8

FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

8.1 Overview

The financial sector remained resilient and financial system stability was preserved amidst uncertainties in major advanced economies and tensions in global financial markets. Subdued external demand given the tepid recovery of global economic activity negatively affecting trade related activity particularly during the early part of the year; the sharp decline in international gold prices from the high levels that prevailed by October 2012; and the lag effects of the tight monetary policy stance adopted in 2012, dampened demand for credit from both banks and non-bank financial institutions. As a result of the slower credit growth, investments increased while non-performing loans rose mainly due to non-performing pawning advances. Consequently, net interest margins declined. However, given that the lending portfolios have been diversified while capital and liquidity buffers are strong, and underwriting and risk management practices have remained sound, the banking sector as well as the finance and leasing companies sector continued to be sound, providing a conducive environment for continued growth of the economy. Assets of banks, finance companies, leasing companies and insurance companies increased. While their branch net-work expanded, the majority of the new branches were established outside the Western Province, enhancing access to financial services and promoting inclusive growth.

Financial markets remained liquid during much of 2013 and market interest rates adjusted downwards gradually during the year, responding to the easing of the Central Bank's monetary policy stance. Yield rates in the government securities market declined significantly during the year, in view of the prudent debt management strategies implemented alongside the easing of monetary policy by the Central Bank. It is expected that lending rates of financial institutions would continue to decline, in line with the downward shifting of the benchmark yield curve for government securities. In spite of the turbulence in global foreign exchange markets following the announcement by the Federal Reserve Board of its intention to gradually withdraw the monetary stimulus in the USA, Sri Lanka's foreign exchange market remained stable. Domestic banking institutions were also little affected by the volatile conditions in offshore foreign exchange markets. An improvement was seen in equity market performance with increased participation by foreign investors including institutional investors.

The regulatory and supervisory regime was further strengthened and disclosure requirements were made more stringent to be in line with international standards and best practices, to ensure that potential risks to financial system stability are addressed in a timely manner. With a view to assessing the capital adequacy of banks and determining whether banks hold adequate capital to cover all risks, Directions in respect of the Supervisory Review Process under Pillar 2 of Basel II, were issued. Following the adoption of the International Financial Reporting Standards from 2012, financial reporting and disclosure standards, which promote market confidence and transparency, have also been further strengthened through the introduction of new formats for the preparation and presentation of Annual Accounts. Banks were also mandated to publish annual audited financial statements and qualitative disclosures on their websites. The regulatory and supervisory framework pertaining to finance companies and leasing companies was also strengthened with the development of internal risk rating models and an early warning system implemented to identify risks so as to be able to take appropriate policy measures in a timely manner. During the year, the Central Bank also took measures to increase the efficiency of payment infrastructure and facilitate the migration to e-payments.

Going forward, Sri Lanka's financial sector is expected to play a dynamic role in facilitating the diverse investment and financing needs of the domestic economy and supporting the growth momentum in the economy. Easing of monetary policy in 2013 and in early 2014 together with the decline in inflation and inflation expectations is expected to stimulate credit growth whilst boosting equity and bond market performance. In early 2014, the Central Bank unveiled the Master Plan for consolidation in the financial sector, which was formulated with the aim of building a strong, dynamic and internationally competitive financial sector with cross-border linkages and a significant overseas presence. Foreign financial institutions are also expected to play a greater role in economic activity in the years ahead. To support the envisaged transformation of the financial sector, the regulatory and supervisory regime will be strengthened with the adoption of Basel III standards. Further, sound corporate governance and risk management practices will be inculcated in financial institutions while promoting the adoption of appropriate disclosure standards, so as to mitigate potential risks to financial stability. A series of measures have also been taken with a view to deepening and broadening financial

Table 8.1 Total Assets of the Major Financial Institutions

	2012 (a)		2013 (b)	
	Rs. bn	Share (%)	Rs. bn	Share (%)
Banking Sector	**6,377.0**	**70.4**	**7,187.5**	**69.7**
Central Bank	1,278.8	14.1	1,246.0	12.1
Licensed Commercial Banks	4,355.7	48.1	5,022.2	48.7
Licensed Specialised Banks	742.5	8.2	919.3	8.9
Other Deposit Taking Financial Institutions	**621.2**	**6.9**	**756.4**	**7.3**
Licensed Finance Companies	536.1	5.9	653.0	6.3
Co-operative Rural Banks	77.2	0.9	94.9	0.9
Thrift and Credit Co-operative Societies	7.9	0.1	8.5	0.1
Specialised Financial Institutions	**310.4**	**3.4**	**375.9**	**3.6**
Specialised Leasing Companies	60.4	0.7	64.5	0.6
Primary Dealers	160.4	1.8	213.6	2.1
Stock Brokers	10.8	0.1	10.3	0.1
Unit Trusts / Unit Trust Management Companies	32.4	0.4	55.8	0.5
Market Intermediaries (c)	43.9	0.5	29.5	0.3
Venture Capital Companies	2.5	0.0	2.3	0.0
Contractual Savings Institutions	**1,752.6**	**19.3**	**1,998.3**	**19.4**
Insurance Companies	307.0	3.4	360.4	3.5
Employees' Provident Fund	1,144.4	12.6	1,300.0	12.6
Employees' Trust Fund	158.4	1.7	178.5	1.7
Approved Pension and Provident Funds	110.3	1.2	123.0	1.2
Public Service Provident Fund	32.9	0.4	36.4	0.4
Total	**9,061.2**	**100.0**	**10,318.0**	**100.0**

Source : Central Bank of Sri Lanka

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

BOX 10 Consolidation in the Financial Sector to support Growth of the Economy and Stability of the Financial Sector

Introduction

A healthy, robust and stable financial sector could play a catalytic role in promoting economic growth. A resilient financial system that is well-regulated and supervised would ensure financial system stability thereby supporting economic stability. Acquisitions, amalgamations, joint ventures, mergers and strategic alliances in the financial sector could foster strengthening of the financial sector in terms of its ability to support the realisation of the growth potential of the country and ensure stability of the financial system. Given the benefits stemming from consolidation of financial institutions, both within and across countries, consolidation of financial institutions has become a notable feature of the financial landscape. Technological advancements as well as deregulation in the financial sector have encouraged financial institutions to consolidate while more stringent regulatory requirements, particularly following the recent global financial crisis, have reinforced the trend towards consolidation among small players.

Advantages and opportunities arising as a result of consolidation have a strong bearing on the performance of financial institutions and therefore on the financial sector. Consolidation allows a financial institution to become larger in size and more competitive by achieving economies of scale and economies of scope. It also offers a potentially effective means of creating shareholder value as synergies could be generated through consolidation, whereby revenues could be increased while reducing costs. Consolidation of financial institutions would also result in risk reduction due to the ability of larger institutions to invest in more sophisticated risk management systems as well as due to business diversification in terms of products and services as well as geographic dispersion of markets. Moreover, the stronger positioning following consolidation would enable some institutions to raise funds internationally, to fulfil funding requirements of the country.

Many emerging market economies have, in the past, implemented restructuring plans for their respective financial sector and most such programmes have given prominence to consolidation of financial institutions with the aim of strengthening the financial sector. Sri Lanka's national budget for 2014 too emphasised the need for consolidation in the financial sector to support the government's efforts to boost economic growth while preserving stability of the financial system. Accordingly, tax incentives would be accorded to facilitate the consolidation process. The master plan for consolidation of financial institutions in Sri Lanka, which was formulated with the objective of promoting a more stable and internationally competitive financial sector was unveiled by the Central Bank of Sri Lanka in early 2014.

Consolidation of Financial Institutions in Other Parts of the World

In recent decades, consolidation of financial institutions has been a notable feature of the financial sector in many countries around the world. In advanced economies such as the United States of America, as well as in some Central European and Latin American countries, market driven consolidation of financial institutions, motivated by the objective of enhancing competitiveness, particularly in a global context, has been common. In Singapore and Hong Kong too, the authorities advocated consolidation of financial institutions with a view to enhancing their competitiveness. Consolidation in Singapore's financial sector was promoted primarily with the objective of building several strong banks that could help the country become an Asian financial hub. Increased competition from both domestic and global players motivated Hong Kong's banking sector to move towards consolidation. While the authorities in Singapore and Honk Kong strongly advocated and provided appropriate incentives for consolidation, they let the new structure of their respective financial sector to be determined by market forces. In Taiwan, a fragmented financial services industry, with many small players, made it difficult for banks in Taiwan to compete in the global marketplace. This motivated Taiwan's banking sector to move towards consolidation. A large number of small banks with high fixed costs necessitated consolidation and repositioning of banks in Nigeria. India too has identified the need for banking sector consolidation, whilst recognising the need to have large banks that could compete with international peers.

In many emerging market economies, particularly the crisis-hit Asian economies, consolidation in the financial sector was led by the authorities and pursued as a means of resolving financial crises and building a resilient financial system with sufficient buffers to absorb shocks. For example, the evolution of Indonesia's, Thailand's and Korea's financial sectors has largely been a story of restructuring, adjustment and renewal, following the devastating effects of the Asian financial crisis in the late 1990s. In these countries, governments have played a major role in the consolidation process, which had aimed at strengthening capital and financial viability of the numerous, often small and family owned financial institutions affected by the financial crisis. In Malaysia, the authorities initially implemented the financial sector restructuring plan as a strategy to strengthen the finance companies sector, which was affected by the slowing down of economic activity as a result of the Asian financial crisis. Subsequently, finance companies in Malaysia were taken over by banks, as the process of consolidation in the financial sector progressed.

Post-merger Performance

The performance of the financial sector in most developed as well as emerging market economies has improved due to consolidation of financial institutions. For example, universal banks in Germany and Japan, which emerged with consolidation in the financial sector, offer a wide range of financial products and services and have therefore given those countries an advantage in promoting industrial development and economic growth. In countries such as Korea, Malaysia, Thailand and Singapore, consolidation of financial institutions has resulted in a strong financial sector with a low level of non-performing assets, a strong capital position and healthy profitability. In Singapore, the strength and resilience of the financial sector as a result of consolidation has contributed significantly to its economic growth and development. This is evidenced by the presence of financial institutions providing a range of services that facilitate domestic as well as international, including regional flows of funds for trade and investment related purposes. Currently, Singapore is amongst the leading international financial centres with the three domestic banking groups in Singapore ranking among the top 500 banks in the world. Malaysia was also able to achieve higher economic growth following financial sector consolidation, as strong, well-capitalised banks are better able to support economic growth, given their higher capacity for absorbing risks and offering a broader range of financial products to cater to the needs of different economic agents.

Consolidation of Financial Institutions in Sri Lanka

Sri Lanka's financial sector facilitated the acceleration of economic growth witnessed in recent years, by making funds, payment facilities and other related facilities available to diverse sectors of the economy. To maintain the growth momentum in the economy so as to enable the country to progress towards upper middle income country status, the financial sector should be able to provide funding and other financial services required for expanding economic activity. To do so, banks and other financial institutions including finance companies and leasing companies, must be strong in terms of performance indicators, asset base and resilience to shocks. Moreover, in a globalised economic environment, presence in overseas markets would also be an advantage to domestic banks, particularly in raising funds. Accordingly, with the objective of further strengthening the domestic financial system and creating a financial sector comprising of banking and non-banking institutions that would be capable of supporting the envisaged economic growth of the country, consolidation in the financial sector is being promoted in Sri Lanka, as a proactive strategy. The Central Bank, as regulator, is encouraging financial institutions to consider consolidation a component of their strategic planning, and make necessary investments to upgrade information technology as well as management information systems used in their operations, whilst attracting the required talent.

The consolidation process is expected to result in a stronger financial sector. Following consolidation, the banking sector is expected to comprise of banks with strong balance sheets including a few banks with an asset base of Rs. 1 trillion or more. The Licensed Finance Companies and Specialised Leasing Companies sector is expected to comprise of a smaller number of larger and stronger companies (around one third of the present number), which are fully compliant with the Central Bank's supervisory and regulatory framework. The Central Bank will continuously monitor the progress of the consolidation process and will engage in continuous interactions with the relevant stakeholders to make the process a success. The objective is to build a dynamic, more effective and more resilient financial sector in Sri Lanka.

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markets, particularly the corporate bond market, to enable the financial sector to assume a greater role in enhancing the country's growth prospects.

8.2 Performance of Financial Institutions

Banking Sector

The banking sector remained strong, with capital being maintained at healthy levels along with adequate liquidity buffers. However, asset growth moderated during the year as credit granted by banks to the private sector expanded at a slower pace in 2013 as a result of the lag effects of the tight monetary policy stance maintained in 2012, subdued external demand impacting on trade related activity, particularly during the early part of the year, and the contraction of the banks' pawning advances portfolios given the steady decline in gold prices in the world market from around October 2012. Nevertheless, the banking sector, which comprised 33 licensed banks, that is, 21 domestic banks which include 9 licensed specialised banks in addition to the 12 commercial banks, and 12 branches of foreign banks, expanded in 2013 and continued to support the expansion of economic activity in the country.

Business Expansion

Outreach: The branch network of banks expanded further in 2013, improving financial accessibility. The total banking network expanded with the opening of 89 banking outlets (including student savings units) and the installation of 123 automated teller machines (ATMs) during 2013. Of these, 71 banking outlets and 95 ATMs were established outside the Western Province. Accordingly, by end 2013, the banking system was operating with 6,487 banking outlets and 2,538 ATMs.

Table 8.2 Distribution of Banks and Bank Branches

Category	End 2012 (a)	End 2013 (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	**5,586**	**5,667**
Branches (c)	**2,730**	**2,803**
Domestic Bank Branches	2,510	2,582
Foreign Bank Branches	220	221
Student Savings Units and Other Outlets	**2,856**	**2,864**
Automated Teller Machines	**2,235**	**2,358**
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	**812**	**820**
Branches (c)	**637**	**645**
Regional Development Bank	254	255
National Level Savings Banks	220	223
Long-term Lending Institutions	27	28
Housing Finance Institutions	47	49
Private Savings and Development Banks	89	90
Student Savings Units and Other Outlets	**175**	**175**
Automated Teller Machines	**180**	**180**
Total No. of Bank Branches and Other Outlets	**6,398**	**6,487**
Total No. of Automated Teller Machines (ATM's)	**2,415**	**2,538**
Total No. of Electronic Fund Transfer Facilities at Point of Sale Machines (EFTPOS)	**27,689**	**27,955**
Banking Density: No.of Bank Branches Per 100,000 Persons	**16.5**	**16.8**

(a) Revised
(b) Provisional
(c) The Banking Outlets were reclassified into two categories, namely Branches and Student Savings Units with Outlets except Student Savings Units being upgraded to branches by 01.01.2013

Source : Central Bank of Sri Lanka

Assets and Liabilities

Assets: The total assets of the banking sector increased by 16.5 per cent, year-on-year, to Rs. 5.9 trillion. In comparison, total assets of the banking sector grew by 19.9 per cent in 2012. The moderation in credit growth from 21.1 per cent in 2012 to 8.8 per cent in 2013 resulted in a decrease in the share of loans and advances in total assets from 61.8 per cent in 2012 to 57.7 per cent in 2013. Consequently, funds mobilised were utilised in investment activities resulting in the share of investments in total assets increasing from 23.9 per cent in 2012 to 28.5 per cent in 2013. Government securities largely accounted for the increase in total investments during 2013.

The increase in lending during 2013 was largely on account of lending to five key areas of economic activity. Construction (26 per cent), trading (21 per cent), infrastructure (20 per cent), manufacturing (17 per cent) and transport (11 per cent) mainly contributed to the increase in lending (their respective contribution to the increase in lending is given within parentheses). Notably, lending for consumption related purposes, contributed negatively to credit growth in 2013.

Liabilities: Deposits continued to be the main funding source in the banking sector, accounting for 70.2 per cent of total liabilities as at end 2013. The resultant funding gap was largely bridged through borrowings, and the share of borrowings in funding sources increased from 15.8 per cent as at end 2012 to 17.1 per cent by end 2013. Nevertheless, year-on-year growth of deposits and borrowings slowed from 18 per cent and 26.6 per cent, respectively, at end 2012 to 15 per cent

Table 8.3 Composition of Assets and Liabilities of the Banking Sector

Item	2012 (a)		2013 (b)		Change (%)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2012	2013 (b)
Assets						
Loans & Advances	3,149	61.8	3,427	57.7	21.1	8.8
Investments	1,218	23.9	1,695	28.5	15.2	39.2
Other (c)	731	14.3	820	13.8	23.1	12.2
Liabilities						
Deposits	3,625	71.1	4,170	70.2	18.0	15.0
Borrowings	804	15.8	1,015	17.1	26.6	26.2
Capital Funds	436	8.5	490	8.2	17.5	12.3
Other	233	4.6	267	4.5	34.2	14.8
Total Assets/ Liabilities	**5,098**	**100.0**	**5,942**	**100.0**	**19.9**	**16.5**

(a) Revised
(b) Provisional
(c) Includes cash and bank balances, placements, reverse repurchase agreements and fixed assets.

Source: Central Bank of Sri Lanka

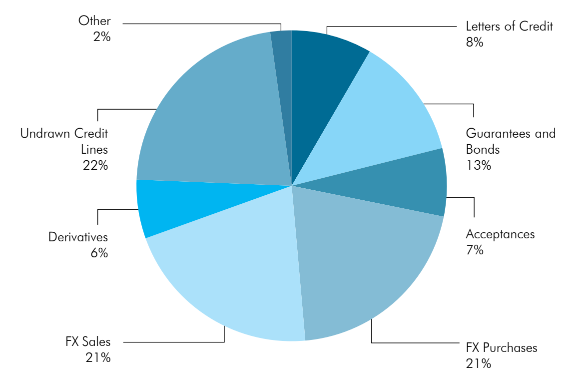
and 26.2 per cent, respectively, as at end 2013. Notably, the share of foreign currency borrowings in total borrowings increased from 54.8 per cent in 2012 to 64.6 per cent in 2013 due to an increase in borrowings from overseas sources by US dollars 1,618 million.

Off-balance sheet exposures: The off-balance sheet exposures increased from 7 per cent in 2012 to 13.9 per cent in 2013, largely resulting from the increase in undrawn credit lines, derivatives and foreign currency (FX) related exposures (both FX sales and purchases). Further, FX related exposures and undrawn credit lines accounted for 41.3 per cent and 22.2 per cent, respectively, of the total off-balance sheet exposure as at end 2013.

Risks in the Banking Sector

Credit risk: During 2013, given the availability of adequate resources in the form of capital, credit risk of the banking sector remained at a manageable level, despite the increase in non-performing loans (NPLs). Credit growth moderated from 21.1 per cent (Rs. 548 billion) in 2012 to 8.8 per cent (Rs. 277 billion) as at end 2013. This moderation in credit growth could be attributed mainly to the lagged effect of the tight monetary policy stance maintained during much of 2012, and the fragile

Chart 8.1 Off-Balance Sheet Exposures of the Banking Sector



recovery of the global economy and the consequent reduction in credit granted for international trade related activities. In addition, the availability of alternative funding sources to corporate entities, both domestically and internationally, is also likely to have impacted on credit growth. Further, the reduction in the pawning portfolio by 17.1 per cent during the year has offset, to some extent, the increase in other categories of lending.

The quality of assets in the banking sector deteriorated as indicated by the increase in the NPL ratio from 3.7 per cent as at end 2012 to 5.6 per cent by end 2013. This was largely the result of weaker loan quality in the pawning portfolio, and slower loan growth. NPLs increased by Rs. 74 billion during 2013, of which Rs. 56 billion relates to pawning advances. In comparison, the increase in NPLs amounted to Rs. 17 billion in 2012. The provision (specific) coverage

Chart 8.2 Non-Performing Loans of the Banking Sector

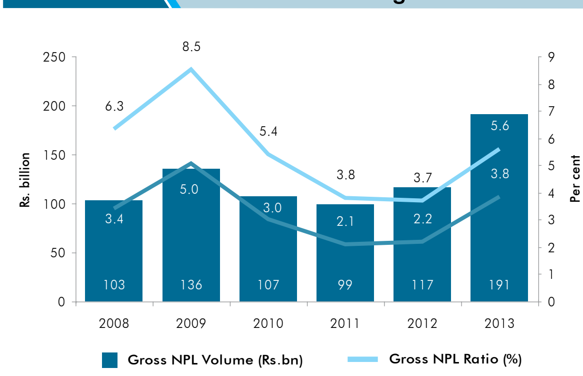
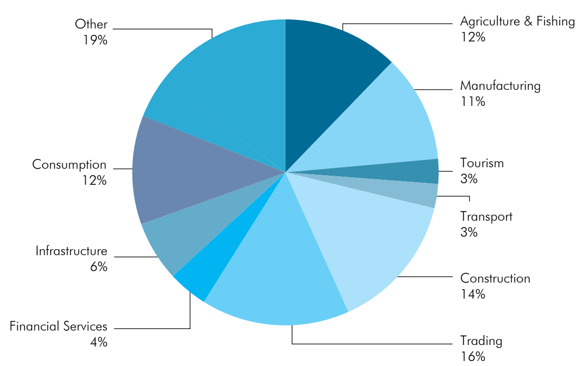


Chart 8.3 Credit Exposure of the Banking Sector

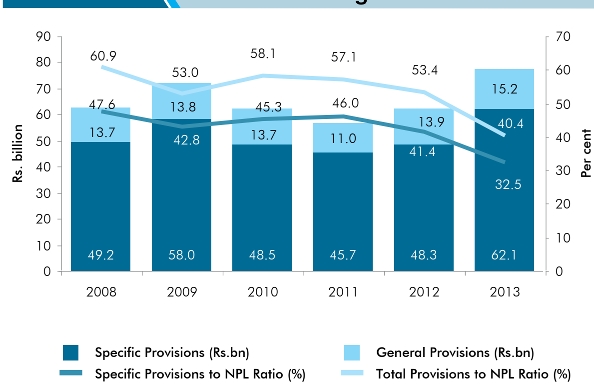


ratio declined from 41.4 per cent as at end 2012 to 32.5 per cent as at end 2013, due to a lower amount of additional provisioning against new NPLs, which were largely in respect of pawning based on gold, where the residual risk is low.

Lending activities of the banking sector continued to be dispersed among diverse sectors. Trading (15.7 per cent), construction (14.5 per cent), agriculture (12.2 per cent) consumption (11.5 per cent) and manufacturing (11.4 per cent) continued to account for a large part of bank lending.

Market risk: Market risk remained low in the overall risk profile of the banking sector as risk weighted assets for market risk accounted for only 2 per cent of the total risk weighted assets and the banking sector reported a capital charge of Rs. 6 billion to cover the market risk.

Chart 8.4 Provisioning for NPLs of the Banking Sector



Interest rates: Responding to the easing of the monetary policy stance, market interest rates adjusted downwards during 2013. Banks were able to effectively manage their exposure to re-pricing risk as the banking sector recorded substantial gains from investments in government securities held for trading. Further, on a cumulative basis, the ratio of the rate sensitive gap, i.e., the gap between rate sensitive assets and rate sensitive liabilities as a percentage of rate sensitive assets in the zero to one year time bucket narrowed from negative 13.2 per cent in 2012 to negative 6.6 per cent in 2013. Hence, the banking sector had limited exposure to re-pricing of interest rate risk.

Prices of Equity: The exposure of the banking sector to equity risk was negligible due to minimal exposure to the stock market. Banks' investments in shares were only 2.4 per cent of total investments and 0.7 per cent of total assets.

Exchange rates: As at end 2013, only 9 per cent of the assets were denominated in foreign currency. Foreign exchange risk was not a significant threat to the stability of the banking sector as the aggregate net open position was less than 1 per cent of the banks' regulatory capital as at end 2013. The depreciation of the rupee against the US dollar by 2.75 per cent had a favourable impact on bank profitability through revaluation of foreign currency assets and liabilities as the foreign currency assets exceeded foreign currency liabilities during much of the year.

Liquidity risk: The banking sector operated with healthy levels of liquidity during 2013. The Statutory Liquid Assets Ratio (SLAR) of the banking sector exceeded the minimum requirement of 20 per cent by a significant margin. The SLAR of the banking sector increased from 31.3 per cent in December 2012 to 37.7 per cent in December 2013, corresponding to the decrease in the credit to deposits and borrowings ratio from 71.1 per cent as at end 2012 to 66.1 per cent by end 2013. The

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FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

Table 8.4 Composition of Statutory Liquid Assets of the Banking Sector

Item	2012 (a)		2013 (b)		Change (Rs. bn)	
	Rs.bn	Share (%)	Rs.bn	Share (%)	2012	2013 (b)
Treasury Bills	285	20.9	577	30.4	30	292
Treasury Bonds	424	31.2	599	31.6	46	176
Sri Lanka Development Bonds	217	16.0	362	19.1	43	145
Cash	73	5.4	84	4.4	13	10
Money at Call	46	3.4	44	2.3	(0.1)	(2)
Balance with Banks	209	15.4	149	7.9	70	(60)
Other	104	7.7	83	4.3	18	(22)
Total Liquid Assets	**1,358**	**100.0**	**1,898**	**100.0**	**219**	**540**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

increase in the liquid assets ratio was mainly a result of the high growth of liquid assets (by 40 per cent). The strengthening of the liquidity position of the banking sector was reflected in both the liquid assets to total assets ratio and the liquid assets to deposits ratio.

Total liquid assets recorded a higher increase of Rs. 540 billion in 2013 when compared with the increase of Rs. 219 billion in 2012. This increase was mainly the result of increased investments in Treasury bills, Treasury bonds and Sri Lanka Development Bonds.

The cumulative maturity gap as a percentage of the cumulative liabilities for all maturity time periods (buckets) less than a period of six months, narrowed from the level that prevailed in 2012. The ratio for a period of less than 1 year increased marginally from negative 13.2 per cent as at end 2012 to negative 13.3 per cent by end 2013.

Chart 8.5 Liquidity Ratios of the Banking Sector

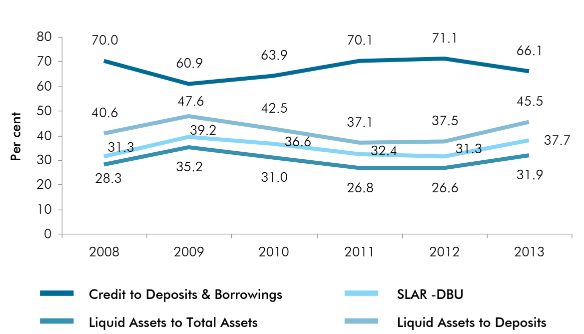


Chart 8.6 Cumulative Maturity Gap as a percentage of the Cumulative Liabilities of the Banking Sector

Resources

Profitability: The banking sector reported a profit after tax of Rs. 74.6 billion for 2013, compared to the profit after tax of Rs. 82.7 billion recorded for 2012. The net interest margin declined from 4.1 per cent in 2012 to 3.5 per cent in 2013, due to the increase in the share of high cost term deposits in total deposits, the moderation in credit growth and the increase in low yielding assets. While the net interest margin declined, partly reflecting the slowing down of core business operations of the banking sector in 2013, provisions for bad and doubtful debt and loans written-off increased from Rs. 6.3 billion in 2012 to Rs. 18.4 billion in 2013. However, there was no significant increase in the operating expenses. Consequent to these developments, all the profitability indicators of the banking sector, i.e., net interest margin (NIM), return on assets (ROA) and return on equity (ROE), declined during the year.

Capital: The capital base of the banking sector increased by 11.7 per cent in 2013, largely on account of internally generated funds, that is, profits. The increase in the share capital through initial public offers, rights issues, new capital infusions to meet the minimum capital requirement, capitalisation of reserves, employee share ownership schemes and script dividends had contributed to 22.8 per cent of the increase in

Table 8.5 Profits of the Banking Sector

Item	2012 (a) Amount (Rs.bn)	2012 (a) As a % of Avg Assets	2013 (b) Amount (Rs.bn)	2013 (b) As a % of Avg Assets
Interest Income	495.6	10.4	591.4	10.6
Interest Expenses	298.4	6.2	394.8	7.1
Net Interest Income	**197.2**	**4.1**	**196.7**	**3.5**
Non-Interest Income	78.9	1.6	85.7	1.5
Foreign Exchange Income	26.7	0.6	16.8	0.3
Non-Interest Expenses	133.5	2.8	141.9	2.5
Staff Cost	68.9	1.4	70.5	1.3
Loan Loss Provisions	6.3	0.1	18.4	0.3
Profit before Tax (after VAT)	**116.8**	**2.4**	**104.7**	**1.9**
Profit after Tax	**82.7**	**1.7**	**74.6**	**1.3**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

capital funds while reserves encompassing retained profits and statutory reserve funds accounted for the remainder.

The total capital adequacy ratio and the core capital adequacy ratio are estimated to be around 16.3 per cent and 13.7 per cent, respectively, subsequent to inclusion of audited profits of the banks for 2013 in the capital.

Currently, Sri Lanka's banking sector is in compliance with the new capital requirements under Basel III, as the banking sector operated with a common equity ratio of 13.7 per cent and a total capital ratio of 16 per cent, well above the minimum requirements of 6 per cent and 10.5 per cent, respectively, under Basel III.

Chart 8.7 Profitability Indicators of the Banking Sector

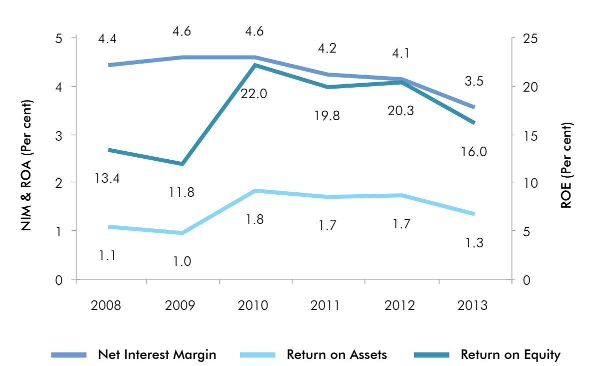


Table 8.6 Composition of Regulatory Capital of the Banking Sector

Item	Amount (Rs.bn) 2012 (a)	Amount (Rs.bn) 2013 (b)	Composition (%) 2012 (a)	Composition (%) 2013 (b)
Tier I Capital	378.0	396.8	100.0	100.0
Share Capital	128.7	140.8	34.0	35.5
Statutory Reserve Funds	24.1	25.2	6.4	6.3
Retained Profits	121.7	114.6	32.2	28.9
General and Other Reserves	126.3	128.0	33.4	32.3
Other	(0.1)	11.6	0.0	2.9
Regulatory Adjustments	(22.6)	(23.3)	(6.0)	(5.9)
Tier II Capital	46.8	76.3	100.0	100.0
Revaluation Reserves	8.9	8.8	19.0	11.6
Subordinated Term Debt	38.9	69.7	83.3	91.4
General Provisions and Other	13.5	13.4	28.9	17.5
Regulatory Adjustments	(14.6)	(15.7)	(31.2)	(20.6)
Total Regulatory Capital Base	423.7	473.1		

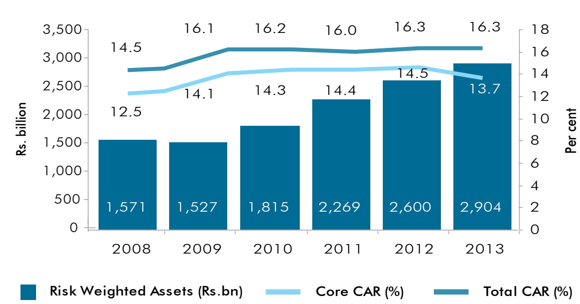
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Supervisory and regulatory developments: The Central Bank continued to implement prudential measures to strengthen risk management in the banking sector. In order to mitigate risks arising from exposures to the stock market and ensure that banks adopt appropriate risk management standards to promote safety and soundness of the banking system, Directions pertaining to the exposure to the stock market were issued. Directions in respect of Pillar 2, specifically, the Supervisory Review Process of Basel II, were also issued, with a view to assessing the capital adequacy of banks and determining whether banks hold additional capital to cover risks that are not covered or whether risks are inadequately covered by the minimum capital requirements under Pillar 1 of Basel II.

Taking into account the changes in the international accounting standards and

Chart 8.8 Capital Adequacy Ratios of the Banking Sector



suggestions made by the licensed banks and the Institute of Chartered Accountants of Sri Lanka, new formats for the preparation of annual audited financial statements and the publication of quarterly financial statements in the press were issued. The new reporting formats will facilitate banks to be on par with other financial institutions adopting international accounting standards and improve disclosures as well as transparency. Banks were required to publish financial statements and other information as per the disclosure requirements, on their websites, in order to enhance uniformity in reporting and promote healthy competition among banks. Further, banks were requested to refrain from publishing misleading and unethical advertisements.

The definitions of liquid assets and lending to the agriculture sector were broadened and a ceiling on interest rates as well as penal interest rates on advances was imposed to facilitate the growing demand for funds alongside the expansion of economic activities in the country. Licensed commercial banks were permitted to invest in international sovereign bonds issued by the Government of Sri Lanka. The restriction imposed on licensed commercial banks, preventing them from providing financial accommodation to licensed finance companies against government securities, Central Bank securities and fixed deposits, without prior approval of the Director of Bank Supervision, was removed. To permit banks to sell, transfer, assign or dispose of immovable assets with prior approval of Director of Bank Supervision, the existing Direction in this regard was amended. The restriction as per the Corporate Governance Directions, preventing the holding of directorships in more than 10 specified business entities was withdrawn, enabling directors with skills and experience gained in diverse business entities to contribute to the progress of banks. Further, regulatory limits on foreign borrowings of licensed commercial banks were liberalised. Meanwhile, women entrepreneurship ventures, low cost housing development projects, and production of energy from sustainable energy sources were identified as permitted sectors for utilising funds in the Investment Fund Account.

In addition to the supervisory framework, the Sri Lanka Deposit Insurance and Liquidity Support Scheme also constitutes a key element of the safety net available to the general public in relation to financial products. As at 31 December 2013, the Scheme comprised of 81 member institutions, that is, 33 banks and 48 finance companies, and the Deposit Insurance and Liquidity Support fund amounted to approximately Rs.12.5 billion.

Policy initiatives taken and prudent regulatory measures in place continued to support the performance and stability of the banking sector in 2013, which ensured continued depositor and investor confidence in the banking sector. The banking sector has undergone structural changes in the past, but further strategic changes in the banking sector are needed for it to grow into its full potential, to be able to support the envisaged strong and sustained growth of the country's economy.

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

The LFC and SLC sector expanded in 2013, with assets of the sector increasing despite the moderation in the sector's accommodation growth. Representing 7 per cent of Sri Lanka's financial system, the LFC and SLC sector continued to complement the banking system. The effectiveness of the regulatory measures in place was reflected in the build up of resilience and soundness of the sector. However, fluctuations in the market prices of gold and relatively high lending rates offered by LFCs and SLCs during 2012 led to an increase in non-performing loans in the sector.

This impacted negatively on the bottom line while increased operational costs further deteriorated profitability.

In view of the envisaged growth of domestic economic activity in the years approaching, the Central Bank adopted several measures to build the capacity of the LFC and SLC sector to facilitate the expansion of economic activity as well as to strengthen the ability of the sector to manage and absorb risks. Key amongst these measures were the steps taken by the Central Bank to promote consolidation of the LFC and SLC sector. These measures would help secure financial system stability whilst facilitating the expansion of economic activity.

Business Expansion

Outreach: This sector comprised of 48 LFCs and 10 SLCs by end 2013, following two SLCs obtaining LFC status, the merger of one LFC with another LFC and the merger of one SLC with an LFC. Meanwhile, the branch network of the LFC and SLC sector expanded by 88 to 1,060 in 2013. Of the new branches, 61 were opened outside the Western Province.

Assets and Liabilities

Assets: The total asset base of the LFC and SLC sector grew by 20 per cent during 2013 to Rs. 717 billion. In comparison, the asset base of the LFC and SLC sector recorded a growth of 22 per cent in 2012. The main contributory factor in the expansion of the asset base has been the growth of the accommodation portfolio and liquid assets. However, accommodation growth decelerated to 17 per cent in 2013 from 21 per cent in 2012, and the accommodation portfolio amounted to Rs. 553 billion as at end of 2013. Finance leases, hire purchases and other secured advances accounted for a large part of the accommodation portfolio, accounting for 46 per cent, 22 per cent and 22 per cent, respectively, of the accommodation portfolio. Among the accommodation products, other secured loans, loans against deposits and finance leases recorded high growth rates of 63 per cent, 26 per cent and 16 per cent, respectively. The investment portfolio of the sector recorded a marginal increase of 3 per cent, in comparison to the growth of 14 per cent recorded for 2012. 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, representing 47 per cent and 27 per cent, respectively, of the total LFC and SLC sector liabilities. The deposits of LFCs grew by 33 per cent to Rs.337 billion as at end of 2013, compared to a 37 per cent growth in 2012. SLCs obtaining LFC status has also contributed to the LFC sector deposit base

Table 8.7 Distribution of Branches of LFCs & SLCs by Province

Province	End 2012	End 2013 (a)
Western	316	344
Southern	112	119
Sabaragamuwa	76	78
North Western	99	112
Central	107	118
Uva	52	51
North Central	69	75
Eastern	78	87
Northern	63	76
Total	**972**	**1,060**

(a) Provisional

Source: Central Bank of Sri Lanka

Chart 8.9 Product-wise Accommodations of the LFC and SLC Sector

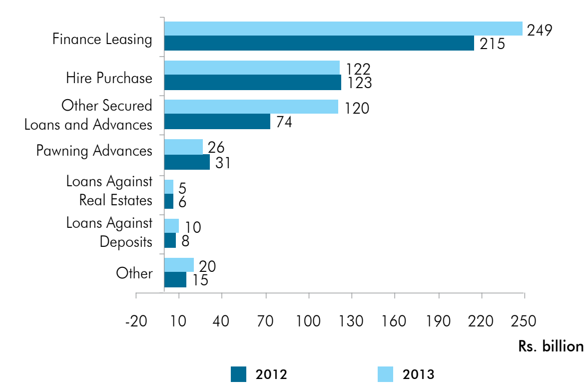


Table 8.8 Composition of Assets and Liabilities of the LFC & SLC Sector

Item	2012 (a) Rs.bn	2012 (a) Share (%)	2013 (b) Rs.bn	2013 (b) Share (%)	Change (%) 2012	Change (%) 2013 (b)
Assets						
Accommodations	471.7	79.1	553.1	77.1	21.4	17.3
Finance Leasing	214.9	36.0	249.1	34.7	29.4	15.9
Hire Purchase	123.0	20.6	122.2	17.0	3.9	(0.7)
Investments	15.4	2.6	15.8	2.2	14.1	2.5
Other	109.6	18.4	148.8	20.7	24.5	35.8
Liabilities						
Total Deposits	254.1	42.6	337.3	47.0	36.6	32.7
Total Borrowings	176.0	29.5	192.3	26.8	2.6	9.3
Capital Elements	94.9	15.9	97.4	13.6	23.2	2.6
Total Funds	**525.0**	**88.0**	**627.0**	**87.4**	**20.8**	**19.4**
Other	71.6	12.0	90.6	12.6	29.6	26.5
Total Assets/Liabilities	**596.6**	**100.0**	**717.6**	**100.0**	**21.8**	**20.3**

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

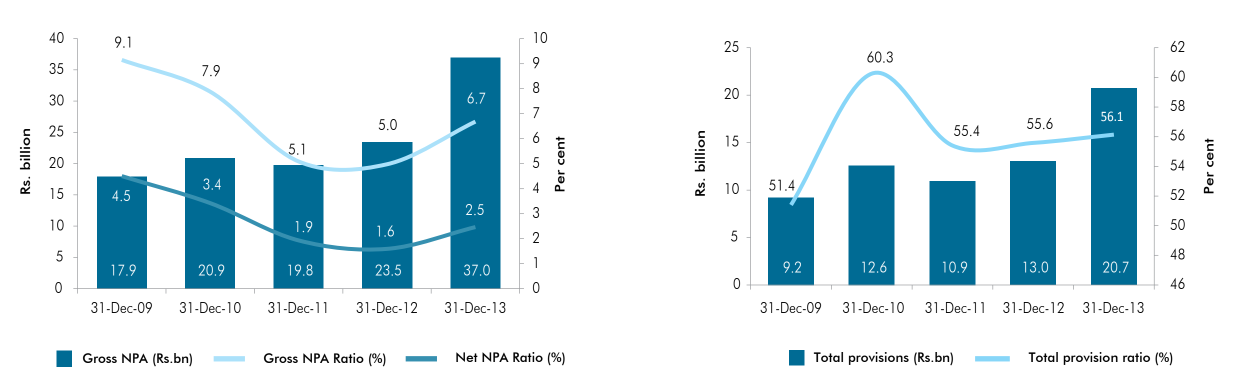
increasing. With respect to deposits of LFCs, time deposits accounted for 98 per cent of the total deposits. The total borrowing in the sector reached Rs. 192 billion, an increase of 9 per cent as at end 2013, compared to the growth of 3 per cent recorded in 2012. During 2013, 11 LFCs and SLCs have issued listed debentures, valued at Rs. 21.9 billion. The accommodation to deposits and borrowings ratio decreased from 110 per cent in 2012 to 104 per cent in 2013, indicating a deceleration in demand for lending activities of the sector. The capital of the sector increased marginally by 3 per cent in 2013 to Rs. 97 billion, compared to an increase of 23 per cent in 2012, mainly due to a decrease in profitability of the sector.

Risk Management

Credit Risk: The total amount of non-performing accommodations (NPAs) increased during 2013 to Rs.37 billion, from Rs.23 billion in 2012. The exposure to NPAs relative to the total accommodations outstanding increased to 6.7 per cent by end 2013 from 5 per cent in 2012.The LFC sector accounts for 92 per cent of the NPAs with the restructured companies being the main contributors to the NPAs. With respect to loan loss provisioning, the net NPA ratio was 2.5 per cent as at end 2013. The total provision coverage for NPAs increased marginally to 56.1 per cent in 2013 from 55.6 per cent in the previous year.

Market Risk: The sector encountered risk due to fluctuations in market interest rates during 2013. However, risks to LFCs and SLCs due to volatilities in prices of equity and exchange rates were minimal due to low exposure to the equity market and foreign currency transactions. The net interest income of the sector increased by 10 per cent to Rs. 44 billion during 2013 from Rs. 40 billion in the previous year. This was mainly due to the lower interest earning capacity of interest rate sensitive assets, the deceleration in credit growth, and the increasing interest rate sensitive liabilities. The interest margin, which is the net interest income as a percentage of total assets of the sector, declined to 6.6 per cent for 2013 from 7.4 per cent in the previous year.

Chart 8.10 Non-Performing Advances and Provision Coverage of the LFC and SLC Sector



Liquidity Risk: The liquid assets available in the LFC and SLC sector by end 2013 were in surplus by Rs. 18 billion, when compared with the stipulated minimum requirement of Rs. 39 billion. The liquid assets to total assets ratio increased from 6 per cent in 2012 to 8 per cent in 2013. This may be attributed to the slowing down of credit growth and the steady growth in the deposits of the sector. The liquid assets of the sector increased by Rs. 24 billion in 2013, in comparison to the increase of Rs.11 billion in 2012. This was mainly as a result of increased investments in Treasury bills and deposits with licensed banks.

Resources

Profitability: During 2013, LFC and SLC sector profitability declined, mainly due to an increase in the operational cost and provisioning requirements. The sector posted a profit after tax of Rs. 8 billion for 2013 compared to a profit after tax of Rs.15 billion in 2012. Alongside the increase in the net interest income, non-interest income and non-interest expenses increased by Rs. 4 billion and Rs. 9 billion, respectively. Loan loss provisions increased by Rs. 7 billion in 2013 when compared to an increase of Rs.3 billion in 2012. The profitability indicators of the sector i.e. Return on Assets (ROA) and Return on Equity (ROE) declined to 2 per cent and 8 per cent in 2013 from 4 per cent and 19 per cent, respectively, in 2012.

Capital: Capital funds, which increased by 27 per cent in 2012, increased further in 2013 by 10 per cent, mainly due to internally generated funds, that is, profits, and amounted to Rs.95 billion by end 2013. The capital adequacy ratios of the sector remained above the required minimum levels although they decreased due to the growth of risk weighted assets. The total capital adequacy ratio as a per cent of risk weighted assets decreased to 15 per cent by end 2013 from 16 per cent at end 2012. The core capital ratio as a per cent of

Table 8.9 Composition of Income and Expenses of the LFC & SLC Sector

Item	Amount (Rs.bn)		Growth 2012 (a)		Growth 2013 (b)	
	2012 (a)	2013 (b)	Amount (Rs.bn)	%	Amount (Rs.bn)	%
Interest Income	92.9	117.3	24.8	36.5	24.5	26.4
Interest Expenses	52.6	73.2	17.5	49.7	20.7	39.3
Net Interest Income	**40.3**	**44.1**	**7.4**	**22.4**	**3.8**	**9.5**
Non - Interest Income	13.3	17.2	(3.9)	(22.6)	3.9	29.2
Non - Interest Expenses	30.1	39.3	4.1	15.9	9.3	30.8
Staff Cost	11.0	13.6	2.3	26.0	2.6	23.5
Loan Loss Provisions (Net)	1.5	8.1	3.0	(205.2)	6.6	(436.3)
Profit before Tax	**22.7**	**13.8**	**(2.9)**	**(11.5)**	**(8.8)**	**(38.9)**
Tax	6.5	6.1	(0.2)	(2.4)	(0.3)	(5.2)
Profit after Tax	**14.9**	**7.7**	**(4.0)**	**(21.3)**	**(7.2)**	**(93.6)**

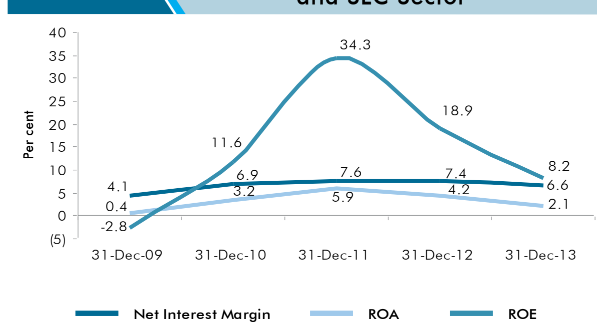
(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

risk weighted assets too decreased to 13 per cent in 2013 from 15 per cent in 2012. Similarly, the ratio of capital funds of LFCs to total deposits also decreased to 23 per cent in 2013 from 28 per cent at the end of 2012.

Action against Unauthorised Conduct of Finance Business: The Central Bank continued to carry out investigations into institutions allegedly engaged in finance business without authorisation while assisting courts with respect to pending litigation issues. During 2013, country-wide seminars/workshops were conducted by the Central Bank by way of conducting awareness campaigns to educate the public about the risk of investing in unauthorised finance institutions. Special messages stating the risks of investing in unauthorised institutions were conveyed to the public through regional transmissions of the Sri Lanka Broadcasting Corporation and TV

Chart 8.11 Profitability Indicators of the LFC and SLC Sector



8

FINANCIAL SECTOR PERFORMANCE AND SYSTEM STABILITY

Table 8.10 Composition of Regulatory Capital of the LFC & SLC Sector

Item	Amount (Rs.bn)		Composition (%)	
	2012 (a)	2013 (b)	2012 (a)	2013 (b)
Tier I: Core Capital	**72.8**	**77.6**	**100**	**100**
Issued and Paid-up Ordinary Shares/ Common Stock (Cash)	53.0	56.5	73	73
Non-Cumulative, Non-redeemable Preference Shares	0.0	1.8	0	2
Share Premium	2.6	0.2	4	0
Statutory Reserve Fund	6.7	8.1	9	10
General and Other Free Reserves	17.0	18.0	23	23
Other	(6.5)	(6.9)	(9)	(9)
Tier II: Supplementary Capital	**4.7**	**9.3**	**100**	**100**
Eligible Revaluation Reserves	2.5	2.6	53	28
General Provisions	0.4	0.2	8	2
Eligible Approved Unsecured Subordinated Term Debt	0.9	5.8	18	62
Other	1.0	0.8	21	8
Regulatory Adjustments	**(2.5)**	**(3.2)**		
Total Regulatory Capital Base	**75.0**	**83.8**		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

commercials telecast in both Sinhala and Tamil languages. Further, posters containing the lists of Licensed Banks and LFCs were distributed among Grama Niladharies in selected Districts and special notices were published in newspapers in all three languages during the second half of 2013, to educate the public about the risks pertaining to identified unrealistic schemes.

Supervisory and Regulatory Developments: On-site and spot examinations of LFCs and SLCs were conducted with a risk based approach, as the main supervisory mechanism, and the relevant companies have been instructed to implement the recommendations that were made based on the findings of the examinations, within a stipulated time period. In addition, continuous off-site surveillance was carried out, while internal risk rating models and an early warning system were implemented to identify risks so as to be able to take preventive measures in a timely manner. During 2013, the Central Bank introduced several policy measures and regulations and the scope of the existing Structural Changes Direction was enlarged. The requirement making it mandatory to obtain prior approval of the Monetary Board with respect to writing off of accommodations to related parties of finance companies has been replaced by a requirement whereby it is required to obtain approval of the Director of Supervision of Non-Bank Financial Institutions (D/SNBFI) in such cases. A supervisory framework was introduced in respect of debt instruments issued by finance companies, especially to deal with areas such as liquidity and interest rates. Guideline on the adoption of Sri Lanka Accounting Standards (LKAS) 32 and 39 and Sri Lanka Financial Reporting Standards (SLFRS) 7 require LFCs and SLCs to obtain prior approval of D/SNBFI for dividend distribution, and the relevant amendments have been incorporated into the disclosure requirements in the Corporate Governance Direction. In addition, the annual licensing fees payable by a LFC were revised.

Primary Dealers in Government Securities

Performance of the Primary Dealers continued to improve in 2013. Total assets, capital funds and profits recorded higher growth in 2013, when compared with the previous year. Increased demand for government securities from the banking sector and the moderation in inflation caused a gradual downward shift in the yield curve, especially during the latter part of 2013, enabling the sector to earn higher capital gains on trading portfolios while increasing the total holding of government securities in 2013. During the year under review, Licensed Commercial Banks (LCBs) were allowed to become primary dealers (PDs) in government securities without having to maintain capital as per the minimum capital requirement that is applicable to standalone PDs, with a view to increasing competition and the total subscription levels at the primary auctions for government securities. Accordingly, two LCBs, namely, Pan Asia Banking Corporation PLC and The Hongkong and Shanghai Banking Corporation Limited, have been appointed as PDs during the year. With the appointment of Perpetual

Treasuries Limited, a non-bank PD, the total number of PDs increased to 15, consisting of 7 Primary Dealer Units of LCBs (Bank PD Units) and 8 standalone PDs.

Assets and Liabilities: The total assets of the PD industry increased by 33.5 per cent in 2013 to Rs. 213.6 billion. In comparison, assets of the PD industry increased by 20.6 per cent in 2012. Government securities accounted for 98.1 per cent of the total assets of the sector. The total portfolio of government securities, consisting of securities held for trading, securities available for sale, investment portfolios and securities held under reverse repo, amounted to Rs. 209.6 billion, recording an increase of 31.5 per cent over the year 2012. The trading portfolio of government securities increased significantly by 67.6 per cent in 2013 to Rs. 145.9 billion, from Rs. 87.1 billion at the end of 2012. This was the main contributory factor in the increase in the total portfolio. The investment portfolio, however, declined by 7.0 per cent during 2013 when compared to the portfolio held at end 2012. This was mainly due to the reinvestment of all maturity proceeds from the investment portfolio in government securities held for trading. Borrowings under repurchase agreements (Repo), the major source of funding of PDs, increased by 22.7 per cent to Rs. 127.8 billion by end 2013, from Rs. 104.1 billion at end 2012.

Capital: The capital base of the standalone PDs increased to Rs. 6.7 billion in 2013. However, the ratio of capital to total risk weighted assets of standalone PDs decreased to 18.4 per cent at end 2013 from 22.1 per cent at end 2012, as a consequence of the increase in total assets of standalone PDs. All standalone PDs had met the minimum capital requirement, that is, Rs. 300 million or 8 per cent of the total risk weighted assets, i.e., Risk Weighted Capital Adequacy Ratio (RWCAR), whichever is higher. Capital leveraging of standalone PDs was maintained at a moderate level of 7.5 times at the end of 2013.

Profitability: Profit Before Tax of the sector increased to Rs. 8.1 billion during the year from Rs. 2.9 billion in 2012. The annualised Return on Assets (ROA) and Return on Equity (ROE) of the sector recorded significant growth in 2013. The ROA of the sector increased from 1.8 per cent in 2012 to 4 per cent in 2013 while ROE increased from 17.7 per cent to 34.4 per cent. The significant improvement in profitability of PDs could be attributed mainly to the capital and revaluation gains that resulted from the decline in market interest rates and also the increase in trading volumes during the period under review.

Risk Management

Market risk exposure declined. The exposure of the sector as well as individual PDs to market risk decreased during the year as the primary and secondary market yield rates of government securities continued to decrease gradually during the year. Further, results from stress tests revealed that each of the PDs had the ability to withstand adverse movements in market

Table 8.11 Performance of Primary Dealers

Rs.million

Item	2012 (a)	2013 (b)	Annual Growth Rate (%)	
			2012 (a)	2013 (b)
Total Assets	160,082	213,633	20.6	33.5
Total Portfolio	**159,397**	**209,627**	**21.9**	**31.5**
Trading Securities	87,057	145,949	(1.7)	67.6
Investment Securities	49,674	46,211	116.5	(7.0)
Reverse Repo	18,804	15,357	(2.2)	(18.3)
Available for sale	3,862	2,110	100.0	(45.4)
Equity and Liabilities	160,082	213,633	20.6	33.5
Total Capital (c)	5,478	6,750	15.8	23.2
Repo	104,150	127,769	22.2	22.7
Profit before Tax	2,913	8,099	92.6	178.0
Profit after Tax	2,541	7,524	127.8	196.1
Return on Assets (%)	1.8	4.0	0.7	2.2
Return on Equity (%) (c)	17.7	34.4	17.4	16.7
Risk Weighted Capital Adequacy Ratio (%) (c)	22.1	18.4	3.2	(3.7)
Leverage Times (c)	7.5	7.5	(0.8)	-
Dealings	10,406,840	14,554,616	16.3	39.9
Primary Market Dealings	2,576,323	2,252,438	45.8	(12.6)
Secondary Market Dealings	7,830,517	12,302,178	9.0	57.1

(a) Revised
(b) Provisional
(c) Standalone PDs only

Source: Central Bank of Sri Lanka

interest rates without any material impact on capital. Accordingly, standalone PDs would be able to maintain their capital above the minimum regulatory requirement, that is, Rs. 300 million or the RWCAR, whichever is higher, even if market interest rates move upward by 300 basis points from the levels that prevailed at end 2013.

Liquidity risk exposure improved. The liquidity risk exposure of the PD sector decreased due to an improvement in the maturity profile of assets and liabilities of the sector during 2013. The overnight negative mismatch in the maturity profile of assets and liabilities decreased to Rs. 7.4 billion or 5.7 per cent of the total cumulative liabilities of the sector at the end of 2013, from Rs. 11.2 billion or 10.5 per cent of the total cumulative liabilities of the sector at end 2012. Further, the liquidity risk of the sector was low, as 98.1 per cent of the total assets were held in highly liquid risk-free government securities which could be placed as collateral for obtaining funds in the event of any unanticipated liquidity requirement. Meanwhile, individual PDs had adequate standby funding arrangements to bridge any unforeseen liquidity gaps.

Market Participation

The 'Bank PD Units' recorded a 65.5 per cent effective participation rate at the Treasury bill auctions, during the year. The effective participation rate of standalone PDs and Employees' Provident Fund (EPF) in 2013 stood at 31.4 per cent and 3.1 per cent, respectively. Primary auctions for Treasury bonds were mainly subscribed by the EPF, which accounted for 56.5 per cent of the total issuances during the year. Meanwhile, secondary market transactions in government securities increased sharply by 57.1 per cent during 2013. Repo transactions accounted for 83.2 per cent of the total volume of secondary market transactions in 2013.

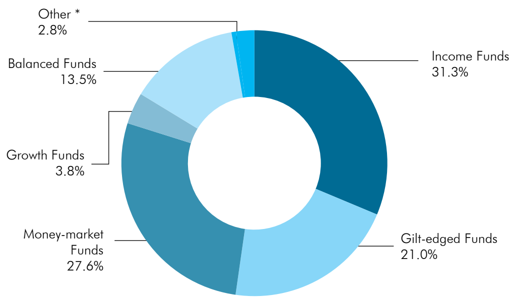
Unit Trusts

The unit trust sector expanded with the establishment of sixteen new funds in 2013. By end December 2013, there were 53 Unit Trusts (UTs) in operation, managed by 13 Unit Trust management companies. By end 2013, there was one closed-end fund, which was an equity growth fund. The other UTs are open-ended funds. By end 2013, the open-ended funds included 11 income funds, 9 gilt edged funds, 9 money market funds, 7 growth funds, 4 balanced funds, 4 sharia funds, 1 equity fund, 2 IPO funds, 1 index fund and 1 corporate debt fund.

Business growth: The net asset value (NAV) of the UTs increased significantly by 76 per cent to Rs. 54.4 billion as at end December 2013, supported by an increase in the number of units in issue and an appreciation of the value of investments, particularly in government securities and corporate debt securities. The net asset value per unit however, was marginally lower at Rs. 13.27 by end 2013, in comparison to the net asset value per unit of Rs. 13.87 in 2012. Nevertheless, the NAV per unit of income funds, which is the largest segment of UTs with a share of 31 per cent in the total NAV of the sector, increased from Rs. 114.70 at end 2012 to Rs. 171.00 by end 2013, following a growth of 241 per cent in their NAV in 2013. Amongst the other categories of funds which recorded increases in the NAV per unit in 2013 were money market funds, growth funds and sharia funds.

Responding favourably to various policy measures introduced by the government and the Central Bank, the total number of unit holders and the units in issue increased during the year. The number of unit holders increased to 29,940 by end 2013 from 27,253 at end 2012, while the number of units issued increased to 4,103 million by end December 2013 from 2,227 million at the end of 2012.

Chart 8.12 Categorisation of the Unit Trust Industry in terms of the Net Assest Value



*Other: Equity Growth Funds 1.9%, Sharia Funds 0.6%, Equity Index Funds 0.2%, Equity Sector Funds 0.1%, IPO Funds 0.02%, Index funds 0.01%, Corporate Debt Funds 0.002%.

Investment: The share of investment in equities continued to decline, while investment in government securities and corporate debt securities increased in 2013. The share of equities in the investment portfolios of unit trusts declined to 17.4 per cent as at end December 2013 from 28.6 per cent in 2012. The government securities and corporate debt securities portfolios increased to 32.0 per cent and 50.2 per cent, respectively, of the investment portfolios of unit trusts by end 2013. This increase could be attributed to the new entrants to the unit trust industry, which have made significant investments in government securities and corporate debt securities. Gilt edge funds largely contributed to the increase in investments in government securities and accounted for 62 per cent of the investments in government securities by UTs. Income funds largely contributed to the increase in investment in corporate debt securities and accounted for 56 per cent of the investments in corporate debt securities by UTs.

Table 8.12 Performance of the Unit Trust Sector

Details	2012 (a)	2013 (b)
No. of Unit Trusts	37	53
Total No. of Unit Holders	27,253	29,940
No. of Units in Issue (million)	2,227	4,103
Total Assets (Rs. million)	31,088	54,323
Net Asset Value-NAV (Rs. million)	30,890	54,448
Investments in Equities (Rs. million)	8,841	9,486
Share of Total Assets (%)	29	17
Investments in Government Securities (Rs. million)	5,919	17,363
Share of Total Assets (%)	19	32

(a) Revised
(b) Provisional

Source: Unit Trust Association of Sri Lanka

Supervisory and Regulatory Developments: Lowering the income tax applicable to Unit Trust Management Companies (UTMCs) to 10 per cent from 28 per cent and exempting UTMCs from the VAT charged on services supplied by them to UTs have raised the profitability of UTMCs, thereby attracting more investments into the capital market via UTs. In addition, with a view to popularising investments in UTs among foreign small time investors and Sri Lankans working and living abroad, direct foreign remittances into UTs would be allowed without having to channel funds through Securities Investment Accounts (SIA). Promoting institutional investments by allowing private pension funds and private provident funds to make investments in the domestic capital market via unit trusts that invest exclusively in listed equities and listed corporate bonds is expected to increase demand for units by institutional investors. In addition, the Central Bank determined that the investments in gilt unit trusts (GUTs) by licensed banks could be included in liquid assets for the purpose of meeting the Statutory Liquid Asset Ratio (SLAR), subject to certain conditions, which will also have a positive impact on the development of the UT sector.

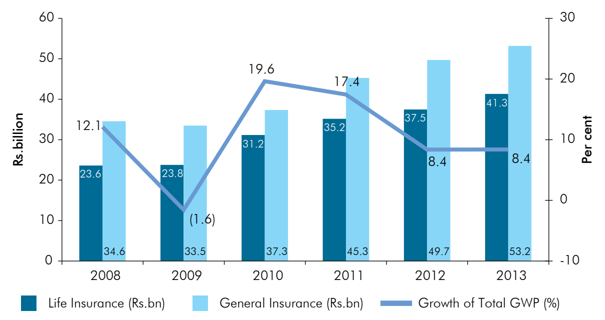
Insurance Companies

The Insurance sector accounts for around 3.5 per cent of the total assets of the financial sector. As at end December 2013, there were 21 insurance companies operating in Sri Lanka which are registered with the Insurance Board of Sri Lanka (IBSL). Of these, a total of 12 companies are composite insurers engaged in both long-term (life) and general insurance (non-life) business, 6 companies engage exclusively in general insurance business and 3 companies conduct only long-term insurance business. At the end of the year, there were 54 insurance brokers, mainly involved in general insurance, and about 37,000 insurance agents. By end 2013, seven insurance companies were listed on the Colombo Stock Exchange (CSE) while six companies had foreign collaboration.

Insurance penetration and density in Sri Lanka is relatively low in comparison to other Asian countries. Insurance penetration, that is, total premium as a percentage of GDP, was 1.14 per cent in 2013 while insurance density, that is, the ratio of premium to total population was Rs. 4,807 million (US dollars 37 million) in 2013. Relatively low per capita income when compared with some Asian countries and a lack of appreciation of the concept or benefits of insurance are amongst the key contributory factors in the low insurance penetration in the country. However, the government's efforts to develop the country and raise disposable income of the people will continue to have a positive impact on the insurance industry and in turn, on insurance penetration and insurance density.

Business Growth: Total assets of insurance companies increased by 13.0 per cent in 2013, in comparison to the 21.1 per cent growth recorded in 2012. Total assets in respect of long-term insurance business amounted to Rs. 217 billion as at end 2013, accounting for 60 per cent of the total assets of the insurance sector. At end December 2013, total assets in respect of general insurance business amounted to Rs. 147 billion, accounting for 40 per cent of the total assets of the insurance sector. The total gross written premium (GWP) of the insurance sector recorded accelerated growth during the period from around mid-2009 up to around mid-2011, but thereafter, growth of total GWP of the sector moderated and in 2013, total GWP grew by 8.4 per cent, year-on-year. Amongst those factors which contributed towards the moderation in the growth of total GWP were the measures taken in 2013 to curtail vehicle imports, that is, requiring

Chart 8.13 Gross Written Premium of the Insurance Industry



letters of credit (LCs) opened with commercial banks for the purpose of importing specified vehicles to be covered by a minimum cash margin of 100 per cent of import value deposited with the LC opening bank at the time of opening such LCs and prohibiting banks to grant advances for the purpose of meeting the minimum margin requirement. Primarily as a result of these measures, GWP in the general insurance sector, which accounted for 56.3 per cent of the total GWP, decelerated and recorded a growth of 7 per for 2013, compared to the growth of 15.1 per cent in 2012. GWP earned of all major sub-classes classified under general insurance, except marine insurance, increased in 2013, but at a slower pace than in 2012. The GWP in respect of motor insurance, which is the largest segment within general insurance with a share of 62 per cent, increased by 4.6 per cent. The GWP in respect of fire insurance, with a share of 12 per cent, and miscellaneous insurance, with a share of 22 per cent, grew by 16.4 per cent and 11.4 per cent, respectively. However, the GWP in respect of marine insurance decreased by 4.0 per cent. The GWP in respect of long-term insurance, which accounted for 43.7 per cent of the total GWP, grew by 10.2 per cent in 2013, compared to the increase of 6.6 per cent in 2012.

Earnings and Profitability: The total investment income of the insurance sector grew by 23 per cent to Rs. 29 billion in 2013, compared to the growth of 3.6 per cent in 2012. The higher growth of investment income is largely due to the

Table 8.13 Performance of the Insurance Sector

Rs.billion

Item		2012(a)	2013 (b)
Total Assets		321.8	363.8
Government Securities		127.7	121.6
Equities		41.6	40.1
Cash & Deposits		47.4	62.6
Total Income		110.7	123.5
Premium Income		87.2	94.5
Investment Income		23.5	29.0
Profit Before Tax		12.1	13.5
Solvency Margin Ratio	- Life Insurance	7.2	8.9
	- General Insurance	2.4	2.6
Retention Ratio (%)	- Life Insurance	96.2	96.0
	- General Insurance	82.5	83.5
Claims Ratio (%)	- Life Insurance	37.2	46.2
	- General Insurance	61.8	58.7
Combined Operating Ratio (%)	- Life Insurance	82.7	93.7
	- General Insurance	100.3	101.7
Return on Assets (ROA) (%)	- Life Insurance	3.3	3.1
	- General Insurance	5.3	5.1
Return on Equity (ROE) (%)	- General Insurance	9.9	9.1
Underwriting Ratio (%)	- General Insurance	20.5	20.8

(a) Revised
(b) Provisional

Source: Insurance Board of Sri Lanka

significant growth of investment income in the long-term insurance sector, where a large part of the investments were in government securities and corporate debt securities. Total investment income of the long-term insurance sector increased by 25 per cent in 2013 compared to the marginal growth of 2 per cent in 2012. Total investment income of the general insurance sector increased by 18.4 per cent in 2013, in comparison to the growth of 7.9 per cent in 2012. The profit before tax of the insurance sector increased by 11.4 per cent in 2013 in contrast to the decline of 2 per cent in the previous year. Underwriting profits (the difference between insurance premium earned and claims paid and expenses incurred over the given period) of the general insurance sector recorded a growth of 11.1 per cent during the year.

Compliance with Regulatory Requirements: All insurance companies except three met the statutory solvency margin requirement at end 2013. The solvency margin ratio for general insurance increased to 2.6 times at end December 2013 from 2.4 times at end December 2012, while the solvency margin ratio for long-term insurance increased to 8.9 times at end December 2013 from 7.2 times at end December 2012. Nevertheless, the impending segregation of insurance business, that is, the segregation of composite insurance so as to separate long-term and general insurance business, as per the amendments made to the Insurance Industry Act No. 43 of 2000 could pose a challenge to insurance companies in meeting regulatory requirements in respect of capital. However, these regulatory amendments are likely to encourage consolidation in the insurance industry in the medium term, which would be beneficial to the insurance sector. All insurance companies were able to comply with the requirement of investing 20 per cent of the technical reserves in respect of general insurance and 30 per cent of the long-term funds in government securities. As at end 2013, government securities accounted for 43 per cent of the assets of long-term insurance business and 19 per cent of the assets of general insurance business. The shares of equity and corporate debt securities in the total assets of the insurance sector were 11.0 per cent and 10.7 per cent, respectively, at end 2013.

Supervisory and Regulatory Developments: The regulatory framework and the supervision and enforcement regime pertaining to the insurance sector was further strengthened in 2013. The IBSL issued guidelines and instructions to insurance companies specifying eligibility criteria that a valuer should meet in order to be able to value land and buildings in Sri Lanka for the purpose of the Solvency Margin Rules pertaining to long-term and general insurance Business. Moreover, capital to be maintained by insurance companies and insurance brokering companies as per the minimum capital requirement pertaining to them was increased, with a view to promoting their financial soundness. Accordingly, insurance companies would be required to maintain capital at a level not less than Rs. 500 million from 2015 while insurance brokering companies would be required to maintain capital at a level not less than Rs. 2.5 million from 2014.

Superannuation Funds

The superannuation funds sector accounts for 16 per cent of the financial sector assets and is dominated by the Employees' Provident Fund (EPF), 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 170 privately managed Approved Pension and Provident Funds (APPFs) in Sri Lanka.

The EPF, the main retirement benefit fund for the private sector, expanded with an increase in the net contributions. In addition to the growth of the net contributions (contributions minus refunds) of the members, income generated through the effective and prudent management of the fund also contributed to the increase in the asset base of the Fund. The total number of member accounts of the EPF was 15 million, of which 2.4 million were active accounts by end 2013. The total value of the Fund increased by 13.6 per cent to Rs. 1,300 billion as at end 2013. In 2013, total contributions increased by 14.7 per cent to Rs. 80.5 billion, while the refunds increased by 3.1 per cent to Rs. 50.2 billion. As a result, net contributions in 2013 increased by 40.9 per cent, year-on-year, to Rs. 30.3 billion. The gross income of the fund in 2013 increased by 12.6 per cent to Rs.136.7 billion from Rs. 121.4 billion in the previous year. Interest income, which was the largest source of income accounting for 76.9 per cent of the total income, grew by 15.5 per cent to Rs. 105 billion in 2013. Capital gains from government securities increased to Rs. 1,019 million in 2013 from Rs. 34 million in 2012 whereas capital gains from equities decreased to Rs. 113 million from Rs. 1,020 million. As at end 2013, the investment portfolio consisted of government securities, which accounted for 92.5 per cent of the investment portfolio, equity, which accounted for 5.8 per cent of the investment portfolio, corporate debt, which accounted for 1.2 per cent of the investment portfolio, and reverse repos. The effective rate of return on member balances of the EPF was 11.14 per cent for the year 2013.

The ETF, the employer contributory retirement benefit scheme in the country, too witnessed an increase in its asset base alongside an increase in the net contributions. The total number of member accounts of the ETF was 10 million, of which 2.2 million were active accounts by end 2013. The ETF had 72,145 employers contributing to the fund as at end December 2013. Total contributions received increased to Rs. 14.4 billion in 2013 from Rs. 12.7 billion in 2012 while benefits paid to members increased to Rs. 9.6 billion in 2013 from Rs.8.6 billion in 2012. The net contribution increased by 15.6 per cent to Rs. 4.8 billion during the year 2013. Total assets of the ETF increased by 12.8 per cent to Rs. 178.5 billion as at end December 2013. The outstanding members' balances in the ETF increased to Rs. 174.3 billion at end 2013 from Rs. 153.6 billion at end 2012. As in the case of the EPF, the investment portfolio of the ETF is concentrated in government securities, which account for 88.9 per cent of the total portfolio. Investments in equity and corporate debt securities accounted for 4.6 per cent and 0.5

Table 8.14 Performance of the EPF and the ETF

Item	EPF		ETF	
	2012 (a)	2013 (b)	2012 (a)	2013 (b)
Total Assets (Rs.bn)	1,144.4	1,300.0	158.3	178.5
Total Member Balance (Rs.bn)	1,124.5	1,281.9	153.6	174.3
Number of Member Accounts (mn)	14.6	15.0	10.0	10.0
Number of Active Member Accounts (mn)	2.3	2.4	2.2	2.2
Number of Employers contributing	68,140	70,392	70,109	72,145
Total Contributions (Rs.bn)	70.2	80.5	12.7	14.4
Total Refunds (Rs.bn)	48.7	50.2	8.6	9.6
Total Investments Portfolio (Rs.bn)	1,105.5	1,257.3	149.7	168.0
o/w : Government Securities (%)	93.6	92.5	89.3	88.9
Gross Income (Rs.bn)	121.4	136.7	13.5	16.5
Profit Available for Distribution (Rs.bn)	111.8	125.6	14.1	15.8
Return on Investments (%)	11.6	11.5	8.4	10.1
Interest Rate paid on Member Balances (%)	11.5	11.1	10.0	10.0

(a) Revised
(b) Provisional

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

per cent, respectively, of the total portfolio. The gross income of the fund increased significantly by 22.2 per cent during the year to Rs. 16.5 billion. The effective rate of return on member balances of the ETF was 10.0 per cent in 2013.

The Public Service Provident Fund which is managed by the Department of Pensions, had 226,837 active members at end December 2013. Total contributions and refunds during the year 2013 amounted to Rs. 1,339 million and Rs. 336 million, respectively. Total assets of the PSPF increased by 10.8 per cent to Rs. 36.4 billion as at end December 2013. The outstanding members' balances also increased by 6.7 per cent to Rs. 35.0 billion at end 2013. With respect to its investments, investments in government securities had a share of 99.8 per cent as at end December 2013.

The privately managed Approved Pension and Provident Funds which are monitored by the Department of Labour, had 155, 096 active members as at end December 2013. The total assets of APPFs increased by 11.7 per cent to Rs. 123 billion as at end December of 2013. The total investment portfolio of the funds amounted to Rs. 105.4 billion.

8.3 Performance of Financial Markets

Money Market

The domestic money market had excess liquidity during much of 2013. Although there was a deficit in market liquidity at the beginning of the year, market liquidity increased subsequently with the Central Bank entering into a SWAP arrangement with Bank of Ceylon in the first week of January, leading to a surplus in market liquidity. Since then, the money market had excess liquidity almost throughout the year. The other main factors that contributed to the liquidity surplus were the Central Bank's SWAP arrangement with National Savings Bank in September, the reduction of the Statutory Reserve Ratio (SRR) by 200 basis points on 1 July 2013, which resulted in Rs.52 billion being released to the market, outright purchases of foreign currency by the Central Bank and the transfer of a part of the Central Bank's profits to the government. The excess market liquidity was mopped up through open market operations (OMO) throughout the year. While overnight repurchase agreements were mainly used to mop up the excess market liquidity till around July, thereafter, short-term repurchase agreements were mainly used to absorb the excess market liquidity. Meanwhile, auctions for the outright sale of Treasury bills held by the Central Bank were conducted to absorb liquidity amounting to Rs.128.8 billion on a permanent basis during 2013. As government securities held by the Central Bank were insufficient to absorb the excess liquidity, the Central Bank utilised borrowed Treasury bonds under the bond borrowing programme for repo transactions. However, on a few occasions during the year, overnight reverse repo auctions as well as term reverse repo auctions were held in addition to supplying liquidity through the standing facility, as market liquidity was in deficit.

Several measures were taken in 2013 to improve liquidity management in the money market and strengthen OMO. Accordingly, for the purposes of reserve computation and maintenance by commercial banks, in place of the 7 day period that was considered, from 1 May 2013, each calendar month is divided into two periods, that is, from 1st to 15th and 16th to the last day of each month. The Rs.100 million restriction on the repo standing facility on days when the Central Bank offers reverse repo auctions was removed to be effective from 1 June 2013. Further, from 24 July 2013, short-term repurchase and reverse repurchase transactions under the auction system, with a tenure of up to one week, on the same day

Table 8.15 Money Market Transactions

Market	Volume (Rs.billion) 2012	Volume (Rs.billion) 2013	Weighted Average Interest Rate (Min-Max) - % 2012	Weighted Average Interest Rate (Min-Max) - % 2013
Call Money	3,179	2,079	8.53-10.71	7.61-9.84
Market Repo	1,431	3,422	7.91-9.68	6.97-9.08
Central Bank Repo	2,740	5,677	7.00-9.46	6.50-8.55
Central Bank Reverse Repo	793	187	7.94-9.75	8.10-9.50

Source: Central Bank of Sri Lanka

settlement basis, were introduced to facilitate better market liquidity management. The reduction of the SRR to 6 percent would complement the above measures.

Call money market rates adjusted downwards during the year, responding to the changes in the Central Bank's policies governing OMO and the management of statutory reserves as well as the easing of the Bank's monetary policy stance. While the Central Bank reduced its Repurchase rate and Reverse Repurchase rate by 50 basis points each to 7.00 per cent and 9.00 per cent, respectively on 10 May 2013, they were reduced by a further 50 basis points each on 15 October 2013, to 6.50 per cent and 8.50 per cent, respectively. Hence, the average weighted call money rate (AWCMR), which hovered above the policy interest rate corridor till mid-February, declined gradually towards the middle of the policy rate corridor by the end of the year. The AWCMR was 7.66 per cent by end 2013, having declined from 9.83 per cent at end 2012.

Domestic Foreign Exchange Market

The depreciation of the Sri Lanka rupee by 2.8 per cent in 2013 could be considered marginal considering the unfavourable global market conditions. The Sri Lanka rupee recorded a marginal appreciation by end May 2013, when compared with the end-2012 position, in view of the increased inflows of foreign exchange, particularly on account of workers' remittances and tourism. However, the rupee depreciated during the period from June to August due to temporary modest foreign currency outflows experienced in the background of the uncertainties surrounding the potential early withdrawal of monetary stimulus in the USA, but recovered thereafter. As a result, the Sri Lanka rupee recorded a depreciation of 2.8 per cent against the US dollar during 2013 i.e., from Rs.127.1608 to Rs.130.7530. The Sri Lanka rupee also depreciated against the sterling pound and the euro by 4.69 per cent and 6.83 per cent, respectively, while it appreciated against the Japanese yen, the Australian dollar and the Indian rupee by 18.78 per cent, 13.35 per cent and 10.16 per cent, respectively.

Transaction volumes in the domestic foreign exchange market recorded an increase. The volume of transactions in foreign exchange in the domestic market had increased marginally to US dollars 13,705 million in 2013 from US dollars 13,420 million in 2012, partly reflecting the impact of the slow turnaround in the global economy on the domestic economy. The daily average volume of inter-bank foreign exchange market transactions increased marginally to US dollars 56.4 million in 2013 from US dollars 55.45 million in 2012.

The daily net open position in foreign currency of commercial banks was revised upward in 2013. It was revised upwards from US dollars 64.7 million in 2012 to US dollars 120 million with effect from 2 January 2013. This was done in anticipation of improved economic activity and to allow commercial banks to engage in their foreign exchange transactions in a more flexible manner.

The Central Bank was a net buyer in the market in 2013. The Central Bank intervened in the market to a limited extent to lessen undue fluctuations in the exchange rate. During the first half of the year, the Central Bank absorbed US dollars 700.75 million from the market. During the period from June up to September, it supplied US dollars 559.45 million to the market, while for the year as a whole, the Central Bank was a net purchaser in the market, with net purchases during the year 2013 amounting to US dollars 435.59 million.

Government Securities Market

Yield rates pertaining to Treasury bills, which remained elevated at the beginning of 2013, declined significantly in the second half of 2013 owing to prudent debt management strategies implemented in an environment of subdued inflation. The favourable market liquidity levels and continuing interest on the part of foreign investors also contributed to the increased level of activities in the government securities market and the decline in interest rates pertaining to government securities. The benchmark weighted average yield rates (WAYR) of 91-day, 182-day and 364-day Treasury bills decreased by 246 basis points, 347 basis points and 340 basis points, respectively, during the year, to 7.54 per cent, 7.85 per cent and 8.29 per cent, respectively, by end December 2013.

Alongside the decline in yields on Treasury bills, yield rates pertaining to Treasury bonds also declined in 2013. The WAYRs of Treasury bonds in the primary market decreased by around 500 basis points to 200 basis points across the yield curve (2 – 30 years) in 2013. With respect to government securities, a shift was seen in foreign investor preference, from Treasury bills towards Treasury bonds during the year 2013. Accordingly, Treasury bill and Treasury bond holdings by foreign investors amounted to Rs. 73.9 billion and Rs. 403.5 billion by end December 2013 compared to Rs. 80.2 billion and Rs. 317.6 billion, respectively, at end 2012.

Table 8.16 Annualised Primary Market Weighted Average Yield Rates of Treasury Bills

Per cent per annum

Year	Maturity			Overall Average
	91-days	182-days	364-days	
2009	11.43	12.18	12.76	12.25
2010	7.86	8.42	8.43	8.32
2011	7.28	7.21	7.41	7.31
2012	10.72	12.29	12.14	11.81
2013	8.95	9.91	10.65	10.45

Source: Central Bank of Sri Lanka

Table 8.17 Yield Rates of Government Securities

Per cent per annum

Item	Primary Market				Secondary Market			
	2012		2013		2012		2013	
	Low	High	Low	High	Low	High	Low	High
Treasury Bills								
91 Days	8.67	12.19	7.54	9.91	8.63	12.06	7.52	10.12
182 Days	8.71	13.12	7.85	10.99	8.71	13.10	7.83	11.26
364 Days	9.30	13.60	8.29	11.38	9.28	13.34	8.27	11.72
Treasury Bonds								
2 Years	9.45	13.62	-	-	9.37	13.77	8.53	11.65
3 Years	10.20	13.50	10.87	10.98	9.58	13.93	9.05	11.75
4 Years	9.55	14.10	-	-	9.69	14.16	9.54	11.95
5 Years	10.75	14.15	10.64	11.17	9.78	14.35	10.26	12.01
6 Years	9.75	14.25	10.97		9.81	14.36	10.37	11.99
10 Years	10.25	14.75	11.76	11.8	9.93	14.63	10.88	12.30
15 Years	-	-	11.9	12.21	10.07	14.59	11.14	12.72

Source: Central Bank of Sri Lanka

To tap the domestically available US dollars and to reduce the cost of borrowing in meeting the financing requirement of the government, the government issued US dollar denominated Sri Lanka Development Bonds (SLDBs) in 2013. Although the primary investors in SLDBs are local commercial banks, foreign investors, except U.S. citizens, can also invest in SLDBs. Up to now, the government has issued SLDBs with maturities of 3 years, 4 years and 5 years, in the primary market. In 2013, the government raised US dollars 1,070.1 million, on a net basis, through the issuances of SLDBs maturing in 3 years and 5 years, which carried yield rates of six-month LIBOR plus a margin of 400 basis points and 415 basis points, respectively.

As a consequence of the concerted efforts to reduce the issuance of Treasury bills and short-tenor Treasury bonds, the amount of medium to long-tenor Treasury bonds issued increased in 2013. In 2013, of the total 30 auctions for Treasury bonds, 15 auctions were held for Treasury bonds with maturities of 5 to 10 years while 13 auctions were held for Treasury bonds with maturities of 11 years and longer including the 30 year Treasury bonds issued for the first time, in line with the medium-term debt management strategy to activate the medium to long-tenor benchmark yield curve for government securities. Lengthening of the maturity structure of government securities contributed to the reduction of the amortisation requirement in respect of the domestic debt portfolio. Medium to long-tenor Treasury bonds (maturity of 5 years or beyond) amounted to 80.4 per cent of total issuances in 2013. As a result, the Average Time to Maturity (ATM), which is a key indicator used to measure the portfolio refinancing risk of Treasury bonds issued, increased to 10.24 years in 2013 from 6.86 years in 2012, helping improve the ATM of the overall public debt portfolio further to 4.82 years in 2013 from 3.23 years in 2012.

Corporate Debt Securities Market

Commercial Paper

The market for commercial paper was relatively less active in 2013 when compared with the previous year. The value of commercial paper (CP) issued with the support of banks amounted to Rs. 28.3 billion in 2013 in comparison to Rs. 36.9 billion in 2012. The interest rates pertaining to CPs varied in a range of 8.5 – 22.0 per cent in 2013 in comparison to a range of 11.25 – 22.00 per cent in 2012. CPs with a maturity of up to 3 months accounted for 80 per cent of the market, while the shares of CPs with 6-month and 12-month maturities were 13 per cent and 7 per cent, respectively. The total outstanding value of CPs amounted to Rs. 7.4 billion as at end December 2013 compared to Rs. 10.6 billion as at end December 2012.

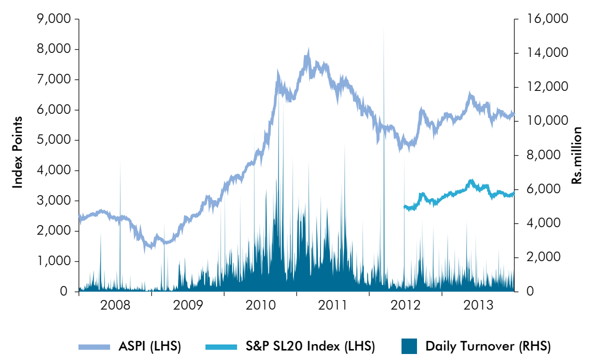
Corporate Bonds

Activity in the market for debentures increased significantly in 2013, with both the value and the number of debentures issued increasing considerably. This growth could be attributed primarily to the tax exemptions provided as per the national budget for 2013. During the year, there were 83 new issues of debentures by 24 companies, which were subsequently listed on the CSE. While debentures amounting to Rs. 69.1 billion were issued in 2013, in comparison, in 2012, there were 9 issues of debentures by two banking institutions which amounted to Rs. 12.5 billion. With respect to the debentures issued in 2013, companies outside the financial sector accounted for 20 debenture issues, from which they raised Rs. 11 billion; banks accounted for 22 issues of debentures by way of which they raised Rs. 36 billion, while finance companies which mobilised funds amounting to. Rs. 22.1 billion accounted for 41 issues of debentures. Notably, National Development Bank PLC raised the highest amount, that is, Rs. 10 billion, accounting for 14.4 per cent of the total amount raised through debentures during the year. Debentures issued in 2013 carried both fixed and floating rates of interest and they varied in a rage of 8 to 20 per cent. The trading turnover of debentures listed on the Automated Trading System (ATS) of the CSE was significantly high at Rs. 2,229 million in 2013, compared to Rs. 75.7 million in 2012. With a view to developing the corporate debt market, income earned by way of interest income from investments in corporate debt securities has been exempted from tax with effect from January 2013, as per the national budget for 2013.

Equity Market

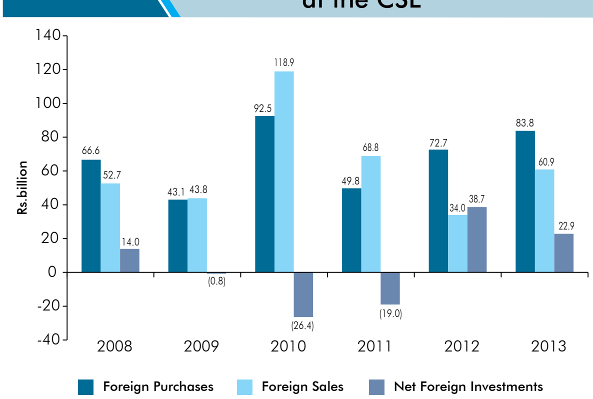
The All Share Price Index (ASPI) and the S & P Sri Lanka 20 Index of the Colombo Stock Exchange (CSE) recorded gains for 2013. The ASPI increased in 2013 following two consecutive years in which it retreated by nearly 16 per cent, that is, by 7.1 per cent in 2012 and 8.5 per cent in 2011. With the All Share Price Index (ASPI)

Chart 8.14 ASPI, S&P SL20 Index and Daily Turnover at the CSE



increasing by 4.8 per cent in 2013, the CSE outperformed several regional markets such as Hong Kong (+3.8 per cent), India (+3.6 per cent), Phillipines (+1.3 per cent), Korea (0.7 per cent) and Singapore (+0.01 per cent). The S & P SL 20 index, which was introduced in June 2012, increased by 5.8 per cent in 2013. Market capitalisation increased by 13.4 per cent, that is, by Rs. 292 billion, to Rs. 2.46 trillion at end December 2013, from Rs. 2.17 trillion in 2012. The downward trend in domestic interest rates, which resulted in a significant drop in interest rates during the year, relatively stable exchange rates vis-à-vis the Sri Lanka rupee, and the favourable impact of the gradual recovery of the global economy on domestic macroeconomic performance were amongst those factors that were supportive of stock market performance. Increased participation by foreign investors including institutional investors, which resulted in a net inflow of foreign investment amounting to Rs. 22.9 billion in 2013 also contributed positively to the performance of the CSE during the year. In comparison, foreign investments at the CSE, on a net basis, amounted to Rs.38.7 billion in 2012. With respect to primary market activity at the CSE, Rs. 25.6 billion was raised by way of rights issues by nine companies and Rs. 2 billion was raised by way of initial public offers (IPOs) by two companies, in 2013. Meanwhile, in an effort to encourage listings on the CSE, companies listing on the CSE in 2014 have been granted a half tax holiday for a period of 3 years, as per the national budget for 2014.

Chart 8.15 Foreign Participation at the CSE



Alongside the increase in the ASPI, several sectoral indices also recorded gains for 2013. Amongst those sectors were Beverage Food and Tobacco (28 per cent), Power and Energy (20 per cent), Healthcare (17 per cent), Land and Property (12 per cent), Manufacturing (9 per cent), Bank Finance and Insurance (6 per cent) and Construction and Engineering (6 per cent), which together accounted for 52.5 per cent of the market capitalisation by end 2013 (the increase in the respective index is given within parentheses). Amongst the sectors which retreated during the year were Information Technology (-27 per cent), Trading (-21 per cent), Stores and Supplies (-17 per cent) and Chemicals and Pharmaceuticals (-13 per cent). Reflecting the movements of share prices as mirrored by the movements in sectoral price indices, the market price earnings ratio (PER) moved to 15.92 by end 2013 from 15.93 at end 2012.

In terms of turnover, activity levels at the CSE recorded a marginal drop. Total turnover for the year 2013 was Rs. 200.4 billion, a drop of 6.2 per cent when compared with the total turnover of Rs. 213.8 billion in the previous year. Average daily turnover was Rs. 828 million in 2013, compared to the average daily turnover

Table 8.18 Performance of the Share Market

Item	2012	2013
All Share Price Index (1985=100) (a)	5,643.0	5,912.8
Year-on-year Change (%)	(7.0)	4.8
S&P SL 20 Index (17.12.2004=1000) (a)	3,085	3,264
Year-on-year Change (%)	8.0	5.8
Market Capitalisation (Rs.billion) (a)	2,167.6	2,459.9
As a Percentage of GDP (%)	28.6	28.4
Market Price Earnings Ratio (a)	15.9	15.9
Turnover to Market Capitalisation (%)	9.9	8.7
Average Daily Turnover (Rs.million)	884.0	828.0
Value of Shares Traded (Rs.billion)	213.8	200.5
Number of Shares Traded (million)	9,691	9,054
Number of Companies Listed	287	289
Introductions (b)	11	1
Number of Initial Public Offers/ Offers for Sale (b)	6	1
Number of Rights Issues	19	9
Amount Raised Through Rights Issues and Initial Public Offers (Rs.billion)	13.3	26.0

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

Source: Colombo Stock Exchange

of Rs. 884 million in 2012. Given the decline in average daily turnover, market liquidity also fell as reflected by the turnover velocity ratio, that is, the ratio of total turnover for the year to average market capitalisation. The turnover velocity ratio declined to 8.6 per cent in 2013 from 10.6 per cent in 2012. The daily average volume of shares traded and the average number of trades also declined in 2013, partly due to lower retail activity. Domestic participants, that is, retail investors as well as locally incorporated companies, accounted for 64 per cent of the total market turnover during the year. In comparison, they accounted for 66 per cent of the total market turnover in the previous year.

During 2013, a number of regulatory measures were taken to promote the equity market. Introducing a mandatory public float for listed companies with the aim of increasing liquidity and turnover in the market, the introduction of a code of best practices in respect of related party transactions, changes to directors' disclosure requirements, reinstating introductions as a method for listing, which gives a company the option of listing without making an offer for subscription or an offer for sale, incorporating additional conditions to the general listing requirements, and allowing primary dealers to become trading members of the CSE, are amongst the key measures taken during the year.

8.4 Development Finance and Access to Finance

With the aim of promoting regional development, the Central Bank continued its refinance schemes, interest support schemes and credit supplementation schemes, which it operates through the Participating Financial Institutions (PFIs). Credit supplied through these schemes was directed to agriculture, livestock and micro, small and medium scale enterprises (MSMEs) sectors. It is anticipated that these schemes would result in increased production of goods and services by increasing access to finance, thereby helping achieve inclusive and balanced growth.

The bulk of the credit facilities were made available to the agriculture and animal husbandry sector . During 2013, the total loans granted to 96,749 farmers in the agriculture and animal husbandry sector amounted to Rs. 8,440 million. These loans helped increase not only access to finance but also food security, by raising production of essential food items. Farmers producing 32 short-term crops were able to meet their working capital requirements with loans disbursed under the New Comprehensive Rural Credit Scheme (NCRCS), the principal agriculture sector loan scheme. In 2013, under the NCRCS, a total of Rs. 8,164 million of loans were granted to 96,381 farmers. As in the previous two years, the Jaffna District received the highest amount of loans under the NCRCS, accounting for a share of 32 per cent, followed by Anuradhapura, Hambantota and Polonnaruwa Districts, which accounted for 10 per cent, 9 per cent and 8 per cent, respectively.

However, compared to the previous year, the amount of loans disbursed under the NCRCS recorded a decrease of 13 per cent due to inclement weather. A new loan scheme titled Commercial Scale Dairy Development Loan Scheme (CSDDLS) was introduced in 2013, to cater to the financial needs of farmers and entrepreneurs in the dairy sector. Under CSDDLS, Rs. 202 million was disbursed among 60 eligible borrowers. Meanwhile, under the Tea Development Project - Revolving Fund Loan Scheme, loans amounting to Rs. 69 million were disbursed among 304 borrowers, during the year.

The Central Bank continued to provide concessionary financing to the Small and Medium Enterprises (SMEs) sector. Such financing was released through seven loan schemes, of which two loan schemes were implemented island-wide and the rest were targeted the Northern and Eastern Provinces and the 2004 Tsunami affected Districts. During the year 2013, a sum of Rs. 3,492 million was disbursed among 9,063 recipients engaged in numerous manufacturing and service related activities, under "Saubagya", the principal loan scheme for the SME sector, which was implemented island-wide. The service related activities included hotels and restaurants as well as health and related services. With a view to assisting youth entrepreneurs who possess vocational qualifications obtained from government accredited vocational training institutions, loan facilities were provided through the Self Employment Promotion Initiative Loan Scheme, which was implemented island-wide. The Post Tsunami Coastal Rehabilitation Resource Management Programme, which covered seven Districts affected by the 2004 Tsunami, the "Awakening North" loan scheme - Phase II, the Resumption of Economic Activities in the Eastern Province Loan Scheme – Phases II and III and the Provincial Development Loan Scheme were the five region specific loan schemes which catered to the SMEs. Loans were provided to develop or rehabilitate SMEs in designated Districts or Provinces under these loan schemes. While a sum of Rs. 2,005 million was disbursed under these refinance schemes to 16,221 entrepreneurs in the SME sector, 25,483 entrepreneurs in the SME sector received concessionary financing amounting to Rs. 5,538 million, during the year.

With the objectives of promoting financial inclusiveness and alleviating poverty, several loan schemes, which could be categorised under microfinance, were continued in 2013. Poverty Alleviation Microfinance Project II (PAMP II) and PAMP II - Revolving Fund (PAMP II - RF) were the major microfinance schemes implemented in 14 Districts. Under these schemes, loans amounting to Rs. 1,158 million were disbursed among 16,166 beneficiaries, in 2013. Meanwhile, under the Poverty Alleviation Microfinance Project - Revolving Fund (PAMP – RF), loans amounting to Rs. 735 million were granted to 15,934 beneficiaries. Under the Small Farmers and Landless Credit Project - Revolving Fund (SFLCP – RF), which aims at improving the economic wellbeing and general welfare of the rural poor, loans amounting to Rs. 249 million were disbursed among 5,919 beneficiaries in the Puttalam, Kandy, Galle and Matara Districts. After the successful completion of the Dry Zone Livelihood Support and Partnership Programme, the Revolving Fund operations of the programme were commenced in 2013 in the Anuradhapura, Badulla, Monaragala and Kurunegala Districts. Under the Revolving Fund, loans amounting to Rs. 123 million were granted to 1,649 beneficiaries. The objective of this loan scheme is to improve the livelihood of marginalised smallholders and poor upland food crop farmers in the designated Districts. In 2013, under microfinance schemes, loans amounting to Rs. 2,545 million were disbursed among 42,724 beneficiaries.

8.5 Financial Infrastructure

Payment and Settlement Systems

Payment, clearing and settlement mechanisms and the underlying payment infrastructure of the country passed several significant milestones in 2013, further enhancing efficiency, security and soundness of the national payment system. While facilitating increasing volumes of payments, the large value payment system and the retail payment and settlement systems continued to operate smoothly without experiencing any major disruption during the year. To address the changing risk profile of the national payment system while providing guidance and support for the development of payment and settlement systems, the Central Bank further strengthened the regulatory framework governing the country's payment and settlement systems, in 2013.

The two systemically important payment systems in Sri Lanka, namely, the LankaSettle System operated by the Central Bank and the Cheque Clearing System operated by LankaClear (Pvt.) Limited, processed the majority of the non-cash payments during the year. The regulatory provisions governing the LankaSettle System and the Cheque Clearing System were streamlined to enhance their user convenience and efficiency. With a view to ensuring that the LankaSettle System operates in accordance with international standards and best practices, the System Rules pertaining to the LankaSettle System were updated and issued on 01 August 2013. Further, in order to extend the benefits of efficiency improvements in the Cheque Clearing System resulting from technological and process advancements to commercial bank customers, the General Direction No. 03 of 2013 on Service Norms and Standard Times for Accepting Cheque Deposits and Crediting Proceeds was issued, revising the standard times for accepting cheque deposits and crediting proceeds stipulated by the General Direction No. 01/2007.

The LankaSettle System comprises the Real Time Gross Settlement (RTGS) system, which is the only large-value electronic payment system in the country, and the LankaSecure System, which is the scripless government securities settlement system. During the year under review, the RTGS system settled 306,977 transactions, registering an increase of 7.9 per cent, when compared with the previous year, while the aggregate value of the transactions settled through the RTGS system amounted to Rs. 54,070 billion, which is an increase of 25 per cent when compared with the previous year. In value terms, the share of transactions settled through the RTGS system in total non-cash payments accounted for 86 per cent, in 2013. The Central Bank continued to provide the Intra-day Liquidity Facility (ILF) to the participating institutions of the RTGS System, to minimise the liquidity risk of the system. The daily average value of ILF utilised by the RTGS participants during the year amounted to Rs. 14.5 billion. The scripless securities held by LankaSecure consisted of Treasury bills and Treasury bonds and they accounted for 100 per cent of the Treasury bills and Treasury bonds outstanding. At end 2013, the value of these scripless securities

Table 8.19 Transactions through Payment Systems

Payment system	2012 Volume ('000)	2012 Value (Rs.bn)	2013 (a) Volume ('000)	2013 (a) Value (Rs.bn)
Large Value Payment Systems	**285**	**43,255**	**307**	**54,070**
RTGS System	285	43,255	307	54,070
Retail Value Payment Systems	**101,027**	**7,833**	**110,934**	**8,703**
Main Cheque Clearing System	47,757	6,592	47,876	7,049
Rupee Draft Clearing System	n.a	0.4	2	0.3
Sri Lanka Interbank Payment System (SLIPS)	14,475	553	17,122	702
Credit Cards	20,052	112	21,623	121
Debit Cards	11,560	35	15,059	46
Internet Banking	6,973	526	8,942	772
Phone Banking	210	5	310	6
Postal Instruments	n.a	10	n.a	7
Total	**101,312**	**51,088**	**111,241**	**62,773**
US Dollar Cheque Clearing System	**54**	**26**	**58**	**30**

(a) Provisional

Source: Central Bank of Sri Lanka

amounted to Rs. 3,726 billion, with the value of Treasury bills amounting to Rs. 774 billion and the value of Treasury bonds amounting to Rs. 2,952 billion. As at end 2013, LankaSecure maintained 84,474 accounts through Dealer Direct Participants.

In 2013, the total volume of cheques cleared through the Cheque Clearing System grew marginally by 0.2 per cent to 47.9 million and the value of cheques cleared increased by 6.9 per cent to Rs. 7,049 billion. In terms of transaction volume, cheques continued to be the most popular non-cash payment instrument, with cheque payments accounting for 43 per cent of the non-cash payments during the year 2013.

The Sri Lanka Inter-bank Payment System (SLIPS), which is the electronic interbank payment system operated by LankaClear (Pvt.) Limited to cater to the low-value fund transfer requirements of people in the country, also recorded an expansion in its operations, in terms of both the volume and the value of payments processed through the system. During the year, 17 million fund transfers were processed through the SLIPS while the aggregate value of the payments processed through the SLIPS amounted to Rs. 702.3 billion.

In discharging its responsibilities as the regulator of the national payment system, the Central Bank focused its attention to enhance stability, safety and efficiency of the payment and settlement systems. The Payment Cards and Mobile Payment Systems Regulations No. 1 of 2013 was issued on 07 June 2013, replacing the previous regulations pertaining to payment cards and mobile payment systems, in order to fine-tune the regulatory provisions applicable to the licensing procedure and oversight practices. During the year, three institutions were licensed to operate as service providers of payment cards while a telecommunication network operator was also granted a licence to operate a mobile phone based e-money system.

In 2013, the launch of the Common ATM Switch (CAS) operated by LankaClear (Private) Limited under the brand name "LankaPay" marked an important milestone in the evolution of electronic retail payments in the country. Being the first phase of the Common Card and Payment Switch (CCAPS), the CAS facilitates the integration of the ATM infrastructure throughout the country thereby providing a national level ATM network for the ATM cardholders to carry out their transactions and a national level platform for clearing domestic interbank ATM transactions. The switch was launched on 23 July 2013, with the participation of the two state owned commercial banks. Another commercial bank obtained membership thereafter, in September 2013, and consequently the total number of ATMs connected to the CAS increased to more than 1,000 terminals. The CAS promotes the sharing of the ATM infrastructure among financial institutions with a view to reducing the costs incurred by financial institutions in providing ATM facilities, the benefits of which will be ultimately passed on to the ATM cardholders. During the year, the Central Bank issued two Directions in respect of the CAS, setting out the regulatory provisions applicable to the operations of the switch and the fees chargeable on the transactions effected through the CAS.

A remarkable step in the direction of migrating towards electronic payments in Sri Lanka was recorded in 2013, with the launch of a single purpose stored value transport card and fare collection system for private buses operating in the Western Province, with the approval of the Central Bank. This system will be beneficial to both commuters and bus owners as it enhances passenger convenience whilst increasing efficiency of fare collection. Further, it is anticipated that this stored value transport card and fare collection system will induce and encourage digitalising low value retail payments in other areas of economic activity too.

At the end of the first quarter of 2013, the financial acquirers of payment cards completed the adoption of the Terminal Line Encryption technology, adhering to the directive given by the Central Bank with a view to enhancing the security of payment card transactions. The terminal line encryption technology obstructs attempts of fraudsters to obtain cardholder data during transmission, which in turn minimises the risk of fraud associated with payment card transactions.

Credit Information

The Credit Information Bureau of Sri Lanka (CRIB) continued to play a facilitation role in credit markets. The CRIB, which provides credit information reports on borrowers, issued 3,117,316 credit reports on corporate and individual borrowers, during the year 2013. In comparison, the CRIB issued 2,326,504 credit information reports in 2012. Accordingly, credit information reports issued increased by 34 per cent in 2013. The CRIB has a total of 93 reporting credit institutions as its members. With the objective of creating a disciplined society as regards financial transactions, the CRIB also issued about 7000 self-inquiry reports among the borrowing community, in 2013. The on-line service to facilitate self-inquiry, that is, iReports, was implemented in October 2013 and several public awareness programmes about this facility were conducted during the year. As a result, about 200 users of this facility have been registered by the CRIB during the two months ending December 2013. The CRIB intends to revamp its technology infrastructure with assistance from a service provider in the industry, to meet the increase in demand for credit related information and add value to the existing information base. Its Corporate Development Plan for the period from 2014 to 2018 meanwhile, aims at further improving the service standards of the Bureau.