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Financial reforms in Sri Lanka and their influence on the banking industry

Abstract

Financial reforms in Sri Lanka began in 1977 with the introduction of open economic policies. The aim of this paper is to summarize the major reforms and evaluate their influence on the banking industry in Sri Lanka. The analytical discussions presented in this paper demonstrate that market structure and scope in the banking industry have drastically changed after the reforms. Further, the analysis found that the depth of the banking industry has improved significantly as a result of the reforms.

Keywords: banking industry, Sri Lanka, financial reforms, unit trusts, superannuation funds.
JEL Classifications: E44, E58, G21.

Introduction

In the late 1970s, most developed and developing countries began to introduce financial deregulation to promote involvement of private sector in economic decision making (Harper and Leslie, 1993; Hogan, 1992; Maghyereh, 2004). During the same period Sri Lanka embarked on her financial reforms. Since a large proportion of the assets of the financial service sector is held by the banking sector in Sri Lanka, those reforms affected the banking industry to a greater degree. In this backdrop, the main objective of this paper is to examine financial deregulation in Sri Lanka and its consequences on the banking industry during the last three decades.

The evolution of financial systems is not isolated from that of the other socio-economic environments. In part, continual evolution of financial sectors may have resulted from the natural evaluation of the economy. According to Davis (2007), feasible and desirable reform paths are likely to be country-specific, not always readily apparent, and are subjected to opposition from powerful forces who stand to lose as a result of change. This phenomenon has been clearly demonstrated by the environment and the reform process adopted in Sri Lanka. Especially, political interference, corruption, bureaucratic rigidities, political and social ideologies, ethnic issues, financial illiteracy and many other factors have affected the reform process in Sri Lanka (Edirisuriya, 2007). These factors have also affected the types of reforms that were introduced and the phases of reforms throughout the last 30-year period. Therefore, this unique environment provides a comprehensive laboratory to investigate the reforms and their outcomes in an emerging economy. The results of such an investigation will be helpful to policy makers to re-shape the reform process.

This paper is structured as follows. The first section focuses on the basic research approach adopted in the paper. The next section dwells on the financial sector reforms in Sri Lanka. The third section analyzes the impact of financial sector reforms on the banking industry in Sri Lanka. The last section presents policy implications and conclusions of the paper.

1. Analytical approach

This paper investigates the consequences of financial reforms during the post liberalization period (1977-2008). The required data for the analysis have been collected mainly from the annual reports of the Central Bank of Sri Lanka during this period. To illustrate consequences of the financial reforms, this study uses graphical and tabular forms of data presentation techniques. Further, to identify the overall impact of the reforms, this paper uses the market concentration ratio of the Sri Lankan banking industry, which is measured using Herfindahl-Hirshman index (HHI). It is true that the recorded data in the above period have been influenced by other economic forces. Those influences are difficult to separate from the impact of financial reforms. However, notable unexpected changes in the recorded data which were not expected under normal circumstances may represent the consequences of financial reforms.

2. Financial sector reforms in Sri Lanka

In the early 1880s, the British planters commenced the banking industry in Sri Lanka for the comfort of their trading activities. Until 1948, there was a liberal economic system in Sri Lanka which had little direct government involvement in economic activities. Before 1948 there was neither government intervention in international trade nor exchange controls (Karunasena, 1999). Subsidiaries of foreign banks dominated the banking sector which mainly met the financial requirements of international trade and the working capital requirements of Sri Lanka's plantation sector.

Direct government intervention in the banking industry began after the country gained its independence from Britain in 1948. The goal of a self-sufficient economic system led the government

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to set priority areas for development, namely: to control the allocation of loan funds; to intervene in setting interest rates; and to introduce strict foreign exchange regulations. The government used banking industry as the main vehicle for mobilizing financial resources in the process of economic development and for providing the most fundamental financial intermediary and payment functions. In 1950, Government of Sri Lanka established the Central Bank of Sri Lanka (CBSL) as the main regulatory body which governs the financial services sector. During this period, government was able to increase its control over the banking sector assets by owning two large commercial banks, namely, the Bank of Ceylon[1]' and the People's Bank (Fernando, 1991). The government sponsored the expansion of operations of these two banks by legislating them to allow into new areas such as specialized lending facilities, international trade finance and as the bankers for the government (Karunasena, 1999). During the same period, operations of the private sector banks were restricted.

The inefficient allocation of financial resources which was a result of government intervention in the industry had undermined the economic development of the country. Particularly, the economic hardships experienced in the early 1970s due to the rigid government intervention in the economy highlighted the need for less regulatory intervention in the financial services market.

Three phases are evident in the deregulation of the financial services sector in Sri Lanka (i.e. 1977-1988; 1988-1995 and after 1995 to date). Initial reforms from 1977 to 1988 were mainly related to economic regulations which imposed controls over the economic capacity of decision-making units in the financial services sector. Those reforms were aimed at promoting financial intermediation through the establishment and promotion of sound financial infrastructure. During this period, reforms were directed to the removal of entry barriers to the sector, allowing bank branch expansion, introduction of new forms of financial institutions, removal of interest rate ceilings and reducing preferential credit facilities. These reforms are summarized in Table 1. Majority of these reforms took place during the first phase of deregulation. The Sri Lankan government still continues to introduce some form of changes to the economic regulations.

[1] Bank of Ceylon commenced its operations in 1931 as a private bank and has been nationalized in 1961. Currently, both the Bank of Ceylon and the People's Bank are functioning as state-owned banks.

Table 1. Financial service sector reforms (economic regulations)[2]

Year	Action
1977	• Abandonment of the former exchange control regulation by introducing a unified exchange system under a floating exchange rate regime
1979	• Relaxation of operational restrictions (allowed to open branches of foreign banks, granted new banking licences, allowed to expand branch networks of existing banks) • Introducing new form of specialized financial institutions (National Development bank) • Banks were allowed to establish foreign currency banking units to promote offshore banking services and international money market transactions
1981	• For the first time, CBSL used quantitative measures such as open market operations and the variation of Statutory reserve requirements (SRR) to control money supply • CBSL incorporated a secondary market for treasury bill (TB) and offered TBs at discounted rates between 15% to 16%
1982	• Credit ceilings on bank credit to residents or companies registered in Sri Lanka for the purchase of estates or immovable property were withdrawn • Colombo Stock Exchange Ltd was established
1983	• Credit ceilings on selected non-priority sectors were removed
1987	• CBSL removed the limits placed on commercial banks relating to the issue of CDs
1993	• CBSL established a market (REPO-market) for repurchasing treasury bills with a view to establish the lower end of the call money market • The private sector started to issue commercial papers for covering short-term funding needs
1994	• Commercial banks are allowed to issue international credit cards
1998	• CBSL started electronic trading of government's bonds
1999	• The CBSL set the single borrower limits to 30% of the capital of the banks as of the end of its preceding financial year • Foreign individual and institutional investors are allowed to participate in trading activities in the Colombo Stock Market
2000	• Limits on foreign ownership of local commercial banks and insurance companies were raised to 60% and 90%, respectively • CBSL allowed independent floating of the exchange rate
2002	• Minimum required maturity period of deposits in finance companies was reduced to one month from three months • Stamp duty and the national security levy on financial transactions were removed • Debit tax on all withdrawals from checking accounts was introduced
2003	• Daily determination of SRR on commercial banks' deposits was introduced

As in other countries, financial reforms in Sri Lanka also targeted prudential aspects of the financial services sector. The reform in this area has mainly aimed at enhancing the credibility of all industries in the sector. Table 2 summarizes some of those reforms implemented during the last 30-year period.

[2] Tables one, two and three were compiled using information in Ariyarathna (1993), Athukorala and Rajapatirana (2000), Bandara (1998), Cooray (2000), Dunham and Kelegama (1997), Fernando (1991), Karunasena (1999) Karunasena and Jayatissa (1987), Karunatilaka (1986; 1988), Yapa (2003) and various issues of CBSL annual reports (from 1977-2004).

Table 2. Financial service sector reforms – health and safety regulations

Year	Action
1981	• Statutory reserve requirements (SRR) were increased with respect to demand deposit from 12% to 14% and savings deposit from 5% to 6%
1984	• National Saving Bank (NSB) was allowed to set its own deposit rates. • State Mortgage and Investment Bank was reorganized as a specialized housing bank and was authorized to accept deposits
1988	• The Banking Act 1988 gave more power to the CBSL for regulation and control of banking in Sri Lanka
1990	• CBSL established the Credit Information Bureau (CIB) to function as a resources base for banks in screening borrowers to avoid loan defaults
1991	• Rescheduling loan portfolio of state-owned commercial banks by making provisions for non-performed loans
1992	• Disclosure requirements and loan recovery mechanisms were introduced
1994	• Acceptance of article VIII of the International Monetary Fund (IMF) agreement allowed external 'liberalization'
1999	• The CBSL set the single borrower limits to 30% of the capital of the banks as of the end of its preceding financial year
2002	• The financial sector reform committee was established • The lower limit on Statutory reserve requirements was removed • Minimum required maturity period of deposits in finance companies was reduced to one month from three months • Prudential norms applicable to the domestic banking units were extended to the offshore banking units
2003	• The risk-weighted capital-adequacy ratio (CAR) for banks was raised by 10%

Financial sector reforms in Sri Lanka also focused on enhancing the public accountability of the financial services sector (see Table 3). Particularly, the Basel Accord II has affected those reforms.

Table 3. Financial service sector reforms – information regulations

Year	Action
1990	• CBSL established the Credit Information Bureau (CIB) to function as a resources base for banks in screening borrowers to avoid loan defaults
1992	• Disclosure requirements and loan recovery mechanisms were introduced
1994	• Acceptance of article VIII of the International Monetary Fund (IMF) agreement allowed external 'liberalization'
1999	• The CBSL introduced specified disclosure requirements to all banks as a means of promoting a sound and efficient banking system
2002	• Prudential norms applicable to the domestic banking units were extended to the offshore banking units

3. Impact of financial reforms on the banking industry in Sri Lanka

Examination of the trends in banking industry and its operational environment during the last three decades indicates influences of the financial sector reforms on the industry. During the first phase of reforms, private sector was allowed to establish new banks subject to minimum capital requirements. At the same time, the banking industry was opened to foreign banks. For all practical purposes, domestic banks were permitted to open new branches with permission from the CBSL. Accordingly, the government was directly involved in expanding the branch networks of state-owned banks throughout the country. However, the expansions of the branch networks of state-owned banks were aimed at enhancing the popularity of governing political party. Consequent structural changes of financial reforms are presented in Table 4.

Table 4. Infrastructural developments in deposit taking institutions in Sri Lanka

Year	Local commercial banks	Foreign commercial banks	Regional development bank – branches	Savings banks	Rural bank branches	Licensed specialized banks	Unit trust	Finance companies
1977	4 [298]	7	-	1 [25]	544	Na	-	29
1980	4 [486]	17	-	1 [42]	641	Na	-	27
1985	4 [600]	21	-	1 [57]	914	Na	-	56
1986	4 [604]	21	-	1 [60]	932	Na	-	56
1987	4 [608]	21	-	1 [62]	955	Na	-	53
1988	6 [678]	19	80	1 [64]	Na	Na	-	54
1989	6 [690]	18 [21]	89	1 [69]	Na	Na	-	60
1990	6 [719]	18 [23]	100	1 [76]	Na	Na	2	40
1991	6 [737]	18 [25]	124	1 [81]	Na	Na	2	24
1992	6 [781]	17 [29]	156	1 [84]	Na	Na	2	27
1993	6 [845]	23 [33]	163	1 [85]	Na	Na	2	26
1994	6[876]	23 [36]	169	1 [90]	1216	Na	2	26
1995	6 [876]	26 [37]	171	1 [96]	1251	Na	4	24
1996	7 [906]	26 [37]	175	1 [99]	1293	Na	5	24
1997	8 [949]	18 [38]	176	1 [101]	1329	6	10	25
1998	8 [988]	18 [40]	176	1 [102]	1351	8	10	25

Table 4 (cont.). Infrastructural developments in deposit taking institutions in Sri Lanka

Year	Local commercial banks	Foreign commercial banks	Regional development bank – branches	Savings banks	Rural bank branches	Licensed specialized banks	Unit trust	Finance companies
1999	9 [1009]	17 [38]	177	1 [101]	1418	12	12	25
2000	10 [1042]	16 [38]	181	2 [101]	1476	12	12	25
2001	11 [1080]	14 [37]	188	2 [101]	1507	12	12	25
2002	11 [1185]	12 [31]	190	2 [103]	1554	14	13	26
2003	11 [1285]	12 [40]	194	2 [112]	1594	14	13	26
2004	11 [1342]	11 [38]	196	2 [112]	1594	14	14	27
2005	11 [1380]	11 [37]	197	2 [114]	Na	14	13	28
2006	11 [1491]	11 [39]	201	2 [201]	Na	14	14	29
2007	11 [1758]	11 [43]	218	2 [218]	Na	15	Na	32
2008	11 [1894]	11 [41]	219	2 [219]	Na	14	Na	34

Notes: Numbers of commercial banks' and savings banks' branches are in parentheses; Na = data is not available.
Sources: Various issues of CBCL annual reports.

Both organized and unorganized sectors play a vital role in the financial services sector in Sri Lanka. Before the deregulation, a large portion of financial transactions took place in the unorganized sector. Financial reforms were also aimed at formalizing the operations of the unorganized sector. By law, every deposit-taking institution should be registered with the Central Bank of Sri Lanka. However, business units in the unorganized sector are still operating in the financial services sector with very little legal control.

As shown in Table 4, the financial reforms have significantly affected the development of institutional structure of deposit-taking institutions[1] in Sri Lanka. The number of fully licensed banks increased from four in 1977 to eleven in 2009. Their branch bank network has increased from 298 to 1894 bank branches during this period, which is a six fold increase. These capacity expansions in the local banking sector mainly resulted in the increased involvement of the private sector. During this period, the entry of seven new privately-owned banks could be regraded as a progressive outcome of financial reforms in Sri Lanka. Number of branches of foreign banks in Sri Lanka has increased from 7 branches to 41 branch offices of 11 foreign banks. However, at the initial stage these banks were restricted to the corporate banking operations. Recently, these banks were allowed to extend their services in the retail sector. Together with the reforms, government invited foreign bankers to open their branches in Sri Lanka. Overall, these changes in the commercial banking sector evidence the success of the financial reforms.

Number of savings bank branches has increased to 219 in 2008 from 25 in 1977. Regional development banks, licensed specialized banks, and unit trusts are the new players that have come into operation as a result of financial reforms. Financial reforms also increased the number of finance companies in the sector at the beginning. However, the formalization of the regulatory structure of financial companies has affected the registration of new finance companies. Currently there are 34 finance companies registered with the CBSL. The increase in the number of finance companies may enhance the competition in the medium- and long-term savings in the market. In the 1980s, three merchant banks were incorporated by the leading commercial banks targeting specific needs of local entrepreneurs and the capital market. These merchant banks are performing as information intermediaries by providing consultancies, underwriting of share issues and helping to find sources of capital. The CBSL promotes venture-capital institutions as a medium of providing seed capital for emerging entrepreneurs. Further, to enhance capital-market operations, CBSL promoted the creation of mutual funds. Consequently, a number of fund-management companies have entered the market during the last two decades. These fund management firms have established 14 unit trusts so far. Those unit trusts significantly contributed to changing the way savings are mobilized in the capital market.

Financial reforms have reduced the monopoly of commercial banks in the financial services sector. In the early stages of the financial reforms, newly-established specialized non-bank financial institutions took over some traditional commercial banking functions such as granting project finance and accepting long-term deposits. Moreover, financial reforms have allowed capital market to emerge as the main avenue of private sector direct financing in Sri Lanka.

Fully-licensed banks have to compete with other financial institutions in lending markets as well as in the deposit markets. Most other financial institutions can offer long-term and medium-term deposit

[1] Deposit taking institutions in Sri Lanka have been broadly divided into two groups; namely fully-licensed bank and specialized banks. Fully-licensed banks which also called as commercial banks have been permitted to provide all banking services.

instruments to attract the savers. Other financial institutions such as development banks, venture capitalists and mortgage institutions operate in the lending markets more assertively than the fully-licensed banks. On the other hand, foreign banks have emerged as a main player in the domestic banking market with a greater freedom in both deposit and lending markets. These banks were allowed to offer similar banking products (both deposits and lending) to the local banks. As a consequence, fully-licensed banks are forced to diversify their product lines and to find new fee-based services instead of interest-based products.

The scope of the Sri Lanka's financial services industry has been widened. Particularly, the operations of the banking industry have expanded both in relation to the number of banks and the number of branches. New financial instruments have been introduced to the market. The financial reforms allowed more freedom to open up different forms of financial intermediaries. However, the banking industry is the main intermediary in the financial services sector in Sri Lanka. Prevailing market-based interest rates offer a positive real interest rate for savers and consequently enhance domestic savings. On the other hand, trade liberalization has increased the demand for funds. Concomitantly, the new forms of financial intermediaries have increased competition in the financial services market.

Initial steps to let market forces determine interest rates were taken by creating an open market for government treasury bills and bonds in 1993. Restrictions on the foreign exchange market were relaxed. Banks were allowed to open foreign currency banking units. However, a reversal of economic reforms occurred in the middle of the 1980s. During the initial period, Sri Lanka's foreign exchange rate appreciated noticeably due to the huge foreign currency inflow to the three major foreign-funded development projects (Dunham and Kelegama, 1997). This had the effect of decreasing the export income of the country and increasing the trade account deficit. Hence, in the mid-1980s, the government reintroduced preferential credit facilities for some sectors. On the other hand, the reform process was further undermined by the escalated ethnic crises after 1983 and the insurgencies from 1987 to 1989. Furthermore, as indicated by Dunham and Kelegama (1996), consequent high interest rates, high inflation and the greater expense of welfare and defence expenditure reduced the speed of the reform process.

The next turn of the reform process was initiated with a number of political events. In 1989, the ruling party was able to re-elect for a third term, though under a new leadership. In the same year, the government was able to crush the insurgents in the south. These events provided a great opportunity for accelerating the economic reforms (Yapa, 2003). In the second stage, economic reforms were aimed at stabilizing and further liberalizing the economy in order to promote the private sector as an effective 'engine of growth' (Dunham and Kelegama, 1996). Accordingly, the government's fiscal policy was used to reduce the budget deficit. The privatization process was expedited using a popular term "Peoplization" (Salih, 1999). During this period many of the government corporations were privatized. The government made some unsuccessful attempts to privatize the two state banks which led to frequent work stoppages in the banking sector (CBSL, 2000).

In 1994, a third regime of reforms commenced with the major political change in the country. The new ruling party did not accept the economic deregulation process which was introduced by the previous government. But they pledged to rationalize the economic reform process with public scrutiny. The newly-formed government believed that the state should intervene in the priority sectors to provide better services. Political lobbying against the privatization of state banks by strong labor unions in the banking sector also affected the reforms. In 1996, the government created the Public Enterprise Reform Commission (PERC). The PERC was entrusted to find alternative ways to enhance the performance of government-owned-business-undertakings (GOBU) and to overcome the growing public criticism against the privatization.

Instead of privatizing state banks, a process called commercialization was introduced. Through this process, government intended to promote these banks as purely commercialized businesses as in the private sector. State-owned banks were converted into public limited companies giving some freedom to bank management to take radical decisions on the banks' operations. Further, the government forced a write-off of non-performing assets in state-owned banks. The state banks were authorized to recruit consultants with international credentials to reorganize the banks. The main aim of these initiatives was to improve the services offered by state banks.

During the last three decades, various governments in Sri Lanka have introduced different policies to liberalize the financial services sector. These reforms, which were very similar to those made in Australia, facilitated the entry of new financial services providers including unit trusts, fund managers, venture capitalists and investment bankers. Removal of entry restrictions also allowed the entry of foreign banks and the expansion of the activities of the existing foreign banks. The

government privatized the two major development banks, the National Development Bank and the Development Finance Corporation of Ceylon. Commercial banks were encouraged to offer new forms of financial products and facilities such as credit cards, automatic teller machines (ATM), non-residence foreign-currency accounts and branded deposits schemes. In 1987, two newly-formed private sector banks entered the financial market. These new banks pioneered the use of information and communication technology (ICT) in the banking industry of the country. Entry of these banks in 1988 significantly affected the market structure of the industry (see Table 4). However, the government continued to function as the major participant in the banking industry by retaining the two large commercial banks, namely the Bank of Ceylon and the People's Bank.

The major financial reforms introduced since 1977 and the consequent structure of banking industry in Sri Lanka have affected the financial services sector in different ways. Edey and Gray (1996) identified three areas which reforms can influence. These are: (1) the role of financial regulatory policies, (2) improvements in technology used by institutions, and (3) changes in the cost and pricing structures of the intermediation process. In the Sri Lankan context, the reforms further changed the institutional structure of the financial services sector in general.

One goal of financial reforms in Sri Lanka was to increase the productivity and efficiency of the entire financial services sector by promoting competition among different forms of financial intermediaries. Therefore, initial financial reforms were intended to reduce government control in banks' operating environment. Foreign banks were also encouraged to enter and expand banking operations in Sri Lanka.

3.1. Operational environment of commercial banks. Along with the structural changes, widening of operational activities of other forms of financial institutions such as insurance and leasing companies, unit trusts and superannuation funds has increased the competition in the financial services sector. The new banks have started to use ICT as part of their strategy to provide customer-friendly banking services. Consequently, those banks were able to achieve better competitive positions than the old commercial banks. Accordingly, old banks also commenced gradually to transform their out-dated manual-based banking systems to ICT-based modern automated banking systems. However, a premeditated (less-aggressive) approach followed by existing banks did not allow them to reap the full benefit of automation.

Reforms have affected the banks' operational environment. Banks introduced new products and improved their existing facilities and delivery channels. There was a competition among banks to introduce new technologies to the industry. This competition resulted in the introduction of new banking facilities. The banking operations were also switched from manual systems to computerized operating systems. Systematically banking operations were moved from a branch-bank system to a uni-bank system. Alternative banking services which used internet and phone came into operation.

Table 5. Development in banking facilities in Sri Lanka

Year	Banking density[1]	Number of ATM	Number of credit cards issued
1998	0.58	270	85,964
1999	0.58	316	161,079
2000	0.59	379	205,324
2001	0.60	466	253,258
2002	0.61	635	349,524
2003	0.69	710	393,854
2004	0.71	810	507,591
2005	0.72	NA	637,326
2006	0.87	1155	811,289
2007	0.97	1422	889,338
2008	1.02	1538	917,418

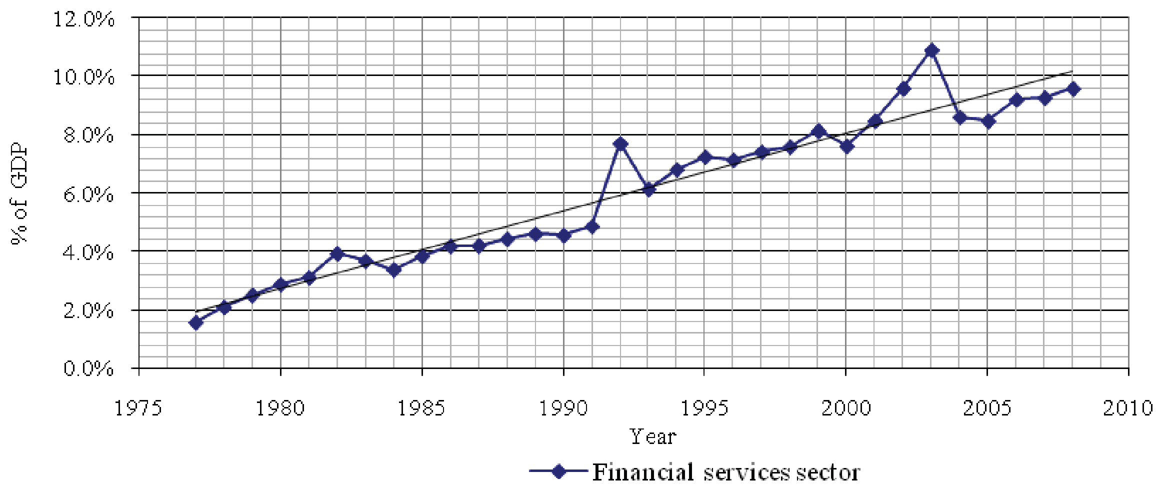
Source: Various issues of CBSL annual reports.

According to Table 5, the number of ATMs operated and the number of credit cards issued have significantly increased during the period under review. With the increasing number of bank branches, the bank concentration ratio[2] has significantly improved from 0.58 in 1998 to 1.02 in 2008 as shown in Table 5. During the 1970s, private sector and foreign banks were not allowed to expand their bank branch networks. Deregulation measures introduced in the early stages of financial reforms removed this restriction. As a result, the total number of ATMs has increased to 1,538 in 2004. This provides evidence that the reform has significantly improved the banking density of the country during the period under review.

Another objective of financial reforms in Sri Lanka is to deepen the financial services sector. In particular, changes in the institutional structure and the regulatory environment have helped deepen the financial services sector activities. Consequently, the sector contribution in the gross domestic product (GDP) improved during the period from 1977 to 2008. As exhibited in Figure 1, the contribution increased from 1.6% of GDP in 1977 to 9.58% of GDP in 2008 indicating a clear upward trend in the sector's contribution after 1990 when the second phase of the reforms commenced. This improvement

[1] Number of bank branches per 10,000 people.
[2] Number of bank branches available per 10, 000 people

in the sector coincided with a widening of economic activities in the country with open economic policies. This substantial growth has verified that the financial services sector has played a notable role in Sri Lanka's economic development confirming the McKinnon's (1973) and Shaw's (1973) arguments.

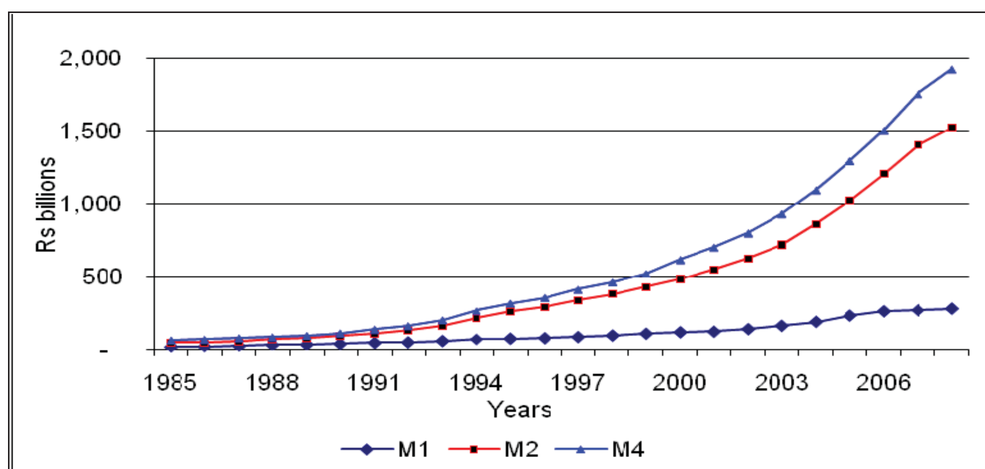


Source: Various issues of CBSL annual reports.

Fig. 1. Financial services sector's contribution to GDP

The deepening of the financial system due to the reforms was reflected in the changes in the aggregate money supply during the past 30-year period. Aggregate money supply incorporates currency, commercial banks' demand deposits, time and savings deposits and deposits in finance companies. CBSL uses three different measures to identify the aggregate money supply. The first, narrow money (M1) supply consists of currency and demand deposits of commercial banks. The second, M2 adds time and saving deposits to M1. The third, broad money supply (M4) includes all currencies and savings accounts including deposits in finance companies. Figure 2 outlines the behavior of money supply during the period. The graph indicates that there is a gradual expansion of Sri Lanka's money supply during the financial reforms.

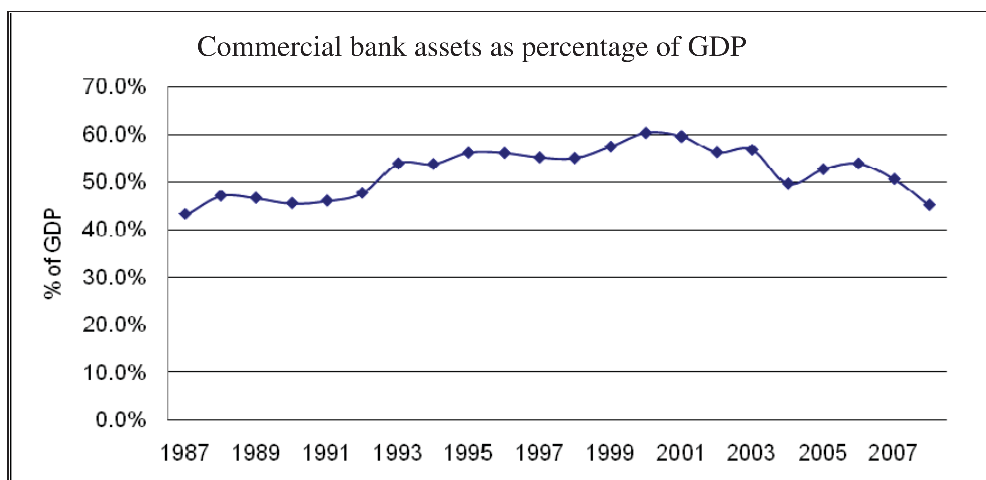
The rapid increase in M2 identifies the expansion of commercial banking activities in the financial services sector. In 1985, commercial banks' contribution to the broad money supply was relatively insignificant. However, by 1990 it had become a significant portion of broad money supply. Accordingly, developments in the financial services sector have widened the market for deposits.



Source: Various issues of CBSL annual reports.

Fig. 2. Monetary aggregates

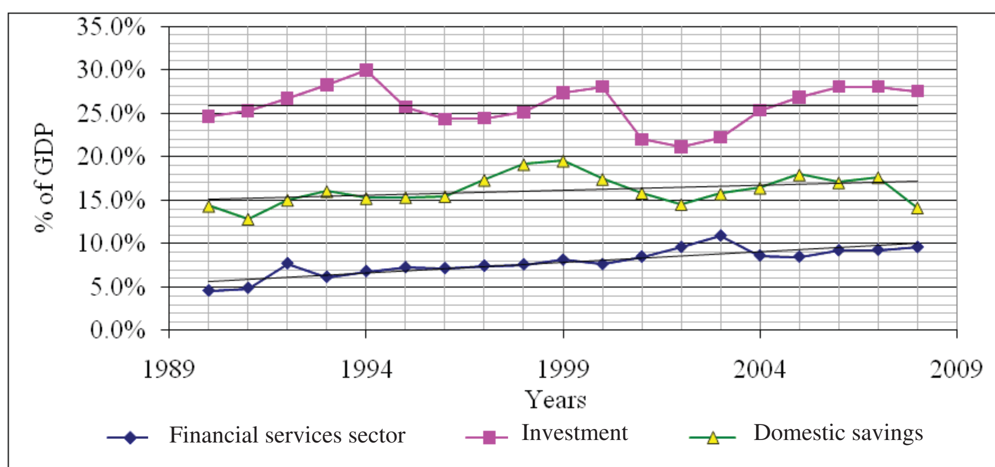
Figure 3 shows how the total assets base of commercial banks has widened during the period 1987 to 2004. The evolution of the financial services sector has increased the assets base of the commercial banks. The percentage of the commercial banks' assets to GDP grew from 43.2% in 1987 to 45.8% in 2008 (CBSL, 2008). In rupee terms, the assets base of the commercial banks has significantly increased from Rs. 76.8 billion in 1987 to Rs. 1948 billion in 2008 (CBSL, 2008).



Source: Various issues of CBSL annual reports.

Fig. 3. Bank assets as proportion of GDP

However, the financial services sector was unable to attract all of the domestic savings in the economy. In year 2008, the contribution of financial services sector to the GDP was 9.6% while the total domestic savings accounted for 28% of GDP. In the same year, the total investment was 14% of GDP. This indicates a significant portion of financial assets is flowing through institutional system other than the financial services sector. However, Figure 4 shows that financial services sector was able to improve its intake during the last 30-year period.

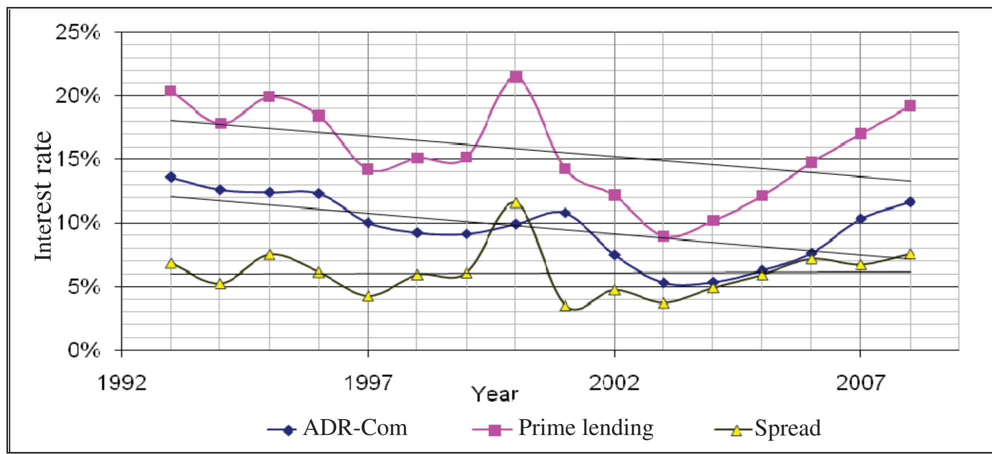


Source: Various issues of CBSL annual reports.

Fig. 4. Domestic savings, investment and financial services sector contribution to GDP

3.2. Deposit and lending interest rates. Deregulation gave more freedom to market forces in determining interest rates by removing preferential credit schemes and by establishing a market for government debt instruments. The CBSL uses two key policy interest ratios, repurchase (Repo)[1], and reverse repurchase (Reverse Repo)[2] to guide the market interest rates. The NSB is given latitude in determining its deposit rates. These policy rates and the NSB deposit rates are the main factors that determine the market rates. The market interest rates are sensitive to both domestic and international interest rates. The economic recession in the industrialized countries in the late 1990s occasioned a reduction in both the levels of deposits and a reduction in the interest rates in the international markets.

[1] The rate at which commercial banks and primary dealers invest their surplus funds government securities held by the CBSL.
[2] The rate at which commercial banks and primary dealers can obtain funds from the CBSL by keeping investment in government securities as collateral

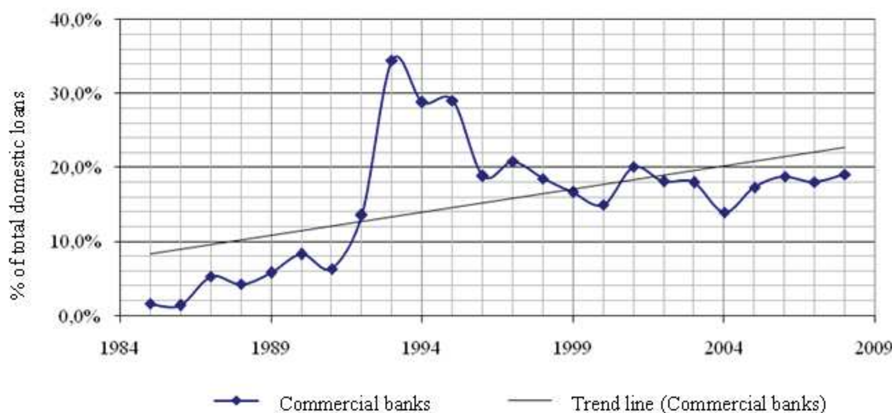


Source: Various issues of CBSL annual reports.

Fig. 5. Commercial bank lending and deposit rates

Commercial banks use multiple interest rates for their different deposits and lending products. The interest rates differentiation was the main strategy which commercial banks used to counter peer rivalry in the market. The establishment of the CIB and publication of all deposit and lending interest rates of commercial banks by the CBSL assisted in keeping the market informed regarding interest rates. During the last two decades, market interest rates have readily responded to both changes in locally and internationally determined interest rates. Figure 5 indicates the gradual reduction in the lending and deposits rates by commercial banks during this period. The average weighted deposit rates which are based on the weighted average interest rates of the outstanding interest bearing deposits of commercial banks declined commensurately during the period. Similarly, lending rates indicated a slower downward trend. The 'interest rate spread' is commonly used as an indicator of the efficiency of financial intermediation (Heffernan, 1996). During the period being considered, the interest rate spread declined at a slower rate. This may be a result of slow adjustments in lending rates, high operational costs, low quality lending portfolios and less reliance on the non-interest-bearing (commission based) activities. However, the financial reforms have forced banks to adopt rigid risk control procedures; to cut down unnecessary expenses and to be more responsive to the market changes. The declining trend in the interest rate spread indicates that the measures used to reduce interest rates have been successful.

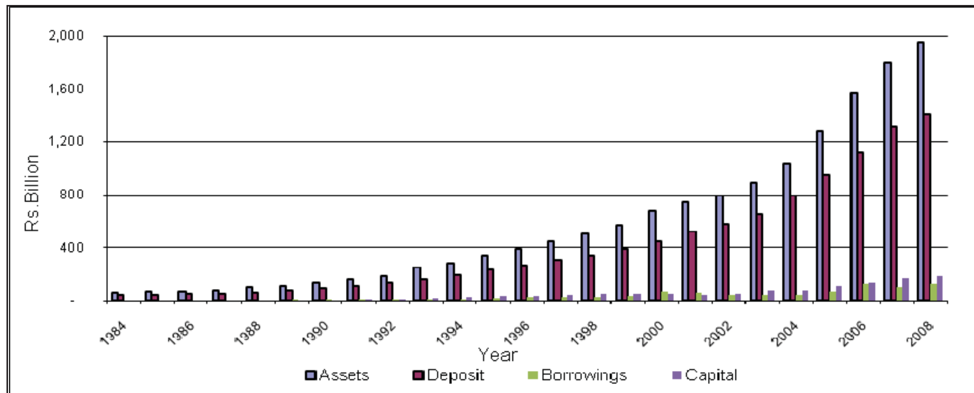
During the 1990s, the Sri Lankan government introduced an open-market policy for government securities. Aggressive open-market operations affected banks' holdings of government debt. As shown in Figure 6, since 1991 the banks' stake of the government debt grew significantly. On the other hand, banks' involvement in the open market for government securities has affected the market determined interest rates. The increase in banks' involvement in the open market resulted in an upward trend in interest rates. Furthermore, the government used overdraft facilities provided by the two state banks to feed short-term funding needs. Higher total contribution was reported to be mainly due to the overdraft facilities provided by the two state banks to the public corporations. As indicated in the CBSL 2001 annual reports, the two state banks provided Rs. 38.1 billion of overdraft facilities to the government in 2001. In the year 2002, the government used market-oriented instruments such as treasury bonds and government restructuring bonds to pay out this debt obligation (People's Bank, 2002 and Bank of Ceylon, 2002).



Source: Various issues of CBSL annual reports.

Fig. 6. Commercial banks' ownership of government debt

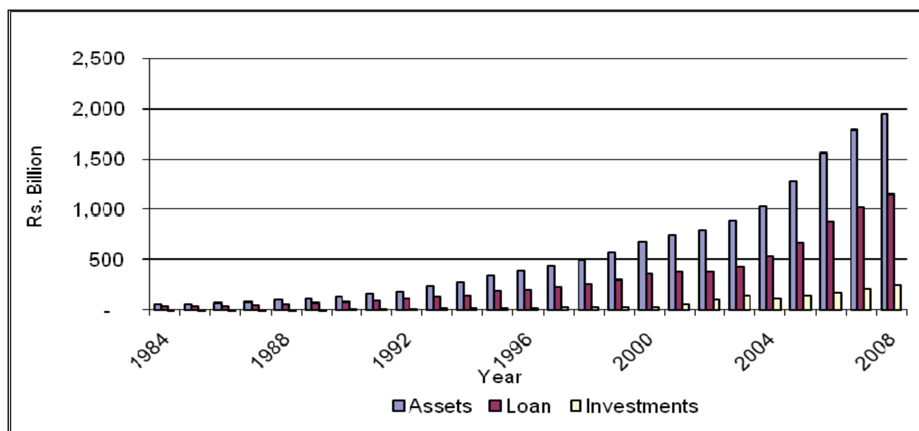
3.3. Total assets and liabilities of commercial banks. A drastic change in the total assets and liabilities base of commercial banks has been recorded during the past three decades (see Figures 7 and 8). Compared to 1987 records, the total assets of commercial banks (Rs. 77 billion) grew by 25 fold (to Rs. 1,948 billion) by 2008. The improvements were mainly achieved by the expansion of the deposit and lending portfolios of commercial banks. Banks' investment portfolios recorded a comparatively slow growth rate. Even though the total assets base significantly increased, total capital contribution recorded a relatively and comparatively small growth rate.



Source: Various issues of CBSL annual reports.

Fig. 7. Funding sources of banks

Figure 7 shows that total deposit base of commercial banks increased substantially throughout the period under review. However, indirect taxes imposed on interest income and debit transactions in current accounts diminished the deposit growth rate.



Source: CBSL annual reports.

Fig. 8. Use of commercial banks assets

Prior to 1977, the local banks used manual procedures for banking activities. Manual processing characteristically took a relatively long time to complete each transaction. The new banks were the first to use ICT in the banking industry in Sri Lanka. They also introduced the uni-banking system to Sri Lanka's financial sector. The new banks pioneered the expansion of automated banking facilities throughout the country. These new trends in the industry first started with the introduction of an automated teller machine in 1986 in its city office of HSBC bank. In the beginning, new banks used ICT to stay ahead of the market. Their success in the application of technology caused the established banks to change from manual procedures to automated operations.

Under the regime before the introduction of financial reforms (before 1977), banks tended to offer very limited services to the market with no encouragement for new banking products. With the opening up of the economy, banks differentiated their product lines by introducing services with various features. During the past two decades, many banks, including the foreign banks, have introduced various competitive preferential deposit and lending schemes.

3.4. Ownership of commercial banks' assets. The financial reforms were also aimed at reducing the state banks' monopoly in the commercial banking sector. The influence of the powerful trade unions has prevented the privatization of the two state banks. The reforms enhanced private sector participation in commercial banking. In 1989, more

than 65 per cent of commercial bank assets were owned by the government sector. However, the proportion of government assets to the total assets of banks declined to 45 per cent in 2008. Figure 9 illustrates the changes in ownership of banking assets during the study period.

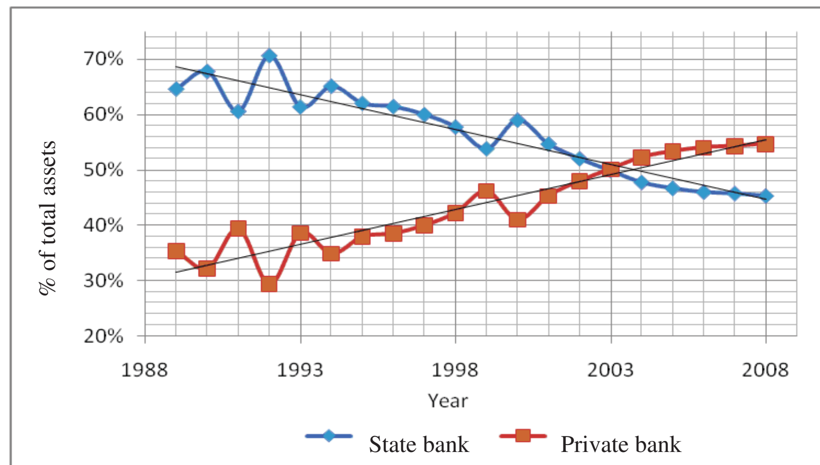


Fig. 9. Ownership of commercial banks assets

3.5. Banking concentration. Consequences of financial reforms are well explained by the structural changes that have taken place in the market. To identify the overall impact of the reforms, this paper used the market concentration ratio of the Sri Lankan banking industry, which is measured using Herfindahl-Hirshman index (HHI)[1]. The HHI has been estimated on the basis of certain market indicators of banking industry available in the annual reports of CBSl such as total deposits, total loans and advances, total assets and total turnover. Table 6 presents the market concentration index for the Sri Lankan banking industry. All estimated concentration ratios have indicated a gradual reduction in market concentration evidencing an increase in the degree of market competition in the banking industry. The resultant changes in market concentration have resulted from the entry of new banks as well as the expansion of operational activities of the existing banks.

Table 6. Degree of market concentration (HH index) of banking industry in Sri Lanka

Year	Deposits	Loan	Total assets	Turnover
1989	26%	35%	27%	25%
1990	26%	33%	27%	25%
1991	25%	29%	25%	24%
1992	23%	25%	24%	22%
1993	22%	25%	23%	22%
1994	22%	25%	22%	22%
1995	21%	24%	21%	22%
1996	21%	21%	21%	21%
1997	20%	21%	20%	21%
1998	19%	20%	19%	19%
1999	18%	18%	18%	19%
2000	18%	19%	19%	18%
2001	17%	20%	18%	18%
2002	17%	17%	16%	17%
2003	16%	16%	16%	15%
2004	16%	15%	15%	15%

[1] $HHI = \sum_{i=1}^{N}\left(\frac{v_i}{V}\right)^2$, N = Number of firms, v_i = market share of ith firm, V = Total market share .

Conclusions

This paper examined the extent of regulatory reforms in the financial services sector and their influence on the banking industry in Sri Lanka. The analysis in the paper has found that the financial services sector in Sri Lanka has experienced a gradual reform process. However, reforms were not undertaken at the same speed throughout the study period. Socioeconomic barriers such as leftwing political upsurge, civil war and the influence of trade unionists have slowed down the speed of reforms. Further, the policy makers have not capitalized on all favorable opportunities to introduce reforms.

Moreover, the analysis has found that the reforms have affected the structure of the banking sector, generating significant improvements in banking activities during the period under review.

The analysis also found an increase in the contribution of the financial services sector to GDP and a deepening of the sectors' operations. Improvements were observed in the institutional infrastructure of the financial services sector and the asset and deposit bases of commercial banks. There was a reduction in government ownership of commercial banks' assets during the period under review. While interest rate margin exhibited a negative trend, the government relied heavily on commercial banks for budget-deficit financing. Further, a reduction in bank concentration was observed.

The banking industry in Sri Lanka has gained improvements in terms of depth of the industry (new entrants, number of branches, foreign banks

involvement, total assets) and resilience (on responding to the concurrent regulatory reforms). Furthermore, these reforms have changed the technology used and the products offered by the banking sector. The changes in market structure have intensified competition not only in the banking industry but also in the overall financial services sector. Diversification of operational activities of banking firms has changed the relative importance of the traditional sources of income of the banking sector, from reliance on interest earned to greater emphasis on fees earned.

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