FX) mainly from overseas sources (Rs. 164 billion or 97 per cent).

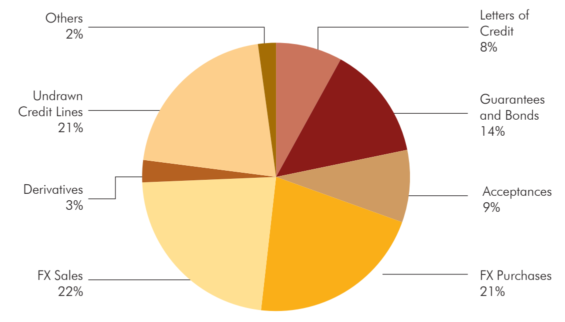
Table 8.3 Composition of Assets and Liabilities of the Banking Sector

Item	2011 (a) Rs.bn	2011 (a) Share (%)	2012 (b) Rs.bn	2012 (b) Share (%)	Change (%) 2011	Change (%) 2012
Assets						
Loans	2,602	61.2	3,143	61.6	31.7	20.8
Investments	1,057	24.9	1,197	23.5	(2.2)	13.2
Others	593	13.9	762	14.9	20.2	28.2
Liabilities						
Deposits	3,073	72.3	3,598	70.5	18.8	17.1
Borrowings	635	14.9	805	15.8	25.4	26.7
Capital Funds	371	8.7	436	8.5	25.9	17.5
Other	173	4.1	263	5.1	6.4	51.4
Total Assets/ Liabilities	4,252	100	5,102	100	19.8	20.0

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 8.1 Off Balance Sheet Exposures of the Banking Sector

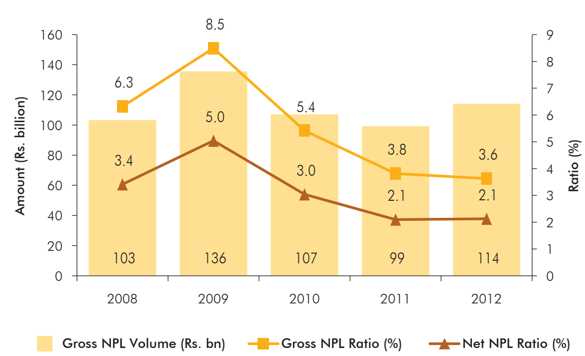


Off-balance sheet exposures: The growth of off-balance sheet exposures which was high at 35 per cent, year-on-year, by end 2011, declined to 7 per cent by end 2012. This was mainly due to the decline in documentary credit and the lower growth of acceptance and FX related exposures. However, FX related exposures (both FX sales and purchases) accounted for 43 per cent of the total off-balance sheet exposure, thus continuing to be the main off-balance sheet item of the banks.

Risk Management

Credit risk: Credit risk of the banking sector was at a manageable level by end 2012 as reflected by the moderation in the growth of loans and advances and the adequate distribution of loans among the main economic sectors.

Chart 8.2 Non-Performing Loans of the Banking Sector



BOX 10 Interconnectedness of Financial Institutions and Systemic Risk

Introduction

The recent global financial crisis has emphasised the importance of managing systemic risk, which disrupts the financial system and has a significant adverse impact on the real economy. The interconnectedness of financial institutions has been identified as a critical source of systemic risk. Financial institutions can be connected to each other in several ways, such as by having common shareholders and directors, being subsidiaries or associates of a common parent/holding company or by making considerable investments in and/or granting loans to each other. Financial sector supervisors/regulators realise that any systemic event carries contagion effects as in the case of the recent global financial crisis and conventional supervisory approaches mainly focused at individual banks are insufficient to address such systemic risk and contagion effects. Accordingly, the supervisors/regulators have now initiated mechanisms to assess financial system vulnerabilities arising from interconnectedness and to mitigate the impact of contagion.

Risks arising from financial interconnectedness

Increased interconnectedness of financial institutions (banks, finance companies, leasing companies, primary dealers, insurance companies, stock broking companies, unit trusts etc.) amplifies several risks that could affect the stability of the financial system as a whole. The following are among the most significant:

a) *Contagion:*

Contagion risk occurs when one entity's financial difficulties adversely affect the entire group. Contagion can be due to intra-group exposures such as credit extension and intra group guarantees or commitments. Even if there is no financial exposure, news of losses or falling profits in related companies may still weaken depositors' confidence in a financial institution and bring it under liquidity pressure.

b) *Lack of Transparency:*

Transparency means the availability of accurate, timely and relevant information about the entire group to its stakeholders. The legal and managerial structure of an entire group is crucial for regulators to identify the group as a whole to enforce regulations. Complex group structures facilitate dishonest or fraudulent personnel to hide their activities from regulators. Financial institutions may deliberately choose a complex structure to conceal their true operations or true ownership, and thereby avoid effective regulatory supervision.

c) *Regulatory Arbitrage:*

Different financial institutions may have different regulators and may be subject to different regulatory requirements. The term "Regulatory Arbitrage" is used to refer to the shifting of certain activities or positions within a corporate group, either to avoid a situation of relatively more strict prudential supervision by one regulator compared to another, or to avoid supervision altogether (by transferring the activities or positions to a non-regulated entity).

d) *Intra – group Transactions and Exposures:*

Intra – group Transactions and Exposures (ITEs) take the form of direct and indirect claims among entities within a group. According to the Joint Forum of Banking, Insurance and Securities Regulators, ITEs can originate in a variety of ways, for example through cross shareholdings, central management of short term liquidity, the provision of management and other service arrangements, guarantees, loans and commitments to entities within the group, purchase or sale of assets with other group companies and transfer of risk through reinsurance etc. Any material ITE could trigger resolution action or failures in group companies, which in turn could impact financial system stability.

Measures to address financial interconnectedness

When there is increased interconnectedness among the entities within a conglomerate, it necessitates regulation and supervision by an extended regulatory regime. This can be achieved by way of adopting appropriate supervisory techniques such as follows:

a) *Improvements in Information Sharing and Cooperation:*

When there are multiple regulators supervising different entities within a group, supervisors should form an understanding between themselves to share information on the financial condition and adequacy of risk management controls in the differently regulated entities.

b) *Establishment of Firewalls:*

Firewalls can be established among companies with common ownership in order to reduce risks, including contagion risk. These firewalls can include prudential limits on permissible activities, ownership of other companies, connected lending/investments etc.

c) *Consolidated Supervision:*

In recent times, much importance has been placed on consolidated supervision as opposed to conducting solo basis supervision (i.e. supervision of entities on an individual basis.) Consolidated supervision provides a comprehensive approach to supervision of financial institutions and seeks to evaluate the strength of an entire group, considering all the risks which may affect a bank, regardless of whether those risks are booked in the bank or related entities (Ronald MacDonald – 1998).

d) *Establishment of Mandatory Regulatory Reporting Lines:*

A mandatory reporting regime should specify the disclosure of legal entity level details and other essential information regarding the financial condition and prospects of the entities. This will facilitate supervisors to access information in an effective and timely manner.

e) *Financial Statements on a Consolidated Basis:*

Consolidated financial statements provide supervisors with a greater understanding of the financial position of a group. The International Accounting Standards (IASs) are the generally accepted accounting standards which are used worldwide. IAS-27 on "Consolidated and Separate Financial Statements" places preparation and presentation of consolidated financial statements for a group of entities under the control of the parent company.

Interconnectedness of Financial Institutions in Sri Lanka

The Central Bank of Sri Lanka (CBSL) commenced a study to assess the impact of any concentration risk arising due to interconnectedness of licensed banks with other entities. Accordingly, information on exposure of banks to subsidiaries, associates, other investee entities and top 20 groups/ customers was collated.

There were 11 banking groups identified with 38 subsidiaries and 22 associates. Further, the banks had invested in 95 business entities other than subsidiaries and associates. The interconnection ranged from financial service providers such as insurance, investment banking, leasing and finance business, stock broking, money exchange business and unit trust management to non-financial service providers such as property development, travel related services, hotel service, venture capital financing, consultancy services and IT related services. The exposure of the banking sector to large 20 corporates was around 18% of the total assets of banks while it ranged between 0.04% and 78.1% with respect to individual banks. However, the exposure of the banking sector to other subsidiaries and associates was only 1.4% of the banks' total assets.

As in many other countries, Sri Lanka also has a multiple regulatory system to regulate the above financial service providing entities as follows:

- CBSL for banks, finance companies, leasing companies and primary dealers in Government securities.
- The Securities and Exchange Commission (SEC) for the securities market and investment banking.
- The Insurance Board of Sri Lanka for insurance companies.

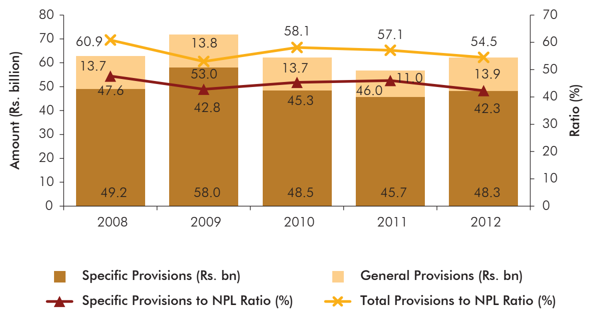
When a group is subject to the supervision of multiple supervisors, it may create regulatory mismatches among regulators. Thus, CBSL has initiated the formation of the Inter Regulatory Institutions Council (IRIC), chaired by the Governor, in order to achieve better communication and understanding among supervisors of different categories of financial institutions. The main responsibilities of the IRIC are to ensure the formation of appropriate policy directions for the orderly development of the financial sector and to ensure that all regulatory agencies coordinate and exchange information in the interest of the stability of the wider financial system. Further, CBSL has initiated amendments to the Banking Act with a view to further strengthening the supervisory and regulatory framework of licensed banks, in line with international best practices, especially considering the importance of supervising bank dominated financial groups on a consolidated basis.

Conclusion

The financial sector of Sri Lanka is expected to keep pace with the evolving needs of the economy, which is driven towards achieving a sustainable high growth path. An inevitable outcome of such efforts would be the tendency for existing stakeholders in the financial system to realign their business models, resulting in increased interconnectedness.

CBSL will continue to appropriately adopt several measures in order to strengthen risk management in the financial system in the context of interconnectedness among financial institutions with a view to make the financial system stronger and more resilient, to preserve public confidence in financial institutions and to protect depositors and the wider economy from the negative effects of any systemic risk. Introducing legal reforms to address existing limitations relating to regulation and supervision of financial conglomerates, developing a mechanism to share information among domestic regulators as well as those in other countries (in the case of international financial conglomerates) and preparing comprehensive resolution plans for banks and other financial institutions to deal with severe financial difficulties are some of these measures.

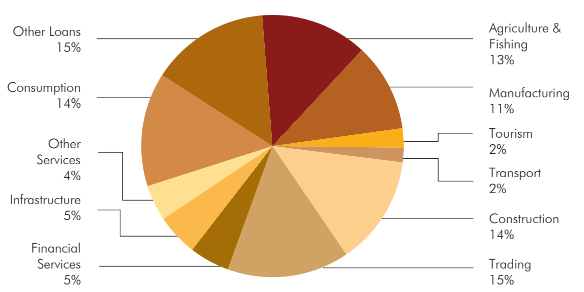
Chart 8.3 Provisions for NPLs of the Banking Sector



The growth of loans and advances of the banking sector declined from 32 per cent (Rs. 626 billion) in 2011 to 21 per cent (Rs. 541 billion) by end 2012, mitigating the potential adverse effects of continued credit expansion on banking sector stability as well as economic stability. The increase of Rs. 434 billion in rupee (LKR) loans was well within the expected growth of credit.

The quality of assets of the banking sector improved as indicated by the decline in the non-performing loan (NPL) ratio from 3.8 per cent as at end 2011 to 3.6 per cent by end 2012. However, the volume of NPLs increased by Rs. 18 billion during 2012. The increase in NPLs in the special mention category (26 per cent of the increase in NPLs) did not require specific provisions. Accordingly, the increase in specific provisions was lower than the increase in NPLs, which resulted in a decline in the specific provisions coverage by end 2012.

Chart 8.4 Sector-Wise Credit Exposure of the Banking Sector



Banking sector lending continued to be concentrated in trading (15 per cent), construction (14 per cent), consumption (14 per cent), agriculture (13 per cent) and manufacturing (11 per cent).

Market risk: Despite volatility in the domestic financial markets during the year 2012, market risk remained low in the overall risk profile of banks. In 2012, risk weighted assets for market risk accounted for only 2 per cent of the total risk weighted assets of the banking sector and it has declined from 3 per cent in 2011. Consequently, the capital charge for market risk declined from Rs. 7 billion at end 2011 to Rs. 5 billion by end 2012.

Interest rates: During the period under review, banks were able to effectively manage their exposure to re-pricing risk as measured by the assets and liabilities gap (i.e., rate sensitive assets (RSA) - rate sensitive liabilities (RSL)) to total assets ratio of the banking sector. On a cumulative basis, the gap between RSA and RSL as a percentage of total assets in the 0 to 1 year time bucket narrowed to negative 13.2 per cent in 2012 from negative 14.1 per cent in 2011. Hence, the overall impact of the volatility of domestic interest rates on banks' profitability in 2012 was marginal when compared with 2011. The net interest margin (NIM) of the banking sector declined marginally from 4.2 per cent as at end 2011 to 4.1 per cent by end 2012.

Prices of Equity: The exposure of the banks to the equity market was minimal and hence the risk arising from volatility in equity prices was negligible. In 2012, the Central Bank imposed limits on the banks' exposure to the stock market. Hence, the exposure to the equity market through investments in shares as at end 2012 was only 3 per cent and 0.7 per cent of the total investments and total assets, respectively.

Exchange rates: Risks emanating from exchange rate movements were well contained as aggregate foreign exchange (FX) net open position (NOP) exposures of banks were not significant. As at end 2012, only 10 per cent of the assets of the banking system were denominated in foreign currency. Individual banks were exposed to FX risk to varying degrees, based on their different NOPs in various currencies. However, the foreign exchange risk was not a significant threat to banking sector stability as the aggregate value of NOPs was less than 3 per cent of banks' regulatory capital as at end 2012. FX positions of the banking sector declined in 2012 primarily due to the reduction of regulatory NOP limits of banks in March 2012. Additionally, banks reduced their exposure to fluctuations in exchange rates by reducing their NOPs, particularly in relation to US dollars, where a notable change was seen, that is, from a negative NOP of Rs. 4 billion by end 2011 to a positive NOP of Rs. 0.2 billion by end 2012. The depreciation of the rupee against the US dollars by 10.43 per cent during 2012 had a positive impact on the banks' profitability through the revaluation of foreign currency assets and liabilities, where a significant gain of Rs. 15 billion was made in comparison to Rs. 9 billion in 2011.

Liquidity risk: The banking sector operated with adequate levels of liquidity during 2012. The Statutory Liquid Assets Ratio (SLAR) of the banking sector declined marginally from 32 per cent in December 2011 to 31 per cent in December 2012, corresponding to the increase in credit to deposits and borrowings ratio from 70 per cent as at end 2011 to 71 per cent by end 2012. The decline in the

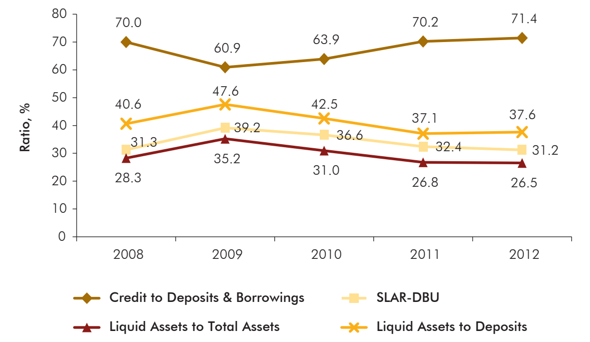
Table 8.4 Composition of Statutory Liquid Assets of the Banking Sector

Item	2011 (a)		2012 (b)		Change (Rs. bn)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2011	2012
Treasury Bills	255	22.3	285	21.0	(120.4)	29.9
Treasury Bonds	378	33.1	424	31.3	27.4	45.8
Sri Lanka Development Bonds	174	15.3	217	16.1	67.5	43.2
Cash	61	5.3	73	5.4	13.4	12.6
Money at Call	46	4.0	46	3.4	(6.9)	0.2
Balance with banks abroad	87	7.6	134	9.9	(3.2)	46.8
Other	140	12.3	175	12.9	51.7	34.4
Total Liquid Assets	**1,141**	**100.0**	**1,354**	**100.0**	**29.5**	**212.9**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 8.5 Liquidity Ratios of the Banking Sector

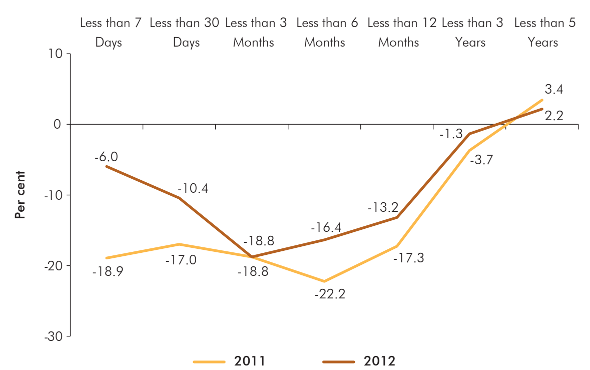


SLAR was mainly a result of the higher growth of the liability base (by Rs. 781 billion). Nevertheless, the SLAR of the banking sector was significantly higher than the minimum requirement (20 per cent). The moderation in the liquidity position of the banking sector was further reflected in both the liquid assets to total assets ratio and the liquid assets to deposits ratio.

Total liquid assets of the banking sector increased by Rs. 213 billion in 2012 in comparison to the increase of Rs. 30 billion in 2011. This was mainly the result of increased investments in Treasury bills and Treasury bonds as well as short-term foreign currency balances with banks abroad.

Given the tightening of monetary policy and the improvement in assets and liabilities management practices, the cumulative maturity

Chart 8.6 Cumulative Maturity Gap - % of Cumulative Liabilities of the Banking Sector



gap as a percentage of the cumulative liabilities in all maturity time periods (buckets), narrowed in 2012. Noticeably, the ratio in the less than 01 year period declined from negative 17 per cent as at end 2011 to negative 13 per cent by end 2012.

Resources

Profitability: Profitability of the banking sector improved during 2012. The banking sector reported a higher profit after tax of Rs. 82 billion for 2012 when compared with the profit after tax of Rs. 66 billion reported in 2011. Further, despite the marginal decline in the net interest margin from 4.2 per cent in 2011 to 4.1 per cent in 2012, the banking sector was able to maintain its return on assets at 1.7 per cent by end 2012. This was possible as non-interest income increased by Rs.18 billion in 2012 whereas non-interest income declined by Rs. 7 billion in 2011. This significant increase in non-interest income could be attributed mainly to the higher foreign exchange income resulting from gains in FX revaluations, which accounted for 45 per cent of the increase in non-interest income.

Accordingly, all the profitability indicators of the banking sector, i.e., net interest margin, return on assets and return on equity, were maintained at healthy levels, indicating an improvement in the risk absorption capacity of the banking sector.

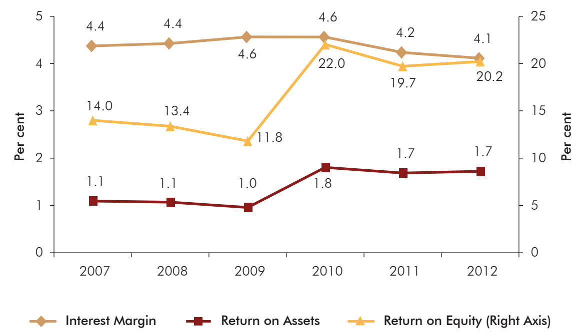
Table 8.5 Profit of the Banking Sector

Item	2011 (a) Amount (Rs.bn)	2011 (a) As a % of Avg Assets	2012 (b) Amount (Rs.bn)	2012 (b) As a % of Avg Assets
Interest Income	357.7	9.2	494.7	10.3
Interest Expenses	192.7	4.9	298.0	6.2
Net Interest Income	**165.0**	**4.2**	**196.7**	**4.1**
Non-Interest Income	60.6	1.6	78.7	1.6
Foreign Exchange Income	14.9	0.4	26.7	0.6
Non-Interest Expenses	116.6	3.0	135.2	2.8
Staff Cost	59.1	1.5	66.3	1.4
Loan Loss Provisions	(2.9)	(0.1)	6.3	0.1
Profit before Tax (after VAT)	**94.1**	**2.4**	**116.3**	**2.4**
Profit after Tax	**65.6**	**1.7**	**82.3**	**1.7**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 8.7 Profitability Indicators of the Banking Sector



Capital: Capital funds of the banking sector increased by 18 per cent in 2012, mainly due to internally generated funds, that is, profits. In comparison, capital funds increased by 26 per cent in 2011. The higher increase in 2011 was due to a few banks raising capital through IPOs and rights issues to meet the minimum capital requirement.

The total capital adequacy ratio and the core capital adequacy ratio are estimated to be around 16 per cent and 14 per cent, respectively, subsequent to including the audited profits of the banks for 2012 in the capital.

During 2012, the Central Bank issued a Consultation Paper on the implementation of the supervisory review process, in accordance with

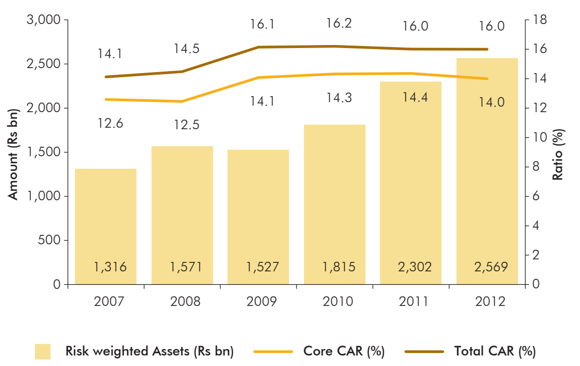
Table 8.6 Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs.bn) 2011 (a)	Amount (Rs.bn) 2012 (b)	Composition (%) 2011 (a)	Composition (%) 2012 (b)
Tier 1 Capital	330.3	337.8	100.0	100.0
Share Capital	126.4	128.6	38.3	38.1
Statutory Reserve Funds	20.2	20.9	6.1	6.2
Retained Profits	103.3	94.5	31.3	28.0
General and Other Reserves	100.9	101.9	30.5	30.2
Other	0.0	14.7	0.0	4.4
Regulatory Adjustments	(20.5)	(22.8)	(6.2)	(6.7)
Tier 11 Capital	38.7	46.7	100.0	100.0
Revaluation Reserves	8.5	8.9	22.0	19.1
Subordinated Term Debt	33.2	38.9	85.8	83.3
General Provisions and Other	11.2	13.5	28.9	28.9
Regulatory Adjustments	(14.2)	(14.6)	(36.7)	(31.3)
Total Regulatory Capital Base	369.0	384.5		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 8.8 Capital Adequacy Ratios of the Banking Sector



Pillar 2 of Basel II, to further strengthen the risk assessment and capital planning processes of banks.

Sri Lanka's banking sector is in compliance with the new capital requirements under Basel III, with a common equity ratio of 14 per cent (estimated) and a total capital ratio of 16 per cent (estimated) which are well above the minimum requirements of 6 per cent and 10.5 per cent, respectively.

Supervisory and regulatory developments: During 2012, the Central Bank introduced several policy measures and regulations. In order to curtail the high credit growth, a ceiling was imposed on the growth of rupee credit granted by licensed banks. Directions were issued specifying measures to be followed in relation to business conduct and market practices relating to foreign exchange trading activities. Directions were also issued specifying measures to be adhered to when outsourcing business operations including internal audits and information technology related functions. Further, the classification of banking outlets was revised and amendments were made to the definition of liquid assets to include investment in government securities held under reverse repo agreements under licensed banks as liquid assets. During the year, greater attention was paid to implementing an integrated risk management framework in banks as well as further strengthening corporate governance in banks. Meanwhile, banks' policies and procedures in relation to customer service were examined with a view to promoting customer protection and thereby enhancing public confidence in the banking sector. The details of these measures are given in Part II and Part III of this Report. Implementing the aforesaid regulatory measures would strengthen the risk management framework as well as the processes and practices within the banking sector while enhancing the stability of the banking sector.

Non-Bank Financial Institutions Sector

The Non-Bank Financial Institutions (NBFIs) sector consisting of Licensed Finance Companies (LFCs) and Specialised Leasing Companies (SLCs) recorded a growth of 22 per cent in 2012. Measures taken to enhance the safety and soundness of the NBFIs and the expansion of the branch network of NBFIs supported the expansion of the NBFI sector. The Central Bank continued to adopt measures to strengthen the risk management practices of NBFIs in order to enable the NBFI sector to absorb risks. As a result, NBFIs recorded an improvement in asset quality, their liquidity was at a healthy level, while adequate profitability and sufficient capital levels were also observed in relation to NBFIs. Distressed NBFIs continued to consolidate and strengthen their financial position in accordance with the resolution measures implemented during the year. However, the decrease in vehicle imports due to the higher excise duty applicable to vehicles imported since the end of March last year along with the depreciation of the rupee during 2012 affected the growth of the leasing and hire purchase portfolios of the NBFI sector.

Table 8.7 Distribution of Branches of NBFIs by Province

Province	End 2011 (a)	End 2012 (b)
Western	265	316
Southern	91	112
Sabaragamuwa	59	76
North Western	67	99
Central	82	107
Uva	43	52
North Central	55	69
Eastern	60	78
Northern	44	63
Total	**766**	**972**

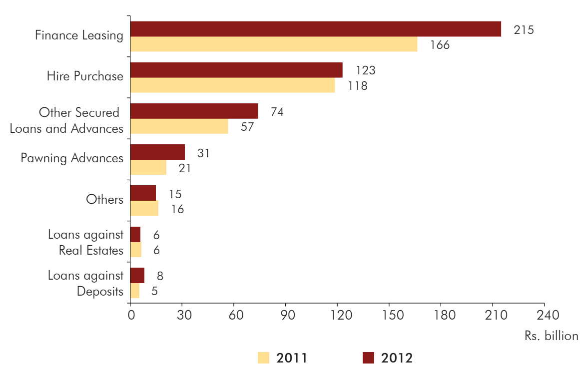
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Business Expansion

Outreach: The NBFI sector comprised of 47 LFCs and 13 SLCs by end 2012. Four companies, namely, Deshodaya Development Finance Co. Ltd., Ideal Finance Ltd., Melsta Regal Finance Ltd. and Richard Peiris Arpico Finance Ltd. obtained LFC licences during the year under the Finance Business Act, No.42 of 2011 (FBA). Further, four SLCs were elevated to LFC status during 2012. Meanwhile, the branch network of the NBFI sector expanded with 206 branches being added in 2012, raising the total number of branches to 972. Of the branches opened in 2012, 155 were opened outside the Western Province. The number of NBFI branches operating in the Northern and Eastern Provinces increased by 19 and 18, respectively, reflecting the growth potential in these areas.

Chart 8.9 Prodouct-wise Accommodations of the NBFI Sector



Assets and Liabilities

Assets: The total asset base of the NBFI sector grew by 22 per cent during 2012 to Rs. 597 billion, following the growth of 26 per cent in 2011. The main contributory factor in the expansion of the asset base was the growth of the accommodations portfolio. Accommodations grew by 21 per cent to Rs. 472 billion by end 2012. A significantly higher growth rate of 46 per cent was recorded in respect of accommodations in 2011. Finance leases, hire purchases and other secured advances were the major sources of accommodations, which accounted for 46 per cent, 26 per cent and 16 per cent, respectively, of the total accomodations. Among the products, loans against deposits, pawning and other secured loans recorded high growth rates of 66 per cent, 53 per cent and 30 per cent, respectively. The investment portfolio of the sector grew by 14 per cent in 2012, whereas in 2011, a negative growth of 46 per cent was recorded. Other assets mainly comprised of liquid assets, trading stocks and fixed assets.

Liabilities: Deposits were the major source of funding for the LFCs, while borrowings were the major source of funding for the SLCs. While deposits with LFCs accounted for 43 per cent of the total liabilities of the NBFIs, borrowings of SLCs accounted for 30 per cent of the total liabilities of NBFIs. Reflecting the increased public confidence in the LFC sector, deposits held by LFCs grew by 37 per cent to Rs. 254 billion by end 2012. In comparison, deposits of LFCs grew by 27 per cent in 2011. The elevation of four SLCs to LFC status also resulted in the conversion of borrowings to deposits. LFCs mobilised funds mainly by way of time deposits, which accounted for 98 per cent of their total deposits. Apart from the deposits mobilised from the public, LFCs have raised funds through borrowings as well. Total borrowings of the NBFI sector as at end 2012 amounted to

Table 8.8 Composition of Assets and Liabilities of the NBFI Sector

Item	2011 (a) Rs.bn	2011 (a) Share (%)	2012 (b) Rs.bn	2012 (b) Share (%)	Change (%) 2011	Change (%) 2012
Assets						
Accommodation	388.4	79.3	471.7	79.1	46.3	21.4
Finance Leasing	166.1	33.9	214.9	36.0	89.8	29.4
Hire Purchase	118.4	24.2	123.0	20.6	23.3	3.9
Investments	13.5	2.8	15.4	2.6	(46.4)	14.1
Others	88.0	18.0	109.6	18.4	(9.5)	24.5
Liabilities						
Total Deposits	186.0	38.0	254.1	42.6	27.3	36.6
Total Borrowings	171.6	35.0	176.0	29.5	23.5	2.6
Capital Elements	77.0	15.7	94.9	15.9	60.1	23.2
Total Funds	**434.6**	**88.7**	**525.0**	**88.0**	**30.5**	**20.8**
Other	55.3	11.3	71.6	12.0	1.1	29.6
Total Assets/Liabilities	**489.9**	**100.0**	**596.6**	**100.0**	**26.3**	**21.8**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Rs. 176 billion, having increased by 3 per cent, year-on-year. In comparison, a sharper growth rate of 24 per cent was recorded in respect of the borrowings of NBFIs in 2011. Around 21 per cent of the total borrowings in 2012 was attributed to the SLC sector. The credit to deposits and borrowings ratio for the NBFI sector increased marginally from 109 per cent in 2011 to 110 per cent in 2012, indicating continued demand for the NBFI sector services. The capital of the NBFI sector increased by 23 per cent to Rs. 95 billion as at end 2012. In comparison, capital increased by 60 per cent in 2011. Sustained profitability strengthened the capital funds of the sector.

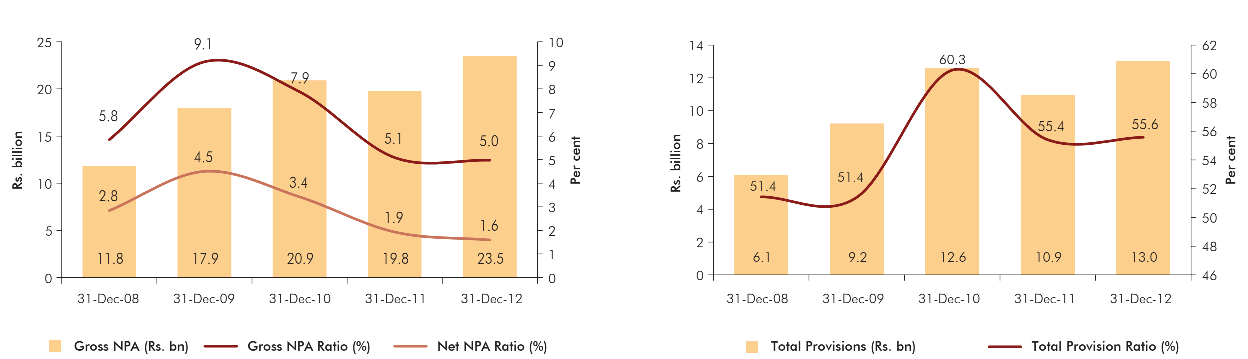
Risk Management

Credit Risk: The total amount of non-performing accommodations (NPAs) increased by 19 per cent during 2012 to Rs. 24 billion, from Rs. 20 billion in 2011. The LFC sector accounts for 92 per cent of the NPAs with distressed companies being the main contributors to NPAs. Further, the exposure to NPAs relative to the total loans outstanding declined marginally to 5.0 per cent as at end 2012, from 5.1 per cent as at end 2011, mainly due to the growth of accommodations. When the loan loss provision is considered, the net NPA ratio was 1.6 per cent as at the end of 2012. The total provision coverage for NPAs increased marginally to 55.6 per cent as at end 2012 from 55.4 per cent as at end 2011.

Market Risk: The NBFI sector continued to generate sustained earnings during 2012 despite the increase in market interest rates and the slowdown in credit growth. The net interest margin which is the net interest income as a percentage of total assets of the sector, increased marginally to 6.8 per cent for the twelve month period ending December 2012, from 6.7 per cent in the previous year. The net interest income of the sector increased by 22 per cent to Rs. 40 billion during the twelve month period ending December 2012, from Rs. 33 billion recorded in the previous year.

Liquidity Risk: Following an increase in the earnings of the LFCs, the statutory liquid assets available in the LFC sector by end 2012 was in

Chart 8.10 Non-Performing Accommodations and Provisions Coverage of the NBFI Sector



surplus by Rs. 4.4 billion, given that the stipulated minimum requirement was Rs. 26 billion (i.e. 10 per cent of time deposits and certificates of deposits and 15 per cent of savings deposits). As per the new direction on liquidity, all SLCs were required to maintain liquid assets from 01.09.2012. The overall statutory liquid assets available in the SLC sector by end 2012 was a surplus of Rs. 1.7 billion while the stipulated minimum requirement was Rs. 1.6 billion (i.e. 5 per cent of the total liabilities and off-balance sheet items excluding liabilities to the shareholders, securitizations and asset backed long-term borrowings over one year).

Resources

Profitability: The NBFI sector was able to maintain healthy profit levels despite pressure on margins and the deceleration in demand for vehicle leases due to the higher excise duty rates imposed on imported vehicles. The sector posted a profit after tax of Rs. 15 billion in 2012. In comparison, the profit after tax in 2011 was Rs.19 billion. The decline in profits was mainly due to the 23 per cent decline in non-interest income and the 16 per cent increase in non-interest expenses. The profitability indicators of the NBFI sector, that is, the Return on Assets (ROA) and the Return on Equity (ROE), declined from 6 per cent and 34 per cent, respectively, in 2011, to 4 per cent and 19 per cent in 2012.

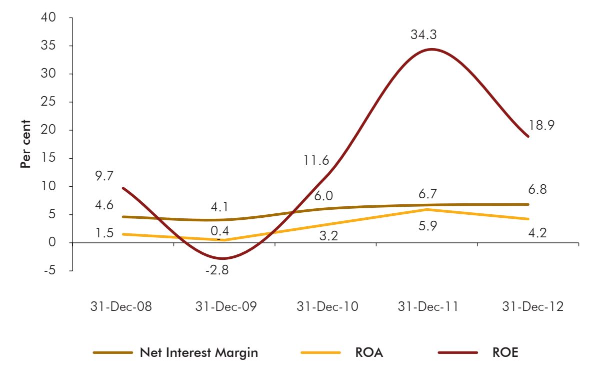
Table 8.9 Composition of Income and Expenses of the NBFI Sector

Item	Amount (Rs.bn)		Growth 2011 (a)		Growth 2012 (b)	
	2011(a)	2012(b)	Amount (Rs.bn)	%	Amount (Rs.bn)	%
Interest Income	68.0	92.9	14.8	27.7	24.8	36.5
Interest Expenses	35.1	52.6	5.2	17.4	17.5	49.7
Net Interest Income	**32.9**	**40.3**	**9.6**	**40.9**	**7.4**	**22.4**
Non - Interest Income	17.2	13.3	4.9	39.8	(3.9)	(22.6)
Non - Interest Expenses	26.0	30.1	5.6	27.7	4.1	15.9
Staff Cost	8.7	11.0	2.0	29.3	2.3	26.0
Loan Loss Provisions (Net)	(1.4)	1.5	(5.9)	(132.2)	3.0	205.2
Profit before Tax	**25.6**	**22.7**	**14.8**	**137.3**	**(2.9)**	**(11.5)**
Tax	6.6	6.5	0.7	12.0	(0.1)	(2.4)
Profit after Tax	**19.0**	**14.9**	**14.1**	**289.0**	**(4.1)**	**(27.1)**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Chart 8.11 Profitability Indicators of the NBFIs Sector



Capital: Capital funds of the NBFI sector increased by 27 per cent in 2012 to Rs. 86 billion. In comparison, an increase of 57 per cent was recorded in respect of capital funds of the NBFI sector in 2011. While LFCs and SLCs were required to increase their minimum core capital to Rs. 300 million and Rs. 150 million, respectively from 01.01.2013, sustained profitability and infusion of new capital during the year strengthened their capital funds. Capital funds worth Rs. 5 billion was infused to the NBFI sector through rights issues amounting to Rs. 1.3 billion, strategic investments amounting to Rs. 1.9 billion, and capital investments amounting to Rs. 1.8 billion. The capital adequacy ratios of the NBFI sector remained above the required minimum levels due to the enhancement of capital funds. The capital adequacy ratio increased to 16 per cent as at end 2012 from 14 per cent as at end 2011.

Table 8.10 Composition of Regulatory Capital of the NBFI Sector

Item	Amount (Rs.bn)		Composition (%)	
	2011 (a)	2012 (b)	2011 (a)	2012 (b)
Tier I: Capital	**56.5**	**75.0**	**100**	**100**
Share Capital	41.2	53.4	73	71
Share Premium	2.7	2.6	5	3
Statutory Reserve Fund	4.7	6.7	8	9
General and Other Reserves	13.3	17.0	24	23
Others	(5.5)	(4.8)	(10)	(6)
Tier II: Capital	**3.4**	**4.7**	**100**	**100**
Revaluation Reserves	2.1	2.5	60	53
General Provisions	0.6	0.4	16	7
Subordinated Term Debt	0.7	0.9	21	18
Others	0.1	1.0	2	21
Regulatory Adjustments	(4.7)	(2.5)		
Total Regulatory Capital Based	**55.2**	**77.2**		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

BOX 11

Consequences of Unauthorised Finance Businesses

Unauthorised finance business (UFBs) activities are promoted primarily by offering or guaranteeing very high returns when compared with those offered by formal financial institutions. In many instances, a majority of the investors attracted to such UFBs are not aware of the illegality and/or the inherent risks in investing in these institutions. In addition to attractive returns, the possibility of evading taxes and the opportunity to engage in money laundering are identified as some of the other factors that tempted investors to invest in these UFBs. These investors assume the risk or deliberately ignore the repercussions in view of the high returns that are offered. As a result of the faulty and unviable nature of the business models of the UFBs as well as the mismanagement of funds by them, these entities finally collapse, and the investors lose their hard-earned money, sometimes their lifetime savings. At the same time, the failure of UFBs tends to affect public confidence in regulated financial institutions and therefore impacts on financial system stability, as well.

UFBs conducted by unscrupulous persons are engaged in advertising and soliciting of deposits without authorization under the laws governing finance business in a country. Many countries have faced the issue of unauthorised finance business mainly due to greedy investors pursuing unsustainable quick and high returns. One key feature of these entities is that they use the funds mobilised from members who subsequently join the scheme to pay high returns to existing members. Globally, such schemes are termed "Ponzi Schemes" and were named after the collapse of the fraudulent investment scheme carried out by Charles Ponzi in 1920 in Boston. More recently, Bernard Madoff was found guilty of running a more elaborate Ponzi scheme in 2008 and the estimated loss due to this scandalous scheme was US $64.8 billion. Bailing out UFBs that fail at the cost of the general public is neither appealing nor fair and could result in a significant revenue loss to the Government.

As there was no effective legal framework which enables taking measures against UFBs, relevant provisions were included in the Finance Companies Act No. 78 of 1988 making carrying on finance business without registration illegal. As the acceptance of deposits is an integral part of finance business, the lacuna of a definition for the term 'deposits' has given rise to difficulties in proving the offence of carrying on finance business without authority. Taking advantage of this loophole, the persons/institutions who mobilized public funds structured their instruments with the intention of avoiding the provisions of the law that prevailed. For example; instead of using the word "Deposit", some UFBs created various fund mobilization products such as "Promissory Notes", "Fund management Agreements" and "Investment Certificates" to collect funds from the general public. Some legitimate but errant financial institutions too, used shadow entities such as investment arms to mobilize funds so as to avoid regulatory requirements.

Thus, the need to amend the Finance Companies Act which was enacted about 20 years ago was recognized by the Central Bank and the financial sector, particularly following the failure of several unauthorised entities in 2008/2009. The Finance Business Act, No. 42 of 2011 (FBA) came into effect, enhancing powers to effectively curb the promotion of unauthorised deposit taking by persons and institutions. In terms of the FBA, the following new provisions have been introduced.

- Deposit taking without authority is an offence.
- Advertising by unauthorised persons/entities, soliciting deposits, is prohibited.
- Media institutions are required to verify the authority of the advertiser before publishing of such advertisement.
- Use of the words 'finance', 'financing' or 'financial' as a part of its name by an entity other than a person authorized by the Central Bank is prohibited.
- Any person who places a deposit with a UFB will be guilty of an offence of aiding and abetting.
- Employees of licensed banks and finance companies are required to inform the Department of Supervision of Non-Bank Financial Institutions of the Central Bank of Sri Lanka (DSNBFI) of any reasonable suspicion of acceptance of deposits by any person/institution without authority.

DSNBFI examines the activities of persons and institutions suspected of carrying on finance business or accepting deposits without authority. The Monetary Board, based on the reports submitted by the DSNBFI determines whether such person/institution is carrying on finance business and may direct such UFB, under the FBA, to divest the business, repay the deposit liabilities or wind up the institution. In terms of the FBA, any person/institution carrying on finance business without authority shall be liable on conviction after trial before a High Court, to imprisonment for a term not exceeding five years or to a fine not exceeding five million rupees or both.

The Central Bank has already initiated legal action against several companies, under the Finance Companies Act, for non-submission of information and conduct of finance business without authority. Further, the Central Bank directed some companies to repay the funds mobilised and such repayments are being monitored.

Preventing the mushrooming of UFBs is a difficult task let alone completely eliminating unauthorised finance business, considering the complexity of their operations. Eliminating UFBs is further complicated by the fact that a segment of the public voraciously pursues high gains, even though they know the potential adverse consequences of their decisions. The Central Bank considers it important to improve financial literacy of the general public and promote financial inclusiveness, so as to prevent people from becoming victims of UFBs. Thus, several notices in newspapers listing banks and non-bank financial institutions that are licensed by the Central Bank to accept deposits from the public have been published to raise public awareness. During 2012, a more intensive public awareness campaign which included telecasts and broadcasts on various Television and Radio channels, was carried out by the Central Bank, highlighting the negative implications of placing funds with UFBs.

The core capital ratio stood at 15 per cent as at end 2012, which is well above the required minimum of 5 per cent. Similarly, the ratio of capital funds of LFCs to their total deposits also increased to 28 per cent as at end 2012 from 20 per cent recorded by end 2011.

Restructuring of Distressed Companies: A few companies that were in distress were closely monitored by the Central Bank through off-site supervision and regular meetings held with the Boards of Directors and the senior management of such NBFIs. Strategic investors were found for most of the distressed companies.

Action against Unauthorized Conduct of Finance Business: Investigations were carried out by the Central Bank on institutions allegedly engaged in finance business without authorization. Moreover, assistance was provided to courts with respect to on-going litigation issues related to unauthorised finance business. During 2012, 26 public awareness campaigns were conducted by way of country-wide seminars/workshops on the risk of investing in unauthorized finance businesses. Special messages on risks of investing in unauthorized businesses were conveyed to the public through regional transmissions of the Sri Lanka Broadcasting Corporation and TV commercials telecast in both Sinhala and Tamil languages. Further, posters containing lists of Licensed Banks and LFCs were distributed among Grama Niladharies in selected Districts. Leaflets containing lists of Licensed Banks and LFCs with other useful information were distributed from time to time among the general public, while publishing the lists of institutions authorized to accept deposits in the newspapers in all three languages on a quarterly basis. The Central Bank spent approximately Rs. 31.1 million for the aforesaid public awareness activities during 2012.

Supervisory and Regulatory Developments: During 2012, an internal risk rating model and an early warning system were implemented so as to be able to identify potential risks and take preventive measures in a timely manner. Steps are being taken to regularize business activities of microfinance institutions in the country, by bringing them under a supervisory mechanism established by the Central Bank. In this regard, a new Microfinance Bill has been drafted and it is expected to be enacted during 2013. Two new Directions were issued to LFCs. While one Direction issued specified guidelines to be adhered to in relation to the information systems security policy, the other Direction specified the upper limit of interest rates that could be offered for deposits mobilised. Further, four Directions were issued during the year to the SLC sector. These Directions dealt with the introduction of the assessment of fitness and propriety of directors and officers performing executive functions, changes to the definition used for the computation of the statutory liquid assets ratio, the minimum core capital and the gearing ratio. In order to ensure that the audits of NBFIs meet the required standards, a panel of external auditors was appointed for the NBFI sector and guidelines were issued to the selected panel of external auditors in order to ensure that standard procedures are followed in carrying out audits of NBFIs. The Directions and guidelines issued during the year are listed in part III of this Annual Report.

Primary Dealers in Government Securities

Performance of the Primary Dealer (PD) sector improved in 2012 as indicated by its key performance indicators. Total assets, the total portfolio, profitability and the capital base recorded healthy growth during 2012 despite the negative implications of increasing yield rates during the first three quarters of the year.

Assets and Liabilities: Total assets of the PD sector increased by 20.8 per cent in 2012 to Rs. 160.4 billion, whereas in 2011, their total assets increased at a much slower pace of 4.3 per cent. The portfolio of government securities in trading, investment and reverse repos accounted for 98.3 per cent of the total assets of the industry. The investment portfolio increased significantly by 122.0 per cent to Rs. 50.9 billion by end 2012, from Rs. 22.9 billion at end 2011. This increase was the main contributory factor for the increase in the total portfolio. The trading portfolio, however, declined by 5.9 per cent during 2012 when compared with the portfolio as at end 2011. The share of borrowings under repurchase agreements increased to 65.7 per cent of total liabilities (or Rs. 103.6 billion) at the end of 2012, from 64.2 per cent of total liabilities (or Rs. 85.3 billion) at the end of 2011.

Table 8.11 Performance of Primary Dealers

Rs.million

Item	2011 (a)	2012 (b)	Annual Growth Rate (%) 2011 (a)	Annual Growth Rate (%) 2012 (b)
Total Assets	132,710	160,351	4.3	20.8
Total Portfolio	**130,750**	**157,669**	**4.6**	**20.6**
Trading Securities	88,586	83,387	19.2	(5.9)
Investment Securities	22,944	50,945	(37.7)	122.0
Reverse Repo	19,221	20,202	38.6	5.1
Available for sale	-	3,135	-	100.0
Equity and Liabilities	132,710	160,351	4.3	20.8
Total Capital	14,403	15,974	6.6	10.9
Repo	85,259	103,609	13.2	21.5
Profit before Tax	1,513	2,528	(69.2)	67.1
Profit after Tax	1,116	2,287	(75.7)	105.0
Return on Assets (%)	1.1	1.9	(2.7)	0.8
Return on Equity (%)	7.7	16.0	(26.2)	8.2
Risk Weighted Capital Adequacy Ratio (%)	23.3	17.9	0.8	(5.4)
Leverage Times	5.9	6.5	0.3	0.6
Dealings	8,951,533	10,406,840	12.6	16.3
Primary Market Dealings	1,767,521	2,576,323	17.2	45.8
Secondary Market Dealings	7,184,012	7,830,517	11.5	9.0

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Capital: The capital base of the PD sector increased to Rs.15.9 billion in 2012. However, the risk-weighted capital adequacy ratio (RWCAR) decreased to 17.9 per cent as at end 2012 from 23.3 per cent as at end 2011, consequent to the increase in total assets of PDs. All PDs had maintained the RWCAR above the minimum regulatory requirement of 8 per cent. Capital leveraging of the PD sector was maintained at a moderate level of 6.5 times by end 2012. All PDs were able to maintain their capital base above the minimum regulatory level of Rs. 300 million.

Profitability: Profits of the sector increased to Rs. 2,528 million in the year 2012, from Rs. 1,513 million in 2011. The ROE and the ROA have recorded a significant growth in 2012. While the ROE increased from 7.7 per cent in 2011 to 16.0 per cent in 2012, the ROA increased from 1.1 per cent in 2011 to 1.9 per cent in 2012. The improvement in the operating performance of PDs could be attributed to the capital gains realized and the revaluation gains from marking to market of trading portfolios as a result of yield rates declining towards the latter part of 2012.

Risk Management

Market risk: PDs' exposure to market risk is moderate as the core business of the PDs is dealing in government securities. Further, results from the stress tests conducted to assess the ability of capital of each PD to absorb adverse movements in interest rates revealed that all PDs would be able to maintain capital funds above the minimum regulatory capital requirement of Rs. 300 million while maintaining the capital adequacy ratio well above the minimum regulatory capital adequacy ratio of 8 per cent, even if interest rates move upward by 100 basis points from their levels at the end of 2012.

Liquidity risk: The liquidity risk of the PD sector was low since 98.3 per cent of the total assets of PDs was held in highly liquid government securities which could be placed as collateral for obtaining funding in the event of any unforeseen liquidity requirement. Further, PDs also have standby funding arrangements to bridge any unforeseen liquidity gaps.

Market Participation

The 'bank PD units' recorded a 64.2 per cent effective participation rate with respect to Treasury bill auctions, during the year. However, in comparison, the effective participation of both independent 'bank PD companies' and 'non-bank PDs' remained low at 23.7 per cent and 11.2 per cent, respectively, during 2012. On the other hand, primary auctions for Treasury bonds were mainly subscribed by the Employees' Provident Fund (EPF), which accounted for 78.5 per cent of the total issuances during the year. Secondary market transactions in government securities increased by 9.0 per cent during the year, when compared with 2011. Secondary market repurchase transactions accounted for 79.8 per cent of the total volume of secondary market transactions in 2012.

Unit Trusts

The unit trust sector recorded growth in terms of total assets and net asset value, in 2012. There were 37 Unit Trusts (UTs) in operation (including 12 new UTs) managed by 11 Unit Trust management companies by end December 2012. Of these, 35 UTs were open-ended funds and 2 UTs were close-ended funds. When UTs in operation were categorized according to their investment focus, there were 7 income funds, 6 money market funds, 6 growth funds, 4 equity funds, 4 balanced funds and 4 gilt edged funds by end 2012. In addition, there are 6 specialised funds in the areas of Sharia, IPOs, tourism and finance. One close-ended fund is listed on the Colombo Stock Exchange.

Table 8.12 Performance of the Unit Trust Sector

Details	2011(a)	2012 (b)
No. of Unit Trusts	24	37
Total No. of Unit Holders	23,403	27,253
No. of Units in Issue (million)	1,286	2,227
Total Assets (Rs. million)	22,674	31,088
Net Asset Value-NAV (Rs. million)	22,547	30,890
Investments in Equities (Rs. million)	9,549	8,841
Share of Total Assets (%)	42	29
Investments in Government Securities (Rs. million)	10,975	5,919
Share of Total Assets (%)	48	19

(a) Revised
(b) Provisional

Source: Unit Trust Association of Sri Lanka

The net asset value (NAV) of the UTs increased by 37 per cent to Rs. 30.9 billion as at end December 2012, from Rs. 22.5 billion as at end December 2011. Although 12 new UTs were set up during the year, those with significant investments in equities were affected by the continued decline in stock market prices during the first half of the year. However, most funds have been able to perform better than the price indices of the CSE on account of portfolio management and diversification. The value of investment in government securities also suffered from marked to market losses due to increasing interest rates until the rates started to decline towards the end of the year. The shares of equities and government securities (Treasury bills, Treasury bonds and Reverse Repos) in the investment portfolios of unit trusts declined to 28.5 per cent and 19.1 per cent, respectively, from 42.3 per cent and

48.6 per cent, respectively, as at end December 2011. The share of other investments including investments in commercial paper, debentures, trust certificates and fixed deposits with banks, increased significantly to 52.4 per cent.

A positive development was the increase in the total number of unit holders and the units issued. While the number of unit holders increased from 23,403 at end 2011 to 27,253 by end 2012, the number of units issued increased to 2,227 million by end December 2012 from 1,286 million at the end of 2011. With a view to broadening the investor base and stimulating the formation of different types of UTs and new products, the Securities and Exchange Commission issued a direction making it mandatory to allocate 10 per cent of shares of all Initial Public Offerings to UTs. Further, foreign investments in UTs have been allowed. The inclusion of a regulatory framework for Exchange Traded Funds (ETFs) in the Unit Trust Code is expected to pave the way for the introduction of such funds in Sri Lanka.

Insurance Companies

The expansion of assets, healthy profitability, adequate solvency margins and the strengthening of the regulatory framework enhanced the soundness of the insurance sector in 2012. While the insurance sector accounted for about 3 per cent of the total assets of the financial sector, its assets grew by 16 per cent during 2012. As at end December 2012, there were 22 insurance companies registered with the Insurance Board of Sri Lanka (IBSL). Of these, 21 companies are currently in operation. A total of 12 companies are composite insurers engaged in both long-term and general insurance business, while 6 companies engage exclusively in general insurance business and 3 companies conduct only long - term insurance business. There are 7 insurance companies that are listed on the Colombo Stock Exchange (CSE).

Table 8.13 Performance of the Insurance Sector

Rs.billion

Item		2011(a)	2012 (b)
Total Assets		265.8	307.0
Government Securities		109.4	126.7
Equities		40.2	35.0
Cash & Deposits		35.4	47.2
Total Income		103.1	115.3
Premium Income		80.4	89.2
Investment Income		22.7	26.1
Profit Before Tax		12.3	13.4
Solvency Margin Ratio	- Life Insurance	6.5	7.4
	- General Insurance	2.0	2.5
Retention Ratio (%)	- Life Insurance	96.2	96.2
	- General Insurance	78.9	79.1
Claims Ratio (%)	- Life Insurance	31.0	37.2
	- General Insurance	63.8	59.9
Combined Operating Ratio (%)	- Life Insurance	74.2	81.6
	- General Insurance	101.8	105.0
Return on Assets (ROA) (%)	- Life Insurance	5.0	3.4
	- General Insurance	5.1	6.7
Return on Equity (ROE) (%)	- General Insurance	10.2	12.3
Underwriting Ratio (%)	- General Insurance	19.1	16.2

(a) Revised
(b) Provisional

Source: Insurance Board of Sri Lanka

Business Growth: Total assets, premium income, investment income as well as profits of the insurance sector expanded in 2012. The asset base of the insurance sector grew by 16 per cent in 2012 in comparison with the 20 per cent growth recorded in 2011. The total Gross Written Premium (GWP) of insurance companies rose by 11 per cent to Rs. 89 billion in 2012 whereas in 2011, the total GWP increased at a much higher rate of 17 per cent. Nevertheless, the growth momentum in the insurance sector continued, given the continued expansion of economic activity. The imposition of higher excise duty rates on motor vehicles imported had only a marginal effect on motor vehicle insurance. Hence, the general insurance sector continued to be the primary driver of growth, while the long–term insurance sector also expanded. The GWP in the general insurance sector increased by 14 per cent to Rs. 52 billion in 2012, whereas in 2011 the GWP in the general insurance sector recorded a higher increase of 21 per cent. The GWP for long-term insurance, which accounted for 42 per cent of the total GWP, grew by 7 per cent to Rs. 37 billion in 2012. In comparison, the GWP for long-term insurance increased by 13 per cent in 2011.

Earnings: The total investment income of insurance companies increased by 15 per cent to Rs. 26 billion in 2012, in contrast to the decline of 37 per cent in 2011. However, the lacklustre performance of the stock market and the re-pricing losses from investments in government securities due to increase in yield rates, negatively affected the investment income of the insurance sector. The total income (investment income plus premium income) of insurance companies increased by 12 per cent to Rs. 115 billion in 2012, whereas in 2011, total income of insurance companies declined marginally. The aggregate profit before tax of the insurance sector increased by 8.4 per cent to Rs. 13.4 billion in 2012 from Rs. 12.3 billion 2011. This was mainly due to the higher profits generated by the general insurance sector. The majority of the companies recorded overall profits. Consequently, the return on equity (ROE) and the return on assets (ROA) for general insurance increased to 12.3 per cent and 6.7 per cent, respectively, in 2012 from 10.2 per cent and 5.1 per cent, respectively, in the previous year. However, the ROA for long-term insurance declined to 3.4 per cent in 2012 from 5.0 per cent in 2011. Further, underwriting profits from general insurance also declined by 4 per cent to Rs. 6.2 billion in 2012 from Rs. 6.5 billion in 2011, reflecting the higher claims and management expenses in the sector.

Capital and Investment: Insurance companies remained sound during the period under consideration. All insurance companies met the statutory solvency margin requirement for both general and long-term insurance as at end December 2012. The solvency margin ratio for general insurance increased to 2.5 times at end December 2012 from 2.0 times at end December 2011, while the solvency margin ratio for long-term insurance increased to 7.4 times at end December 2012 from 6.5 times at end December 2011. Insurance companies are required to invest a minimum of 20 per cent of the technical reserves in respect of general insurance and 30 per cent of the long-term funds in government securities. Accordingly, investments in government securities accounted for 41 per cent of the total assets of insurance companies. The share of equity in the total assets of insurance companies was 11 per cent by end 2012, compared to 15 per cent at end 2011. Corporate debt securities had a share of 5.5 per cent in the total assets of insurance companies by end 2012, compared to a share of 5.4 per cent at the end of 2011.

Supervisory and Regulatory Developments: The regulatory framework and the supervision and enforcement regime pertaining to the insurance industry was strengthened during the year. The solvency margin rule was further amended in 2012, requiring insurers to maintain a solvency margin in respect of each class of insurance business. These amendments were in relation to asset backed securities which are considered admissible assets when determining the solvency margin for both general and long-term insurance. In order to monitor compliance with regulation, assess the risk profile of insurance companies and ensure that risk mitigation measures are being implemented, the IBSL continually conducted off-site surveillance and on-site inspection of insurance companies. The provisions of the Regulation of Insurance Industry Act (RII), amended in January 2011, are to be implemented by 2015-2016. Long-term and general insurance business of the composite insurers are to be segregated into two separate companies by 2015. This regulatory requirement has been introduced primarily to ensure protection for the policy holders by enabling the identification of assets and liabilities of the two classes separately, thus preventing the set off of losses of one class from the profits of the other. Listing on the Stock Exchange by 2016 has been made mandatory for all insurance companies. Whilst enabling insurance companies to access the stock market to raise capital when necessary, listing on the stock market will ensure increased transparency. The IBSL has also initiated action to enable insurance companies to move to a risk based capital adequacy framework.

Superannuation Funds

The superannuation funds sector accounted for 16 per cent of the financial sector in terms of assets and is dominated by the Employees Provident Fund, which accounts for about 79 per cent of the assets of the superannuation sector. While the EPF is a publicly managed fund, there are two other publicly managed funds, namely; the Employees' Trust Fund (ETF) and the state sector Public Service Provident Fund (PSPF). In addition, there are about 171 privately managed Approved Pension and Provident Funds (APPF) in Sri Lanka.

The portfolio value of the EPF, which represents 13 per cent of the total assets of the financial sector, surpassed Rs 1 trillion in 2012. As at end December 2012, the value of the EPF was Rs 1,144 billion with 2.25 million active members of the Fund. There were 12 million non-contributory accounts, which are accounts of members under their previous employers. The EPF is administered by the Commissioner of Labour, while the responsibility for the management of the Fund lies with the Monetary Board of the Central Bank. Total contributions in 2012 increased by 13.4 per cent to Rs. 70.2 billion, while the refunds increased by 3.0 per cent to Rs. 48.7 billion, resulting in a net contribution (contributions minus refunds) of Rs. 21.5 billion. In 2012, total assets of the EPF increased by 12.4 per cent to Rs. 1,144 billon while the total investment portfolio of the EPF amounted to Rs. 1,105.5 billion. The investment income of the Fund during the year ending December 2012 was Rs.121.4 billion. As at end December 2012, the investment portfolio consisted of government securities, which accounted for 91.5 per cent of the investment portfolio, equity, which accounted for 5.4 per cent of the investment portfolio, corporate debt, which accounted for 1 per cent of the investment portfolio, and reverse repos. The effective rate of return on member balances was 11.5 per cent for the year 2012. In comparison, the Unit Trust Industry which had 29 per cent of its investments in equities and 18 per cent in government securities has recorded a weighted average return of 1.96 per cent for the year 2012. In order to facilitate the effective management of the EPF and extend further benefits to the members, the EPF Act was amended in February 2012.

Table 8.14 Performance of EPF and ETF

Item	EPF		ETF	
	2011(a)	2012(b)	2011(a)	2012(b)
Total Assets (Rs.bn)	1,018.0	1,144.0	142.4	158.4
Total Member Balance (Rs.bn)	986.0	1,125.0	135.5	139.6
Number of Member Accounts (mn)	14.0	14.3	9.8	9.8
Number of Active Member Accounts (mn)	2.2	2.3	2.2	2.2
Number of Employers contributing	64,562	68,771	67,041	70,194
Total Contributions (Rs.bn)	61.9	70.2	11.1	12.7
Total Refunds (Rs.bn)	47.3	48.7	7.8	8.6
Total Investments Portfolio (Rs.bn)	985.6	1,105.5	134.1	149.8
o/w : Government securities (%)	91.3	93.9	90.1	89.5
Gross Income (Rs.bn)	116.0	121.4	15.5	13.9
Profit Available for Distribution (Rs.bn)	107.5	111.8	12.5	14.1
Return on Investments (%)	12.4	11.6	8.9	8.4
Interest Rate paid on Member Balances (%)	11.5	11.5	10.0	10.0

(a) Revised
(b) Provisional

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

The ETF, which accounted for about 1.8 per cent of the assets of the financial sector, witnessed an increase in its asset base with increased net contributions, despite a slightly negative growth in gross income. The ETF had a value of Rs. 158 billion as at end December 2012, and has about 9.8 million accounts, of which, about 2.2 million are active. The ETF had 70,194 employers contributing to the fund as at end December 2012. Total contributions increased to Rs. 12.7 billion in 2012 from Rs. 11.1 billion in 2011 while benefits paid to members increased to Rs. 8.6 billion in 2012 from Rs. 7.8 billion in 2011.

The net contribution increased by 25.4 per cent to Rs. 4.2 billion during the year 2012. Total assets of the ETF increased by 11.3 per cent to Rs. 158.4 billion as at end December 2012. The outstanding members' balances in the ETF increased to Rs. 139.6 billion in 2012 from Rs. 135.5 billion in 2011. As in the case of the EPF, the investment portfolio is concentrated in government securities, which account for 89.5 per cent of the total portfolio. Investments in equity and corporate debt securities accounted for 4.7 per cent and 0.6 per cent, respectively, of the total portfolio. The gross income of the fund declined by 10 per cent during the year to Rs. 13.9 billion.

The Public Service Provident Fund (PSPF) is managed by the Department of Pensions and had 239,134 active members at end December 2012. Total assets of the PSPF increased by 10 per cent to Rs. 32.9 billion as at end December 2012. Total contributions and refunds during 2012 amounted to Rs. 1,557 million and Rs. 484 million, respectively. Investments in government securities had a share of 88 per cent as at end December 2012.

There were 171 privately managed APPFs with around 167,096 members, which are being monitored by the Department of Labour. The total assets of APPFs increased by 4.2 per cent to Rs. 110 billion as at end December of 2012.

8.3 Performance of Financial Markets

Money Market

Market liquidity in the money market declined gradually and reached a broadly square position towards the latter part of 2012. The excess liquidity which was, on average, about Rs. 12 billion during the first six months, increased to its highest level of Rs. 58.9 billion at the end of July 2012 with the conversion of a part of the proceeds from the sovereign bond to rupees. The measures taken to absorb excess liquidity, namely, term Repurchase auctions and the outright sale of Treasury bills held by the Central Bank, helped reduce excess liquidity in the market. By September, market liquidity was in a deficit position. Thereafter, although the Central Bank's purchases of Treasury bills and the injection of liquidity through the Reverse Repo window added liquidity to the money market, as a result of the retirement of government securities held by the Central Bank, the repayment of foreign debt and the unwinding of swaps in the domestic foreign exchange market, liquidity in the money market was in a balanced position by end 2012.

Table 8.15 Money Market Transactions

Market	Volume (Rs.bn)		Interest/Yield Rates	
	2011	2012	2011	2012
Call Money	2,434	3,179	7.57-9.40	8.53-10.71
Inter-bank repo	1,099	1,431	6.88-8.34	7.91-9.68
Central Bank repo	14,490	2,740	7.00-7.58	7.00-9.46
Central Bank reverse repo	141	793	7.25-9.00	7.94-9.75

Source: Central Bank of Sri Lanka

Responding to the tight monetary policy measures adopted including the credit ceiling imposed on banks, interest rates in the inter-bank call money market increased till the end of July and remained broadly stable thereafter, until the easing of monetary policy in December. During the first seven months of the year, the average weighted call money rate (AWCMR) increased by around 150 basis points, reaching the highest level of 10.71 per cent on 18th July. Meanwhile, credit growth slowed down in response to the tightening of monetary policy. Reflecting these developments the AWCMR stabilised and hovered around 10.55 per cent from around August till the easing of monetary policy in December. With the reduction of the policy interest rates, the AWCMR declined sharply by about 70 basis points to 9.83 per cent by end 2012. Meanwhile, the volatility seen in the tax adjusted average weighted call money rate during the first seven months of the year was seen becoming subdued thereafter, and it remained stable, closer to the upper bound of the policy rate corridor until around mid-December. The tax adjusted average weighted call money rate however remained within the policy rate corridor throughout the year.

Domestic Foreign Exchange Market

Greater flexibility in the determination of the Sri Lanka rupee exchange rate was allowed from around mid-February 2012. Although the rupee depreciated during the ensuing months up to the end of June, this trend reversed to some extent in the second half of the year. The overall depreciation of the rupee against the US dollar recorded in 2012 was 10.43 per cent, i.e., from Rs. 113.90 as at end 2011 to Rs. 127.16 as at end 2012. The average US Dollar buying and selling rates of commercial banks for telegraphic transfers also indicated a notable increase and were recorded at Rs. 125.56 and Rs. 128.82, respectively in 2012 compared to Rs. 113.01 and Rs. 114.88 respectively, in 2011. The Sri Lanka rupee depreciated against other major currencies too. The depreciation of the Sri Lanka Rupee against the sterling pound, the euro, the Japanese yen and the Indian rupee was recorded as 14.61 per cent, 12.31 per cent, 0.88 per cent and 7.45 per cent, respectively.

The global economic downturn and the policy measures adopted in 2012 influenced the transaction volumes in the domestic foreign exchange market. The slowing down of global economic activity has dampened demand for exports while the policy measures adopted to curb expenditure on imports have also resulted in a decrease in the transaction volumes. Accordingly, foreign exchange transaction volumes in the domestic market amounted to US dollars 13,420 million in 2012. When compared to the transaction volume of US dollars 16,442 million in 2011, this indicates a decrease in volume by US dollars 3,022 million or 18 per cent. The daily average volume of transactions in the inter-bank foreign exchange market too declined from US dollars 68.5 million in 2011 to US dollars 55.4 million in 2012.

The limit on the daily net open position in relation to foreign currency operations of commercial banks was revised downwards from US dollars 185 million in 2011 to US dollars 64.7 million in 2012, with a view to mitigating the risks in the foreign exchange market. During the first three months of the year, the Central Bank had to sell US dollars 1,155 million in order to curb unwarranted fluctuations in the domestic foreign exchange market. These undue market fluctuations eased with the allowing of flexibility in the rupee exchange rate, and in turn, lessened the need for the Central Bank to intervene in the market during the remainder of the year. The Central Bank purchased US dollars 631 million and sold US dollars 1,797 million during the year, in the domestic foreign exchange market.

Government Securities Market

The yield rates of Treasury bills in the primary market increased during the first two quarters of 2012 as a result of the tightening of monetary policy and shifting of investor preference from longer end to the shorter end of the yield curve. Accordingly, the weighted average yield rates (WAYR) on 91-day, 182-day and 364-day Treasury bills increased significantly by 244 basis points, 390 basis points and 357 basis points respectively, to 11.12 per cent, 12.61 per cent and 12.88 per cent, respectively as of end June 2012. However, the timely strategies adopted by the Central Bank such as the gradual reduction of the supply of short-term Treasury bills to the market, discontinuation of direct placement of Treasury bills, promotion of investments in Treasury bonds in the primary market by offering yield rates consistent with macro fundamentals and encouraging more foreign investments into Treasury bonds, led to the moderation of WAYR of Treasury bills at primary auctions during the third quarter, during which the increase in WAYR on 91-day and 364-day Treasury bills was limited to 18 basis points and 14 basis points respectively, while WAYR on 182-day Treasury bills declined by 4 basis points. The Treasury bills WAYR started to move downward during the fourth quarter of 2012 and the reduction became much steeper after the policy rate reduction on 12.12.2012. Accordingly, WAYR at Treasury bills primary auction for 91-day, 182-day and 364-day decreased by 130 basis points, 125 basis points and 133 basis points respectively during the fourth quarter of 2012 and stood at 10.00 per cent, 11.32 per cent and 11.69 per cent as at end December 2012.

Yield rates of Treasury bonds in the secondary market were on an increasing trend during the first two quarters of the year in tandem with the upward movement in WAYR of Treasury bills. However, with the substantial foreign demand for Treasury bonds since late July 2012, the limited supply of Treasury bonds in the primary market and the easing of the monetary policy stance by the Central Bank, yield rates on Treasury bonds declined substantially during the fourth quarter of 2012.

Table 8.16 Market Yield Rates of Government Securities

Per cent per annum

Item	Primary Market		Secondary Market	
	2011	2012	2011	2012
Treasury bills				
91 day	6.97-8.68	8.67-12.19	6.97-8.63	8.63-12.06
182 days	7.05-8.71	8.71-13.12	7.05-8.75	8.71-13.10
364 days	7.25-9.31	9.30-13.16	7.23-9.29	9.28-13.34
Treasury bonds				
2 yrs	7.77	9.45-13.62	7.55-9.56	9.37-13.77
3 yrs	7.99	10.20-13.50	7.97-9.87	9.58-13.93
4 yrs	8.20-8.30	9.55-14.10	8.18-9.99	9.69-14.16
5 yrs	8.50-8.60	10.75-14.15	8.38-10.15	9.78-14.35
6 yrs	8.50-8.85	9.75-14.25	8.48-10.18	9.81-14.36
10 yrs	9.00-9.15	10.25-14.75	9.01-11.13	9.93-14.63
15 yrs	-	-	8.76-10.75	10.07-14.59

Source: Central Bank of Sri Lanka

During 2012, the Average Time to Maturity (ATM) of the overall public debt portfolio, which is a key indicator used to measure the portfolio refinancing risk, improved further. During 2012, the yield curve was extended up to 20 years with the issue of a new Treasury bond with a maturity of 20 years at a yield rate of 11.00 per cent. Further, with the limited supply of Treasury bills and prudential management of the foreign demand within the approved threshold, the Average Time to Maturity (ATM) of Treasury bonds issued during 2012 extended to 6.86 years from 5.65 years in 2011 enabling the ATM of the overall public debt portfolio to be improved to 3.23 years at the end of 2012 from 2.35 years at the end of 2011.

Corporate Debt Securities Market

Commercial Paper

The commercial paper market was relatively active in 2012. The value of commercial paper (CP) issued with the support of banks amounted to Rs. 36.9 billion in 2012 in comparison to Rs. 13.6 billion in 2011. A contributory factor for this increase was the credit restrictions imposed on banks and the high lending rates charged by banks as well as finance companies during most part of the year. However, the interest rates on CPs also increased within a range of 11.25 – 22 per cent in 2012 compared to the range of 8.26 - 12.80 per cent in 2011. CPs with a maturity of up to 3 months accounted for 87.5 per cent of the market, while the shares of CPs of 6 month and 12 month maturities were 2.1 per cent and 10.4 per cent, respectively. The total outstanding value of CPs amounted to Rs. 10.6 billion as at end December 2012 compared to Rs. 7.7 billion as at end December 2011.

Corporate Bonds

Activities in the corporate bond market improved in 2012 with nine listings of corporate debentures by two banking institutions with maturity period of 5 years. These debentures mobilised funds amounting to Rs. 12.5 billion, carrying both fixed and floating interest rates. The fixed rates of interest, payable annually, pertaining to six debentures were in the range of 10.50 – 16.50 per cent, while three debentures were issued with a floating rate. In addition, three debentures were issued in the market by way of introduction during 2012. The trading turnover of debentures listed on the Debt Securities Trading System (DEX) of the CSE was significantly low at Rs. 75.7 million in 2012 compared to Rs. 2,694 million in 2011. In order to fast track the development of the corporate debt market, income tax on the interest income of corporate debt securities was exempted with effect from January 2013 in the budget proposals for 2013.

Equity Market

Although the performance of the equity market remained subdued throughout 2012 after the upsurge witnessed in 2009 and 2010, a positive recovery was seen specifically during the second half of 2012. The All Share Price Index (ASPI) declined only by 7 per cent, which is relatively better than the decline of 8.5 per cent in the previous year. The Milanka Price Index (MPI), which is composed of the 25 most traded stocks, declined by 2 per cent by end December 2012. With effect from 1 January 2013, the MPI was replaced by a newly introduced index, namely, S&P SL20 index. The S&P SL 20 index, which was introduced on 27 June 2012 to meet investors' demand for a transparent and a rule based benchmark, has increased by 8 per cent by end December 2012. Yields on fixed income securities which were relatively high in real terms, volatility of the exchange rate and lack of market liquidity as well as the spill over effects of the developments in global financial markets primarily contributed to the downward trend in the equity market. Another factor that affected the equity market activities was the limits imposed on stock brokers' credit particularly in the early part of the year.

However, the market regained some upward momentum during the second half of the year, mainly owing to gradual recovery of rupee against US dollars amidst slowing

Chart 8.12 ASPI, MPI and Market Capitalisation of the CSE

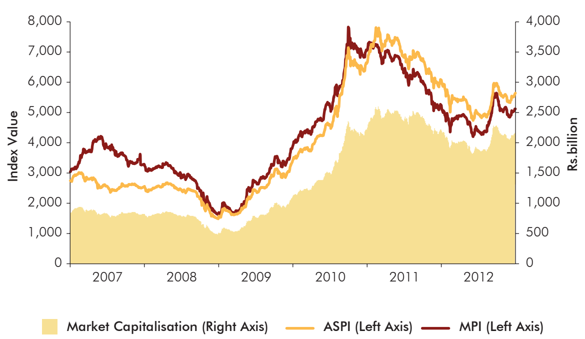


Table 8.17 Performance of the Share Market

Item	2011	2012
All Share Price Index (a)	6,074.4	5,643.0
Year-on-year change (%)	(8.5)	(7.0)
Milanka Price Index (a)	5,229.2	5,119.1
Year-on-year change (%)	(25.9)	(2.0)
S&P SL 20 Index (From 26th June 2012) (a)	-	3,085
June to end December change (%)	-	8.0
Market Capitalisation (Rs.bn.) (a)	2,213.9	2,167.6
As a percentage of GDP (%)	33.9	28.9
Market Price Earnings Ratio (a)	15.8	15.9
Turnover to Market Capitalisation (%)	24.7	9.9
Average Daily Turnover (Rs.million)	2,285.6	884.0
Value of Shares Traded (Rs.bn)	546.3	213.8
Number of Shares Traded (million)	24,543	9,691
Number of Companies Listed	272	287
Introductions (b)	16	11
Number of Initial Public Offers/ Offers for Sale (b)	13	6
Number of Rights Issues	22	19
Amount Raised through Rights Issues and Initial Public Offers (Rs.bn)	45.1	13.3

(a) End of the year

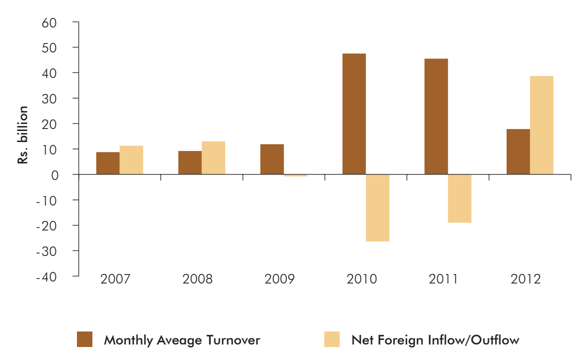
(b) There are 3 methods to obtain listing: i.e an introduction where no public issue is required, an offer for sale where already existing shares are issued to the public and an offer for subscription where new shares are issued to the public.

Source: Colombo Stock Exchange

imports, policy interest rates revision by the Central Bank and relaxation of rules by the Securities and Exchange Commission of Sri Lanka (SEC) on broker credit and trading and continued foreign investor participation in the equity market. The price indices of all sub sectors except one (Beverage, Food and Tobacco) declined, contributing to the slowdown of overall price indices in 2012. The market price earnings (PE) ratio declined to its lowest of 11.4 (during the year) in May 2012 and subsequently increased to 15.9 by end December 2012. The PE ratio was 15.8 in 2011. The current market PE ratio of the Colombo Stock Exchange (CSE) is considered to be broadly in line with high liquidity and company earnings potential, indicating that the market is not overvalued. When compared with other markets in the region the current domestic PE ratio is on par with the average PE ratio of the region.

The market capitalization declined following the movements of share prices but several new listings were made through IPOs and Introductions. The market capitalization which was equivalent to 29 per cent of GDP, marginally declined by 2 per cent (or by Rs. 46 billion) to Rs. 2.17 trillion at end December 2012 from Rs. 2.21 trillion at end 2011 despite six new listings via Initial Public Offerings (IPOs), twelve new listings via Introduction and nineteen rights issues. The largest five sectors in terms of market capitalization were Banking, Finance & Insurance (22.6 per cent), Diversified Holdings (21.9 per cent), Beverage, Food & Tobacco (18.4 per cent), Hotels & Travel (7.3 per cent) and Telecommunication (6.8 per cent). Furthermore, the five largest and ten largest companies accounted for 27.4 per cent and 42.1 per cent, respectively, of market capitalization. The number of companies listed on the CSE increased by 15 to 287 by end December 2012. The CSE generated a lower equity turnover of Rs. 214 billion in 2012 compared to Rs. 546 billion in 2011. The decreased turnover was partly due to the decline in share prices. The average daily turnover also declined to Rs. 884 million in 2012, compared with Rs. 2,286 million in 2011. Domestic investors accounted for about 75 per cent of the turnover, 97 per cent of transactions and 86 per cent of shares traded on the CSE. Of them, local companies and retail investors accounted for 36 per cent and 30 per cent of the turnover, respectively.

Chart 8.13 Turnover and Foreign Participation at the CSE



The net foreign inflows into the stock market increased significantly as opposed to net outflows during the past two years. Total foreign purchases amounted to Rs. 72.7 billion, while total foreign sales were Rs. 34.0 billion during the year 2012, resulting in a net inflow of foreign funds to the market of Rs. 38.7 billion (or US dollars 304 million) in 2012 compared to a net outflow of Rs. 19 billion (or US dollars 167 million) in 2011. Foreign institutional investor interest was mainly seen on stocks such as John Keells Holdings, Ceylon Tobacco, Nestle Lanka, Chevron Lubricants, Commercial Bank, Sampath Bank and Dialog Axiata. Foreign companies dominated, accounting for 95.8 per cent of the total foreign purchases, while foreign individuals accounted only for 4.2 per cent. The six IPOs of shares on the CSE in 2012 raised Rs. 1.7 billion while a further Rs. 11.7 billion was raised though nineteen rights issues.

During 2012, SEC introduced several measures to facilitate the smooth functioning of the stock market. Several conditions were introduced to the listing rules for public companies seeking listings on the CSE. In order to reduce liquidity constraints of retail investors and to reduce volatility in the market, the limits on credit extension by stock brokers was further relaxed by the SEC. In addition, the SEC removed the 10 per cent price band imposed for 5 market days on volatile securities in April 2012. Several measures were also introduced to mitigate settlement risk in the market.

The proposed implementation of the minimum free float requirement is expected to increase the liquidity and turnover in the market. The preparatory work is being made for the establishment of a central counterparty clearing corporation and this is envisaged to mitigate settlement risks enabling moving to a delivery versus payment mechanism.

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

8.4 Development Finance and Access to Finance

In 2012, the Central Bank continued to engage in activities aimed at promoting regional development and coordinated and encouraged credit delivery to strategic sectors. Through refinance schemes, interest subsidy schemes and credit supplementation schemes that were implemented with Participating Financial Institutions (PFIs), the Bank channelled credit facilities for needy business ventures in the agriculture, livestock and micro, small and medium sector enterprise (MSMEs) sectors.

The credit facilities made available to the agriculture sector with the objective of increasing production of essential food items, to ensure food security, continued satisfactorily in 2012. The total loans granted to the agriculture and animal husbandry sector was Rs. 10.4 billion, which covered 115,787 borrowers during 2012. The New Comprehensive Rural Credit Scheme (NCRCS), under which, working capital required by farmers is provided, covered 35 short-term crops in 2012. Under the NCRCS, a total of Rs. 9,388 million loans were granted in 2012 and Jaffna emerged as the district that received the highest amount of agricultural loans (30 per cent). Under the Viskam Loan Scheme, Rs. 523 million was disbursed among eligible investors, while under the Second Perennial Crops Development Project - Revolving Fund Loan Scheme, the Tea Development Project - Revolving Fund Loan Scheme, and the Agro-Livestock Development Loan Scheme, loans amounting to Rs. 552 million was disbursed, in 2012.

The Central Bank continued to assist the Small and Medium Enterprises (SMEs) sector through loan disbursements at concessionary rates, throughout the year. Altogether a some of Rs. 2,464 million was disbursed among 6,985 recipients under the Saubhagya Loan Scheme, through which credit facilities were provided to small and medium scale enterprises. Loans granted under the Saubhagya Loan scheme cover a variety of manufacturing and services activities such as hotels and restaurants, health and related services. Further, with a view to developing the SME sector, assistance was provided through the Provincial Development Loan Scheme, the Self-Employment Promotion Loan scheme, the Construction Sector Development Project Loan Scheme, the Post-Tsunami Coastal Rehabilitation Resource Management Project, the Sabaragamuwa Province Integrated Rural Development Project – Revolving Fund Loan Scheme and the Matale Regional Economic Advancement Project – Revolving Fund Loan Scheme. Under the Provincial Development Credit Scheme, Rs. 340 million was disbursed for eligible medium and long-term projects in trading, transportation education and manufacturing sectors. A total of Rs. 4,129 million was disbursed under refinance schemes to 18,161 entrepreneurs in the SME sector.

The flow of funds to the conflict affected areas and lagging regions continued during the year 2012. Under the loan scheme, “Awakening North – Phase II”, 5,546 loans amounting to Rs. 668 million were disbursed while under the loan scheme “Resumption of Economic Activities in the East – Phase II”, 3,612 loans, amounting to Rs 528 million, were disbursed in 2012. In addition, Rs. 84 million was disbursed for the development of the housing sector in the Northern and Eastern Provinces.

With the objective of promoting financial inclusiveness, Self Help Groups (SHGs) were set up to enable sectors of the population that did not have access to the formal financial sector to obtain microfinance facilities through PFIs. In 2012, under the Poverty Alleviation Microfinance Project II (PAMP II) loans amounting to Rs. 652 million were disbursed among 10,116 beneficiaries in 14 districts. Under the Poverty Alleviation Micro Finance - Revolving Fund Loan Scheme, loans worth Rs. 387 million were disbursed to 9,612 low income earners to commence their own income generating activities. Meanwhile, under the Small Farmer and Landless Credit Project Revolving fund (SFLCP-RF), set up with the intention of improving the economic wellbeing and general welfare of the rural poor, loans to the value of Rs. 180 million were granted to 5,704 beneficiaries. Under the Dry Zone Livelihood Support and Partnership Programme aimed at improving the livelihoods of marginalized smallholders and poor upland food crop farmers in Anuradhapura, Badulla, Monaragala and Kurunegala Districts, loans worth Rs. 84 million were disbursed to 1,424 beneficiaries. In total, loans totalling Rs. 1,351 million were granted to 26,878 beneficiaries under micro finance credit schemes, in 2012.

8.5 Financial Infrastructure

Payment and Settlement Systems

The emergence of innovative payment and settlement mechanisms and the improvements made to the existing systems to cater to the increasing payment needs have led to broadening of the role of the Central Bank as the regulator and facilitator of the national payment system. During the year 2012, the Central Bank initiated several policy measures while continuing to further improve the existing regulatory framework and practices in relation to the payment and settlement system. The country’s payment system, which consists of the two systemically important payment systems (i.e. the LankaSettle System operated by the Central Bank and the Cheque Clearing System operated by LankaClear (Pvt.) Ltd.) and other retail payment and settlement systems operated smoothly without any major disruption.

The LankaSettle System was upgraded in 2012 by adopting several system enhancements aimed at improving operational functionality, system security and monitoring capabilities. Further, in order to examine whether the systemically important payment systems were operating in line with the international standards and best practices, an assessment of the LankaSettle System against the new Principles for Financial Market Infrastructures published by the Bank for International Settlements in April 2012, commenced during the year. With this assessment, it is intended to identify the areas that require changes and improvements and appropriate measures would be taken to ensure that the LankaSettle System conforms to international standards.

Transactions made through the Real Time Gross Settlement (RTGS) System, which is one of the two main components of the LankaSettle System that facilitates real-time settlement of large value and time critical payment obligations, accounted for 85 per cent of the total value of non-cash payments in the country, during the year under review. The RTGS System, being the only high-value electronic payment system in the country, provides the facility of real-time settlement for participating institutions.

Table 8.18 Transactions through Payment Systems

Payment system	2011 Volume ('000)	2011 Value (Rs.bn)	2012 (a) Volume ('000)	2012 (a) Value (Rs.bn)
Large Value Payment Systems	267	57,790	285	43,255
RTGS System	267	57,790	285	43,255
Retail Value Payment Systems	91,069	7,079	101,027	7,833
Main Cheque Clearing System	46,012	6,202	47,757	6,592
Rupee Draft Clearing System	n.a.	0.5	n.a.	0.4
Sri Lanka Interbank Payment System (SLIPS)	12,443	422	14,475	553
Credit Cards	18,609	93	20,052	112
Debit Cards	8,346	24	11,560	35
Internet Banking	5,461	321	6,973	526
Phone Banking	198	5	210	5
Postal Instruments	n.a.	11	n.a.	10
Total	91,336	64,869	101,312	51,088
US Dollar Cheque Clearing System	55	25	54	26

(a) Provisional

Sources: Central Bank of Sri Lanka

It facilitates high-value rupee payments relating to the inter-bank call money market, the government securities market, the foreign exchange market, open market operations and time critical third party (customer) transactions. The final settlement of the multilateral net clearing balances as per the cheque clearing system and the Sri Lanka Inter-bank Payment System, are also made through the RTGS System. The aggregate transaction volume settled through the RTGS System recorded an increase of 6.5 per cent while the total transaction value declined by 25.2 per cent in 2012. The Intra-day Liquidity Facility (ILF), an interest free facility extended to participating institutions of the RTGS System by the Central Bank to facilitate the smooth functioning of the system, was continued during the year and the daily average value of ILF utilized by the participants in 2012 amounted to Rs. 10 billion.

The total value of scripless securities held by LankaSecure at the end of 2012 amounted to Rs. 3,205 billion accounting for 99.9 per cent of the total value of Treasury bills and Treasury bonds outstanding. These scripless securities consisted of Rs. 709 billion Treasury bills and Rs. 2,496 billion Treasury bonds. As at end 2012, LankaSecure maintained 78,896 accounts through Dealer Direct Participants, including accounts of the corporate investors.

The Cheque Imaging and Truncation System (CIT System) operated by LankaClear (Pvt.) Ltd. to provide cheque clearing facilities to LCBs, cleared over 47.8 million cheques during 2012, registering an increase of 3.8 per cent over the previous year. The total value of cheques cleared through the CIT System increased by 6.3 per cent to Rs. 6,592 billion in 2012. In terms of volume, payments made through cheques accounted for 47 per cent of the aggregate volume of non-cash payments executed during the year.

BOX 12 The Clean Note Policy

The Monetary Law Act (MLA) has authorized the Central Bank of Sri Lanka (CBSL) to be the sole authority for issuing currency notes and coins in Sri Lanka. Accordingly, CBSL is entrusted with the task of ensuring the availability of currency notes and coins in required volumes and acceptable quality to meet the demand and to this end spends a substantial amount of financial resources to issue currency to facilitate payments and settlements in the economy.

Over the last decade, currency in circulation has been increasing at an annual rate of 13 -14 % in line with expansion of economic activities and price movements. The total value of currency in circulation at the end of 2012 was Rs. 318 billion, of which around 98% was in currency notes. The CBSL continuously provides new and fit (serviceable) currency notes through the banking system to meet public demand while withdrawing soiled notes out of circulation through the same system. The value of new currency notes issued to commercial banks by the CBSL during the year 2012 was Rs. 75 billion. The CBSL destroyed 159.6 million pieces of unfit (unserviceable) currency notes during 2012. The cost incurred by the CBSL for those destroyed notes was around Rs. 855 million.

Objective of the Clean Note Policy

With usage, currency notes become unfit. The lifespan of a currency note mainly depends on the quality of the paper of note, the frequency of usage and the conditions under which they are used. The lower value currency notes have a shorter lifespan due to their high velocity than the notes with high values. The average lifespan of Rs. 10 and Rs. 20 currency notes is around 20 and 30 months respectively, while the average lifespan of Rs.1,000 is approximately 80 months. The volume of lower denomination notes in circulation is comparatively higher than high denomination notes and this too results in a large volume of unfit low denomination currency notes being in circulation.

The CBSL has now introduced a Clean Note Policy with the objective of having good quality currency notes in circulation. The Clean Note Policy has been promoted in a wider manner since the recent past, due to its multi-dimensional benefits as given below:

a) The quality of a currency note can be improved with correct handling practices, which will consequently extend the lifespan of notes and reduce the cost of printing new notes.

b) Clean currency notes help to distinguish between genuine notes and counterfeits, which is a vital factor in combating counterfeiting efforts.

c) Clean notes help boost the image of the nation among foreign visitors, as their first impressions of the country will be based, among other experiences, on the local currency they receive in exchange for foreign currency.

d) Clean currency notes facilitate manual and mechanical processing of notes. If currency notes are cleaner and more crisp, processing, counting and handling functions are faster and more efficient.

e) Clean notes reduce the chances of being carriers of germs, as a currency note has the highest frequency of moving from hand to hand and is naturally exposed to various types of germs which may cause infectious diseases.

Measures Taken by the CBSL to Implement the Clean Note Policy

The Clean Note Policy can be executed effectively by:

a) Withdrawing unfit currency notes from circulation

b) Expanding the lifespan of notes by establishing proper handling practices among the public.

Withdrawing soiled notes from circulation is as important as releasing fresh and fit notes into circulation.

The CBSL has issued guidelines on sorting standards of currency notes to all commercial banks to provide clear and acceptable criteria in determining the quality of unfit notes to be withdrawn. Banks have been instructed to issue only good quality (fit) notes to the public while depositing unfit notes with the CBSL.

The Licensed Commercial Banks (LCBs) have also been directed to provide the general public with the facility of exchanging soiled/unfit currency notes for fit notes at all their branches and to refrain from re-issuing unfit notes to the public. The CBSL conducts periodical examinations to check the availability of cash exchange facilities to the general public at bank branches and monitors whether the instructions and guidelines issued by the CBSL are being followed.

Further, the CBSL has taken a series of new steps to educate the general public on the importance of maintaining a high standard of cleanliness in currency notes in circulation and refraining from wilful mutilation and defacement of notes. A massive publicity drive was conducted through a series of advertisements on TV, through newspapers, radio and TV discussions, posters and stickers. Public awareness programme included 35 seminars/workshops conducted island wide during 2012.

The CBSL intends to implement the Clean Note Policy with a more aggressive campaign in the future.

Experiences of Other Countries

Many countries have adopted a Clean Note Policy in order to ensure that only good quality currency notes remain in circulation. However, the measures taken by these countries to achieve the same objective are different except in the establishment of sorting standards for currency notes.

The major concern of high income countries is on the durability of materials used for producing currency notes to extend the lifespan of currency. The handling practices of currency are comparatively better and withdrawal of unfit notes by monetary authorities is not a burden due to the advanced cash processing systems that are fully automated. Further, high income countries have the capacity of bearing the cost involved with printing of new notes with desired advancements, such as varnishing, adding of synthetic fibers to cotton pulp etc..

The measures that have been taken by the middle and low income countries have several similarities. Monetary Authorities in Malaysia, India, Ghana, Pakistan, Nigeria, Nepal, Bangladesh, Philippines and Indonesia have instructed their commercial banks to adhere to the sorting standards set by them to prevent recirculation of unfit notes. The public are educated on how to handle currency notes in a clean and proper manner and to deposit/ exchange unfit notes with banks. Banks are instructed to provide unrestricted facilities for exchange of unfit (soiled, damaged or mutilated) notes.

Responsibilities of Stakeholders

The CBSL uses the commercial banks as the main channel to issue currency into circulation and withdraw currency from circulation. Therefore, the commitment and the cooperation of commercial banks is vital to promote the Clean Note Policy. Commercial banks also have the responsibility to sort/process cash deposits as fit and unfit before reissuing fit notes and depositing unfit notes with the CBSL.

The public has a responsibility toward the nation as they are the beneficiaries of currency issue and therefore need to cooperate with the CBSL to implement the Clean Note Policy. The public can contribute to improve cost efficiency of currency management at national level by avoiding improper habits of handling currency notes such as, writing or drawing on notes, defacing security features and images of notes, cutting or scratching notes, handling notes with soiled/ dirty hands, keeping notes in places where they are exposed to heat or damp conditions or liable to damage by insects and collecting notes in tills with coins.

While avoiding the bad habits above, it is necessary to inculcate good habits and attitudes such as use of notes with care, placing notes without folding or crushing in wallets/ purses/ envelopes according to the order of denomination for ease of handling, acquiring the habit of transacting in clean notes, depositing unfit notes in bank accounts or exchanging unfit notes for fit notes from LCBs and keeping notes clean as it is a reflection of our culture, attitude and the level of prosperity.

Sri Lanka Inter-bank Payment System (SLIPS), which was launched in 1994 as an inter-bank retail payment system, has gradually grown over time with more and more retail transactions in the nature of credit transfers and direct debit transfers being effected through the system. In 2012, the total volume of payments made through SLIPS increased by 16.3 per cent to 14 million and the aggregate value of SLIPS payments increased by 31 per cent to Rs. 552.6 billion.

The Central Bank focused its attention on retail payment systems and electronic fund transfer mechanisms in 2012, with the objective of mitigating risks inherent in adopting innovative payment methods whilst encouraging such mechanisms. As a measure of streamlining the operations of the payment card industry, the Central Bank introduced a licensing regime in 2010 and in accordance with that regime, two new licences were issued during the year to a licensed specialized bank and a licensed finance company to operate as card issuers in the payment card industry.

Considering the high level of mobile phone penetration in the country, considerable interest has been shown in offering mobile phone based payment services, in order to reap

the benefits associated with such services. The first mobile phone based e-money scheme was introduced in June 2012 by a telecommunication network operator licensed by the Central Bank. The mobile phone based payment industry in Sri Lanka, which was previously limited to customer account based mobile payment systems operated by financial institutions, has been broadened with this innovative mobile phone based payment solution. Mobile phone based electronic money was introduced as a mode of payment in the country.

In the context of security aspects of card based payments being a prime regulatory concern due to increasing levels of payment card related frauds, the Central Bank mandated the adoption of the line encryption technology for institutions engaged in financial acquiring, as a measure of mitigating fraud risk associated with cardholder data theft while in transit. Accordingly, during the year under review, financial acquirers engaged in updating or replacing the point-of-sale terminals to adhere to the aforementioned mandatory requirement. Adoption of line encryption technology would contribute to enhancing customer confidence in using payment cards for effecting payments.

Credit Information

The significantly high demand for credit reports witnessed during 2010 and 2011 as a result of the higher growth of credit extended by both banks and non-bank financial institutions moderated during the year as several fiscal and monetary policy measures were taken in early 2012 to contain high credit growth. The Credit Information Bureau (CRIB) issued 2,326,504 credit reports on corporate and individual borrowers during the year 2012 compared with 2,275,924 reports in 2011. The CRIB has a total of 93 reporting credit institutions as its members. During the year, enhancements were made in its core technology infrastructure, namely the Credit Information Management System (CRIMS), which facilitated a significant reduction in the data processing time. CRIB also continued improvement to its newly established Secured Transaction Registry System (StrS). The StrS recognised 2,162 transactions in the register reported by 25 member institutions as at end December 2012. In order to strengthen the legal framework of the StrS, CRIB is initiating amendments to the provisions of Secured Transaction Act No. 49 of 2009 with the assistance of the Central Bank and International Financial Corporation (IFC). The CRIB continued its user awareness and educational programs among credit officers and other staff of lending institutions as well as general public to provide a better understanding of the CRIB's role in credit market and to enable prudent interpretation of credit reports for risk management purposes. In addition, the CRIB commenced the development of an online web portal to make available consumer credit reports (iReports) though the World Wide Web.