Country Paper on Financial System Stability in Sri Lanka

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1. Sri Lanka

Sri Lanka (formerly Ceylon) is an independent island country of 65,610 square kilometres located in the Indian Ocean off the southeast coast of the Indian subcontinent. The estimated mid-year population in 2015 was 21 million, an increase of 0.9% compared to the previous year (CBSL 2015). The population density is 334 persons per sq. km and about 80% of people live in rural areas, including the plantation estates. Sri Lanka consists of several ethnic groups. The majority Sinhalese account for 74.9% of the total population while Sri Lankan Tamils and Muslims or 'Moors' comprise 11.2% and 9.2% of the population respectively. Indian Tamils comprise 4.2% of the Sri Lankan population. In addition to these main ethnic groups, 0.5% of the population consists of small communities including aboriginal Veddahs, who are considered to be Sri Lanka's original inhabitants. There are four major religions practised in Sri Lanka, namely Buddhism (69%), Hinduism (15%), Christianity (8%) and Islam (7%). Sri Lanka has maintained participatory democracy since achieving independence in 1948, and has one of the longest democratic traditions in the Asian region. All the democratically elected governments in the post-independence era focused on nation building through introducing policies for socio-economic development.

According to historical records, the cultivation of paddy and other food crops was the main livelihood of Sri Lankan inhabitants from the beginning of settlements by migrants from India in the sixth century BC until the British invasion. The colonial rulers, the United Kingdom, introduced plantation crops, mainly tea, rubber and coconut into the agriculture sector as export crops. With the gaining of independence from the United Kingdom in 1948 the economy of Sri Lanka was mainly driven by the agriculture sector, including plantation crops. At this time, more than half of the total population of seven million was engaged in agriculture for its livelihood (CBSL 1998). Production and trade in three plantation crops, namely tea, rubber and coconut contributed more than 50% of the national income (Karunathilaka 1971). During this period the plantation sector generated 90% of the country's foreign exchange earnings (Kelegama 2006). The performance of other key sectors of the economy such as trade, banking, commerce, transport and insurance also depended on the plantation sector. The export and import sector combined contributed 70% of the gross domestic product (GDP) and the economy was opened to free trade in 1948 (Karunathilaka 1971).

2. Financial sector stability in Sri Lanka

In Sri Lanka, financial stability became a prime policy focus with amendments brought into the Monetary Law Act in 2002 making financial system stability one of the core objectives of the Central Bank of Sri Lanka (CBSL). Several policy measures were taken to develop and diversify the financial institutional structure, strengthen the legal framework, improve the regulatory and supervisory mechanism and broaden the policy analysis to promote financial system stability. At the same time, foreign exchange regulations have been liberalized to achieve a greater efficiency in the conduct of international financial transactions and to sustain a high rate of economic growth.

The efficient operations and stability of key financial institutions and markets are fundamental to a sound and robust financial system. Accordingly, several measures were taken to ensure healthy financial positions, effective risk management and corporate governance and to expand the availability of timely and reliable financial information in key financial institutions. The financial markets continue to be liberalized and broadened to facilitate increased sophistication in cross-border trade and financial flows and operations. The efficient functioning of the financial system has continued to be well supported by the gradual development of the payment and settlement systems infrastructure. To pursue the maintenance of financially stable conditions, the CBSL continually assesses the key components of the financial system and its interaction with the real economy to detect systemic risks and to implement policies for crisis prevention and resolution.

The recent global financial crisis underlined the role of the central bank in safeguarding financial stability. It also prompted a renewed emphasis on strengthening of financial regulation and efforts to intensify supervisory cooperation across borders. Considering these developments, the CBSL is upgrading its prudential frameworks, supervisory arrangements and surveillance mechanisms. At the same time, a series of further measures are aimed at enhancing macroeconomic stability given the changing landscape and the increasingly integrated global financial system.

With the ending of three-decade long conflict in May 2009, Sri Lankan economy is transitioning into a new phase of accelerated development. In 2010, the Sri Lankan economy recorded an impressive growth of 8% and is projected to grow over 8-9 % in the medium term. In addition, Sri Lanka aspires to double its per capita income to US 4,000 during the next five years. The strategic opportunities arise from new growth areas, as economic integration gathers pace regionally and globally, driven by improved business confidence, increasing investment flows and regional and global trade. Going forward, the financial system has to reposition itself to support the higher growth path of the economy This will involve enhancing the capacity of financial system to serve all sectors of the economy with an increased array of products. Therefore, considerable institutional building, financial innovation and financial infrastructure development, as well as progressive liberalization and integration with the global financial system will be necessary. Furthermore, considerable risks, shocks and instabilities arise from the external environment that threatens macroeconomic and financial stability. This will pose considerable challenges for the government, the CBSL, other regulators and financial institutions necessitating prompt action to ensure financial system resilience and the achievement of the goals for the economy.

3. Structure of the financial sector in Sri Lanka

As in other countries, the financial sector of Sri Lanka is comprised of both formal and informal sectors. Banking institutions dominate the formal financial sector while other markets such as the capital market and money market play a limited role in facilitating the efficient and effective allocation and deployment of resources in the economy. In contrast, the informal financial sector does not have an organised setup and mainly provides short-term lending facilities based on personal contacts. Studies have found a significant role played by the informal sector as a source of credit for consumption loans to poor households (CBSL 2005).

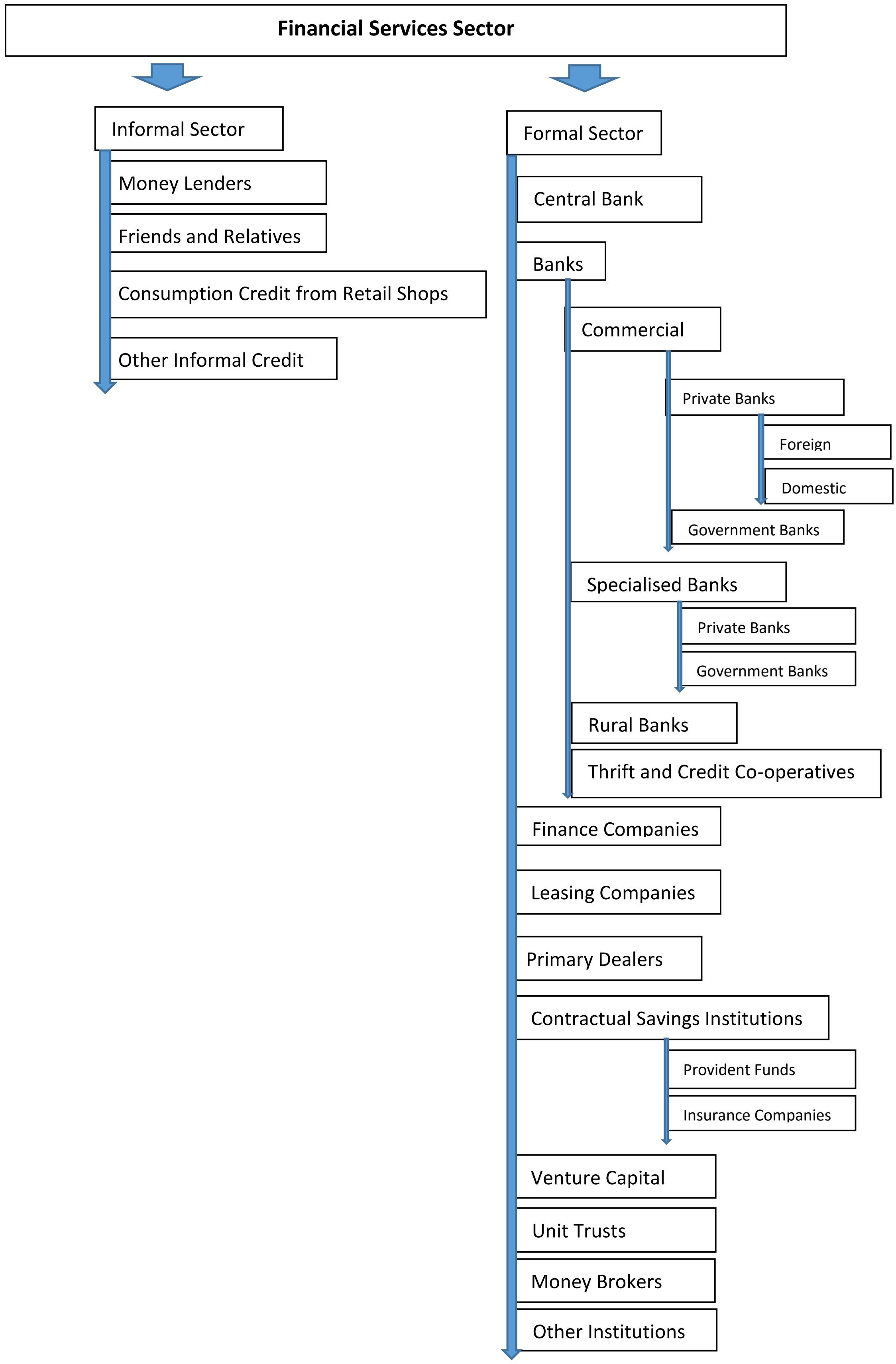
3.1 Banking sector

The banking sector dominates the financial sector in Sri Lanka. It controls most of the financial flows and possesses most of the financial assets. Economic reforms introduced after independence from the United Kingdom in 1948 brought structural change in the financial sector with the establishment of government banks to provide banking services to all segments of Sri Lankan society (CBSL 1998). Figure 1 shows the current institutional structure of the financial sector of Sri Lanka. The banking sector comprises the Central Bank of Sri Lanka, licensed commercial banks, licensed specialised banks, merchant banks, cooperative banks and some other thrift societies.

Central Bank of Sri Lanka

Financial sector developments in the post-independence era started with the establishment of the CBSL in 1950, the apex body of the financial system of Sri Lanka. The CBSL was set up in place of the CBS by the Monetary Law Act no.58 of 1949, with the broad objective of enhancing economic growth through creating an active monetary policy regime and dynamic financial sector. Prior to the establishment of the CBSL central banking functions were handled by the CBS which

Figure 1: Structure of the financial services sector



Source: Author's classification

was established by the Currency Ordinance no.32 of 1884. The core objectives of the CBSL are specified as being the maintenance of price stability and financial system stability for the economic prosperity of the country. Central banks use their monetary instruments, mainly SRR and OMO, to maintain price level stability which is conducive to economic development. Financial system stability is maintained through an effective regulatory environment, a reliable payments and settlements system, efficient financial markets and sound financial institutions. Financial sector supervision is a vital role played by the CBSL in maintaining financial sector stability in the country. Financial institutions come under the supervision of the CBSL and their shares in assets and liabilities are shown in Table 1.

Banks

There are 25 licensed commercial banks and seven licensed specialised banks operating in Sri Lanka. Out of the 25 commercial banks, two are fully owned by the government while the domestic private sector and foreign parties own 10 and 13 respectively. Most of the private domestic banks entered the market after the policy reforms of 1977. These reforms encouraged private sector participation in the provision of financial services.

Table 1: Total assets and liabilities of the institutions in the financial sector at the end of 2012

Institutions	Assets		Liabilities(a)	
	Rupees bn.	% Share	Rupees bn.	% Share
Central Bank of Sri Lanka	1357.4	15.4	n.a.	n.a.
Financial Institutions Regulated by the Central Bank				
Deposit Taking Institutions				
Licensed Commercial Banks	4207.4	47.8	2927.2	77.6
Licensed specialised Banks	708.8	8.0	539.2	14.3
Licensed Finance Companies	428.4	4.9	232.4	6.2
Other Financial Institutions				
Primary Dealers	128.5	1.5	n.a.	n.a.
Specialized Leasing companies	135.6	1.5	n.a.	n.a.
Institutions not Regulated by the Central Bank(b)	1842.2	20.9	74.2	2.0

(a) Excluding Central Bank of Sri Lanka's liabilities.
(b) Institutions not regulated by the Central Bank of Sri Lanka include Rural Banks, Thrift and Credit Co-operative Societies, Employees' Provident Funds, Insurance Companies, Stock Broking Companies, Unit Trusts/ Unit Trust Management Companies, Market Intermediaries that include Underwriters, Margin Providers, Investment Managers, Credit Rating Agencies and Venture Capital Companies.
Source: CBSL (2012)

Although some foreign banks were already established before independence was achieved in 1948, most large foreign banks, such as the Hong Kong and Shanghai Banking Corporation (HSBC), entered into the market in the early 1990s with the shift in government policies that provided equal opportunities for private sector as well as for state sector-owned banks. The 25 commercial banks are allowed to do all banking activities such as deposit taking, granting loans, forex transactions and dealing with derivatives. The seven specialised banks are mostly focused on savings and development banking rather than commercial banking activities. These specialised banks are not allowed to accept demand deposits, which are not entitled to receive interest payments from the banks. Five of the specialised banks are owned by the government while the remainder is a private domestic bank. The CBSL is the regulator of both commercial banks and specialised banks. Its role involves conducting on-site and off-site supervision of these institutions. Merchant banks are established by the commercial banks and they cater to the specific banking needs of their corporate customers and to the demand for financial services in the capital market. There are six merchant banks operating in the country today.

Cooperative banks and thrift/credit cooperative societies also accept deposits and grant credit in the country, catering in particular for the poor and lower middle class households to meet their savings and credit needs. These institutions, focusing on rural development, are regulated and supervised by the Ministry of Cooperative Development which was established to enhance regional economic conditions and development. Although cooperative banks and thrift/credit cooperative societies cater to a large number of households, they account for less than 2% of total banking sector assets due to the small scale of their transactions.

3.2 Non-bank financial institutions

In general, financial institutions which collect deposits from the public are considered to be banks, and non-bank financial institutions are not allowed to accept deposits from the public. In practice, it is difficult to distinguish between the financial services provided by banks and non-bank financial institutions since there are a number of similarities in the services that they provide. Differences can be seen in practices, regulatory environments and legal or formal definitions of the non-bank financial institutions in different countries. In the Sri Lankan context, some non-banking institutions such as finance companies and leasing companies supplement the banks by providing financial services in segments of society which are not reached by the banking sector. Some non-banking institutions compete with banks in the provision of financial services. Other non-banking institutions such as contractual savings institutions and primary dealers mostly concentrate on their specialised sectors and enjoy the advantages of specialisation. This section provides a brief review of the financial services provided by non-banking institutions in Sri Lanka.

Finance and leasing companies

Finance companies also accept short-term, medium-term and long-term deposits from the general public and maintain diversified loan portfolios while offering higher returns to their depositors than either the licensed commercial banks or licensed specialised banks. There was a significant increase in the number of finance companies after economic liberalisation in 1977, with most of the funds invested in higher purchase and leasing businesses (CBSL 1998). There were 72 finance companies registered with the CBSL at the end of 1989. The CBSL introduced new reforms including stringent regulations to ensure the viability of finance companies after some of them failed in the 1980s. The new regulations led to a decline in the number of finance companies to 24 by the end of 1996. With economic expansion after the end of the ethnic conflict in 2009, the CBSL allowed expansion in this sector, issuing new licences to meet the increasing demand for financial services in the economy. Simultaneously, the CBSL introduced the Finance Business Act, no 42 of 2011 to improve the regulation and supervision of finance companies and to ensure stability of the financial sector in Sri Lanka. Today there are 46 finance companies operating (CBSL 2015).

In addition to commercial banks, specialised banks and finance companies, specialised leasing companies are also engaged in leasing activities. Unlike commercial banks, specialised banks and finance companies, these specialised leasing companies are not permitted to accept deposits from the general public. Specialised leasing companies have been engaged in leasing activities since the early 1980s and currently there are 7 of them operating in the country. The CBSL has been vested with powers to regulate and supervise specialised leasing companies by the Finance Leasing Act no.56 of 2000.

Unit Trusts

With the expansion of the capital market, the Security Exchange Commission of Sri Lanka (SEC) issued four licences to establish unit trust in 1992 as a strategic move aimed at stimulating the security market, creating a new way of attracting savings into the capital market. Unit trusts are governed by the SEC as specified in an act passed to establish the SEC and the unit trust code. Although the contribution of unit trusts to the capital market in Sri Lanka is not significant, they contributed to changing the way savings are mobilised in the capital market (Seelanatha 2007). There are 35 unit trusts currently established in Sri Lanka. Out of these, 33 are operated as open-ended funds and the other two are closed. The investment portfolios of unit trusts consist mainly of equity and government securities.

Contractual savings institutions

The two main categories of contractual savings institutions, namely social security funds and insurance companies, also play a vital role in the financial market in Sri Lanka with their ability to accumulate significant amounts of long-term saving from the public. Social security funds in Sri Lanka comprise the Employees' Provident Fund (EPF), the Employees' Trust Fund (ETF), the Public Service Provident Fund and some other provident funds run by semi-government entities or private sector employers. EPF dominates social security funds as the largest fund in terms of member accounts, assets and investments.[1] The minimum contribution of the EPF should comprise 8% of the gross salary of an employee and 12% from the employer totalling 20% of gross earnings of the employee. From its inception in 1961 EPF has invested mainly in government securities. Currently 97% of the EPF's portfolio is invested in treasury bills, bonds and rupee loans while 3% is invested in the Colombo Stock Exchange (CSE).

The ETF is the second-largest social security fund in Sri Lanka.[2] ETF was established in 1981 to enhance the stock ownership of employees. Although most of the features of the EPF are also

[1] The EPF has 2.3 million active member accounts, 11 million inactive member accounts and 900 (20% of GDP) billion rupees of accumulated assets which account for 12.2% of financial sector assets in Sri Lanka (CBSL 2012). The EPF is supervised by the Ministry of Labour and managed by the Central Bank of Sri Lanka.

[2] The ETF has assets of 153 billion rupees (CBSL 2012). The ETF is supervised and managed by a board of trustees appointed by the Ministry of Finance and Planning.

included in the ETF, members are allowed to withdraw their money upon termination of employment. Further, membership is open to people in self-employment and the ETF provides health insurance to its members. The ETF contribution, 3% of the employee's salary, is financed by the employer if the member is not self-employed. The ETF invests mainly in government securities which account for 80% of its current investment portfolio. The government also maintains a social security fund called the Public Sector Pension Scheme, an unfunded, non-contributory pension scheme for civil servants and other government employees. In addition, some Approved Private Provident Funds are maintained by private and semi-government institutions, with finance provided by employers and employees. These contractual savings institutions contribute to the economic development of the country through their investments and provide social security schemes for the workforce of Sri Lanka.

The insurance industry is also a leading player in the economy for mobilising savings and improving investment. The introduction of the coffee and tea industries by the British rulers provided the ingredients for establishing the insurance industry. Therefore, the insurance industry dates back to the pre-independence era. In the beginning the insurance industry comprised only foreign companies and the first Sri Lankan insurance company, the "Sri Lanka Insurance Company" was established after the Company Act of 1938 was passed. Later, a number of private sector players entered into the insurance business by establishing companies to provide insurance services. In 1961 the government established ICSL in line with their policy framework for nationalisation. The Control of Insurance Act no.25 of 1962 provided monopoly power of the life insurance industry to ICSL.

After the economic reforms of the late 1970s, the government established a second state-owned insurance company in 1981 with the objective of improving services through increased competition. To encourage private investment in the insurance industry, the Control of Insurance Act no.25 of 1962 was amended in 1986. An expanding economy and legislative provisions paved the way for a gradual expansion in the insurance industry. At present there are 21 insurance companies operating in the country and the Insurance Board of Sri Lanka (IBSL) was established under the Insurance Industry Act no.43 of 2000 as the regulator and supervisory body of the insurance industry. The insurance industry in Sri Lanka accounts for only 3% of total financial sector assets of the country but has huge potential for rapid expansion, due to the low penetration of insurance services compared to the situation in other lower middle-income countries (AIR 2014).

Primary dealers

Primary dealers play a significant role in the money market in Sri Lanka, particularly in the government securities market, having exclusive rights vested in them for purchasing government securities at primary auctions. Investors can invest in government securities, namely treasury bills and treasury bonds, through these primary dealers. The main objectives of a primary dealer system are: to maintain stable demand for government securities, provide liquidity to the secondary market, provide intermediary services for investing in government securities, and improve market information about government securities. The CBSL is the regulator of primary dealers who are appointed under the Local Treasury Bills Ordinance, No 8 of 1923 and the Registered Stock and Securities Ordinance no. 7 of 1937. Most domestic commercial banks are active in the government security market and in establishing primary dealers companies. In 2014 the total assets of all 15 primary dealer companies was 191 billion rupees, accounting for 1.6% of total financial sector assets in Sri Lanka.

3.3 Informal financial sector

As in other developing countries, the informal financial sector is also an important component in Sri Lanka's financial sector. Although there is no well-established definition for the informal or unorganised financial sector, in general the informal financial sector consists mainly of money lenders, pawn brokers, and friends and relatives who provide financial assistance with or without collateral and interest. Findings of the Consumer Finances and Socio Economic Survey (CFS) conducted by the CBSL in 2003/04 recorded that the credit provided by the above informal sources accounted for 18% of the total borrowings of the household sector in Sri Lanka. Further, rural retail shops in Sri Lanka also have a practice of providing consumption items on credit to their customers without any collateral (CBSL 2005).

Financial Stability Framework at Central Bank of Sri Lanka

The existence of large financial conglomerates, especially those that have banks as part of the conglomerate, is an area that has attracted increased supervisory concern in recent times. The regulation and supervision of such financial conglomerates is becoming increasingly more important and complex, due to the potential systemic risk that could arise from the interrelated nature of their activities. Large numbers of cross shareholdings, common directors and inter company transactions are areas that are of key interest in this regard, as it could result in conflicts of interests and abuse of power, which would not augur well for the stability of the financial system.

Since there are multiple regulators in the financial system, the supervision of conglomerates often falls under the purview of several regulators, requiring close co-operation and supervision. Therefore, a Working Group of Regulators for Financial Conglomerates comprising of the Central Bank of Sri Lanka, the Insurance Board of Sri Lanka, the Securities and Exchange Commission of Sri Lanka, the Accounting and Auditing Standards Monitoring Board and the Department of Registrar of Companies has been established to monitor the systemic risk of conglomerates. The mandate of this working group includes identifying and defining financial conglomerates; identifying the functions of the separate regulators; assessing the systemic risk of such conglomerates by sharing necessary information among regulators, recommending a course of action for regulation and supervision of the respective institutions in a consolidated manner; and proposing necessary legal reforms to address the existing limitations relating to regulation and supervision of financial conglomerates.

The Financial System Stability Committee (FSSC) was set up in 2002 when financial system stability became one of the core objectives of the Central Bank, to co-ordinate efforts to ensure that the overall system is robust and secure and that threats to the system are identified and reduced. The main tasks of the FSSC are to:

- Assess the risks and vulnerabilities that may lead to financial system instabilities or imbalances and to recommend measures and policies to mitigate them, to the Governor and the Monetary Board.

- Monitor the financial system and to submit periodic reports to the Governor and the Monetary Board, recommending policies necessary to promote financial system stability.
- Prepare the Financial System Stability Review.

The figure 2 presents the structure of the financial stability cluster of the CBSL including financial stability committee.

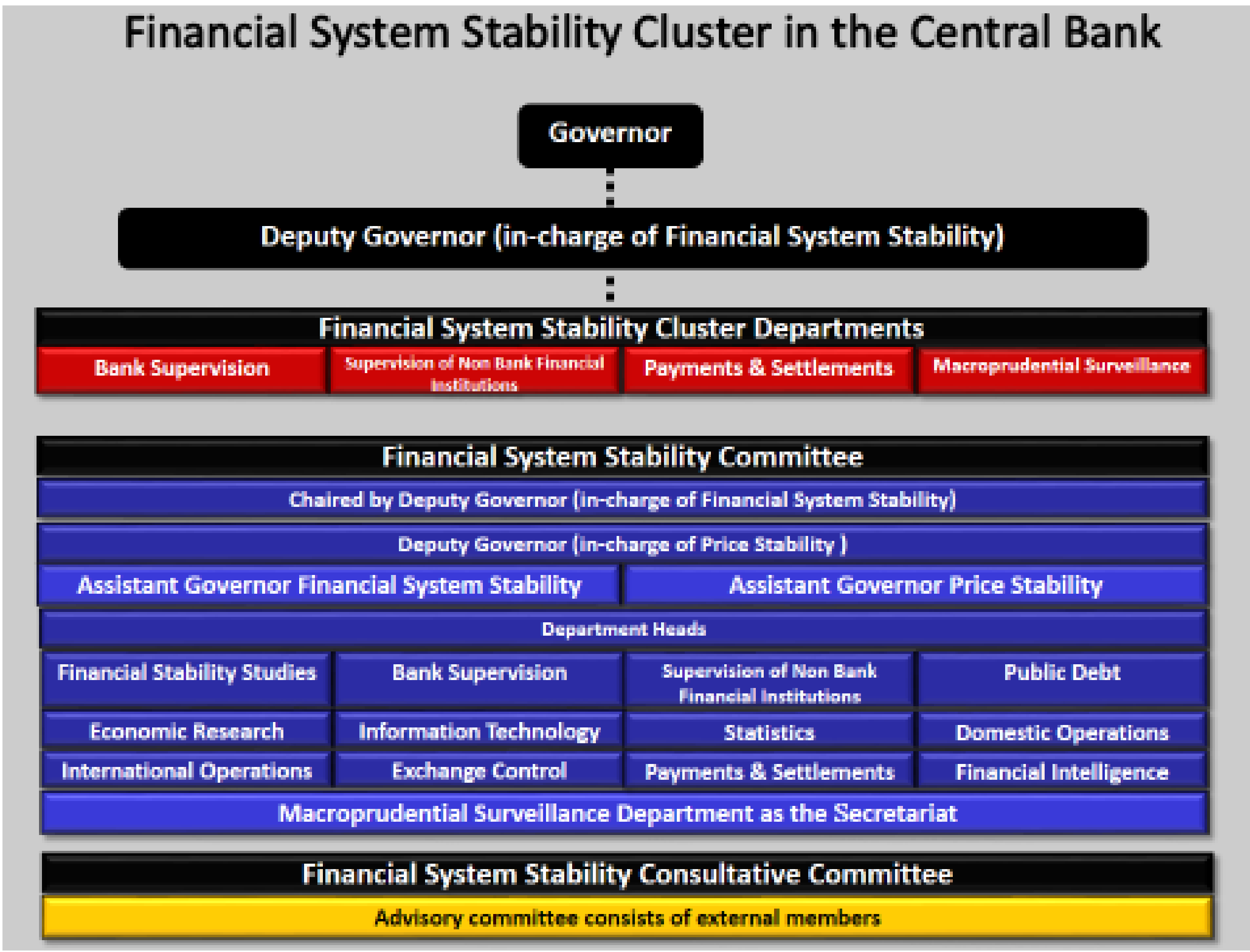


Figure 2

With the intention of maintaining financial sector stability in Sri Lanka, the Monetary Board of CBSL approved the setting up of a Financial System Stability Department (FSSD) in 2007.

FSSD was renamed as Financial Stability Studies Department in 2011, Financial Sector Research Department in 2014 and Macroprudential Surveillance Department(MSD) in 2016 with expanding the scope of the department in terms of the work handled by the Department, incorporating financial sector development related research studies as one of the key areas of work.

4. Implementation of Macro-Prudential Policies and Tools

The financial crisis shows how critical the nexus is between the health of the financial system and the health of the economy. The CBSL implemented a series of measures since 2009 to further strengthen the regulatory and supervisory framework, risk management systems and to instill good corporate governance standards and practices in the financial sector. The overall aim of this process has been to identify emerging vulnerabilities in the financial sector, which could undermine the overall financial system stability, so that early action could be taken to minimise such vulnerabilities. Particular emphasis was also paid to continue to review of prudential standards taking into account both developments in international markets and regulatory changes following the crisis.

The prudential measures taken by the CBSL are listed below.

- Consolidated supervision of financial conglomerates to limit regulatory arbitrage that can arise from fragmented supervision and development prudential requirements.
- Regulation and supervision of microfinance institutions
- Strengthening of regulatory framework relating to banking and non –banking financial institutions
- Strengthening regulations against unauthorized deposit - taking.
- Adopting Pillar II & III of Basel II.
- Implementing Basel III.
- Regulation of private superannuation funds
- Developing the corporate debt market formulating reporting requirements and the securitization market by enactment of regulatory framework.

- Upgrading anti- money laundering framework.
- Regional co-operation

In addition, the CBSL conducts regular stress on banking institutions and the banking sector to assess its capacity to cope with shocks. The stress tests using single factor sensitivity analysis were conducted for credit risk, interest rate risk, foreign exchange risk and liquidity risk shocks to gauge the impact on banks' capital adequacy and liquidity ratios. The results of the tests indicate that the banking sector has adequate capital and liquidity buffers to withstand moderate shocks and moderately resilient to extreme shocks.

Further, MSD compiles following indices to assess the soundness of the financial sector of the country.

1. Financial System Stability Indicator (FSSI)
2. Financial Market Stability Indicator (FMSI)
3. Macro-economic Stability Indicator (MESI)
4. Banking Soundness Index (BSI)
5. Licensed Finance Company Soundness Index (LFCSI)
6. Corporate Sector Credit Worthiness Index
7. Early Warning Indicator (EWI) Pressure on the Rupee

5. Challenges and Way Forward

The presence of a sound and stable financial system is crucial for achieving sustainable economic growth and prosperity. Given the continuously evolving financial landscape and global integration of financial markets, it is of utmost importance that measures are taken to improve efficiency, competition and resilience of the financial sector and strengthen financial system stability.

The outlook for financial system stability in Sri Lanka is favourable given the high growth momentum of the domestic economy and the rebound in the international economy. Internally, the Central Bank will continue to strengthen its macroeconomic surveillance and supervisory capabilities for the early detection of emerging risks to facilitate pre-emptive actions. The Central Bank's will also strengthen prudential framework, supervisory arrangements and processes, and surveillance frameworks will be strengthened further to ensure continued access to funding and to maintain a high level of confidence in the financial system. At the same time, engagements and coordination arrangements between the Bank and other domestic and international regulatory authorities would also be enhanced to ensure that the financial system is well-positioned to manage the implications of the more difficult environment moving forward. Further relaxation of exchange controls is also planned to accelerate further the deepening of the domestic financial system and to promote greater integration of our financial sector with the global financial system.

Internationally, many lessons have been learnt from the current global financial crisis and measures have been proposed to further strengthen the main lines of defence against institutional and systemic risks in the financial sector. This will include further enhancements to the Bank's surveillance systems, the strengthening of the institutional arrangements for dealing with threats to the financial system, improvements to the incentive structure, the promotion of sound corporate governance and risk management practices, and the development of the necessary conditions for increased market discipline.

Emerging economies need to continue to evolve approaches and solutions on how best to manage the vulnerabilities and to promote and preserve stability. In this endeavour, there is potential to not only consider what individual economies can do but also the opportunities for regional arrangements or regional solutions. As the region becomes increasingly more integrated in terms of trade and investment flows, the potential for this will be greater. The desired outcome is to achieve stability, which in turn, will contribute to the overall stability of the international monetary system and thus, enhance the prospects for shared global prosperity.

The continuous dynamic evolution in Asia has strengthen as a greater regional economic and financial integration in this region. In this context, the important partnership between the Government and the private sector remains a key element in ensuring stability and sustainable economic development in the future. Given the dynamics of the financial markets today, more effective engagements between policy makers and the industry, both within and across borders have never been more important so as to bring about a greater awareness of key financial stability issues, to further sharpen supervisory and management judgments and to promote greater collaboration on multiple fronts. Enhanced prospects for greater global financial stability depend on a sustained commitment to these priorities. Ultimately, the goal is to strengthen our collective ability to anticipate and respond effectively to developments that affect financial stability, not just in these present challenging times, but through what will likely be an extended period of global adjustments going forward.

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