

BOX II - 1

MODERNISATION OF THE CENTRAL BANK OF SRI LANKA

1. Introduction

The ever-occurring complexities in financial markets and new thinking on both the economic policy and the role of central banks in a changing world have necessitated the central banks world-over to change themselves in order to build capacity to perform effectively. The Central Bank of Sri Lanka (CBSL), established in 1950, had gone through changes from time to time, but the need for a comprehensive modernisation was more urgently felt after the Bank commenced the rebuilding process following the bomb explosion of 1996. During this phase, the Bank was able to perform all its functions effectively without any disruption to its operations, with limited staff and office space. This confirmed the earlier realisation that the Bank could function effectively with a lesser number of staff, by refocussing on its core functions. The modernisation programme was in-house developed by the staff of the Bank who met for this purpose in several retreats during 1998 – 2000. Finally, it got started formally in 2001.

2. Modernisation Programme

The objective of the modernisation was to create a lean and efficient central bank on modern lines. It required the upgrading of systems and procedures, improving the governance system and establishing a core financial system infrastructure to satisfy the needs of an evolving economy that has to keep pace with the changing world.

The programme was implemented during 2001-2005 at a cost of US \$ 37 million. The Central Bank financed US \$ 10.7 million, while the World Bank and the Swedish International Development Cooperation Agency (SIDA) funded US \$ 25.3 million (soft loan) and US \$ 1 million (grant), respectively.

3. Key Components of Modernisation

The modernisation programme had the following key components:

- (a) Legal and organisational changes
- (b) Human resource (HR) reforms and development
- (c) Introduction of new technology
- (d) Improvement in the governance system

4. Score-card on the achievements

(a) Legal and organisational changes				
No.	Issue	Change Effected	Year of Completion	Outcome of the Change
1.	Existence of multiple objectives	Amendment of the MLA to have 2 core objectives viz. economic and price stability and financial system stability	2002	<ul style="list-style-type: none"> • CBSL can now pay its full attention to the realisation of its core objectives efficiently without being distracted by other incidental activities.
2.	Financial sector legislations not in line with modern banking activities	Amendments to the MLA and the Banking Act and drafting of new legislation	2002 and 2004	<ul style="list-style-type: none"> • Upto date legislation for the financial sector thereby facilitating the implementation of modern banking activities.
3.	Organisation structure not suitable to carryout the revised functions of the modernised Bank	Establishment of a new organisation structure aligning it to the new objectives	Mostly completed by 2004. On-going	<ul style="list-style-type: none"> • Bank has a lean organisational structure with the ability to measure output and steer through the entire modernisation programme
4.	Implementation of non-core activities	Divestiture and outsourcing of non-core/agency functions	2003	<ul style="list-style-type: none"> • Facilitates to perform the core functions better with less number of staff.

(b) Human resource reforms and development				
<i>No.</i>	<i>Issue</i>	<i>Change Effected</i>	<i>Year of Completion</i>	<i>Outcome of the Change</i>
1.	HR policies failing to keep pace with the changing practices	Introduction of progressive human resource management and development policies such as merit based performance evaluation system, incentive payments, consolidated compensation, etc.	On-going	<ul style="list-style-type: none"> • The development of a human capital stock that could harness its maximum potential for the realisation of the goals of the Bank. • Makes the Bank a model and progressive employer
2.	Human capital stock not developing on modern lines	Comprehensive training, promotion of a learning culture and establishment of a Management Development Center	On-going	<ul style="list-style-type: none"> • Upgrading of skills done by the employees themselves in a sustainable manner. • The Bank has been converted into a learning organisation
3.	The existence of excess staff over the needs of the Bank	Offered a Voluntary Retirement Scheme	2001	<ul style="list-style-type: none"> • Lean organisation capable of handling the operations effectively. • Retention of a committed staff
4.	Recruitment of staff to suit the modern bank	New policies regarding entry and exit from the Bank and portability of pensions	On-going	<ul style="list-style-type: none"> • Availability of a stock of competent employees
(c) Introduction of new technology				
1.	Risky and inefficient payment system	Payment reforms through the introduction of RTGS/SSSS, Cheque Imaging and Truncation System and legislation to govern payment and settlement systems	2003/2004 and 2005	<ul style="list-style-type: none"> • Mitigation of settlement risk • Increased the efficiency of the payment system • Established a safe payment and settlement system • Standard time schedule for clearance of cheques throughout the island. • Provides CBSL with oversight and regulatory powers over payment systems • Enables electronic presentment of cheques

(d) Improvement in the governance system, management of core-functions				
<i>No.</i>	<i>Issue</i>	<i>Change Effected</i>	<i>Year of Completion</i>	<i>Outcome of the Change</i>
1.	The need for harmonising with global trends with accounting and auditing	Adoption of International Accounting and Auditing Standards as accounting and auditing framework in addition to the auditing done by Auditor General	2002	<ul style="list-style-type: none"> Central Bank's accounting system is harmonised with global accounting trends.
2.	Inadequate transparency and accountability	Streamlined the decision making process through the creation of advisory technical committees, expansion of the Monetary Board and adoption of improved disclosure policies.	2003	<ul style="list-style-type: none"> Practice of good governance Infusion of more diverse skills and experience Informed decision making by market participants
3.	Manual and <i>ad-hoc</i> accounting and related systems	Automation of the general ledger and introduction of the Treasury Dealing Room Management System	2004	<ul style="list-style-type: none"> Integration of central banking functions into a seamless accounting and management information system Adoption of international best practice Improved management of foreign assets portfolio and related risks.
4.	Need for streamlining the monetary policy action procedures	Establishment of a standing Monetary Policy Committee consisting of senior staff to advise the Monetary Board	2003	<ul style="list-style-type: none"> Regular review of the monetary policy stance and the issue of the results on a pre-announced calendar to keep the market informed.
5.	Need for improving financial system stability action	Establishment of a Financial Stability Committee consisting of the senior staff to advise the Monetary Board.	2003 and on-going	<ul style="list-style-type: none"> Continuous review of system stability, publication of stability reports
6.	Need for an independent assessment of the governance in the Bank.	Establishment of an Audit Committee consisting of a Monetary Board member and senior partners representing two leading international audit firms in Sri Lanka.	2001 and on-going	<ul style="list-style-type: none"> Guiding the preparation of the financial statements of the Bank on the basis of International Accounting Standards. Better systems, procedures and controls. Establishment of a risk management framework Adoption of international best practice of central banks.

Accounts and Finance

Statement of Accounting Policies

(1) Reporting Entity and Statutory Base

These are the financial statements of the Central Bank of Sri Lanka ("Bank" or "CBSL"), the institution established under the Monetary Law Act, No. 58 of 1949 of Sri Lanka as amended ("MLA"), as the authority responsible for the administration, supervision and regulation of monetary, financial and payment system of Sri Lanka. These statements are applicable to the financial year ended 31 December 2004.

(2) Basis of preparation

The financial Statements are prepared on the historical cost basis, except for land & building, trading and available-for-sale securities that have measured at fair value as identified in specific accounting policies below.

(3) Currency of Presentation

All amounts in Sri Lanka Rupees are expressed in thousands, unless otherwise stated.

(4) Statement of Compliance

These financial statements of the Central Bank of Sri Lanka for the year ended 2004 have been prepared in accordance with International Financial Reporting Standards (IFRS)

(5) Foreign Currency Conversions

Transactions in foreign currencies have been converted to Sri Lanka rupees using exchange rates applicable to the trade date of transactions. Monetary assets and liabilities denominated in foreign currencies are reconverted at the exchange rates prevailing on the balance sheet date. All differences are taken in to the Income Statement. For the purpose of reconversion, the following Sri Lanka rupee exchange rates for major currencies were used:

TABLE II – 1
Exchange Rates as at Balance Sheet Dates

	Rs. per unit of Foreign Currency	
	2004	2003
Euro	142.3203	121.6048
Sterling pounds	201.3699	172.1988
Indian rupees	2.3954	2.1247
Japanese yen	1.0179	0.9044
United States dollars	104.6050	96.7382
Special Drawing Rights (SDR)	162.4520	143.7500

(6) Financial Assets and Liabilities

The Bank presents financial assets and liabilities, and the associated income and expense streams, by distinguishing between foreign currency and local currency activities. Foreign currency activities mainly arise from the Bank's foreign

reserves management function. Local currency activities mainly reflect the assets and liabilities associated with monetary policy implementation, investment of rupee proceeds of issuing currency and CBSL's banking activities.

The separate reporting of these activities is considered to provide a better presentation of the Bank's financial position, financial performance and risk profile. The Bank considers that the combined reporting of foreign and local currency activities would weaken the informational value of the financial statements.

All investments are initially recognised at cost, being the fair value of the consideration given and including acquisition charges associated with the investment. After initial recognition, subsequent measurement bases are described below. All regular way purchases and sales of financial assets (ones that require delivery of assets within the time frame generally established by regulation or convention in the market place) are recognised on the trade date.

6.1 Foreign Currency Trading Securities

Foreign currency trading securities are subsequently valued at quoted market prices. Changes in market value are recognised as an increase or decrease in the value of the trading securities in the Balance Sheet, while resulting gains and losses are recognised in the Income Statement.

Where the security is still owned, the gain or loss is reported as gain (loss) from unrealised price revaluations. Where the gain or loss has been realised (through selling the security), this is reported as gain (loss) realised from price changes.

6.2 Foreign Currency Available-for-Sale Securities

Foreign currency available-for-sale securities are subsequently valued at quoted market prices. Changes in market value are recognised as an increase or decrease in the value of the available-for-sale securities in the Balance Sheet under reserves.

Gains and losses arising from changes in the market value of foreign currency available-for-sale securities are recognised on a separate component of equity (shown under reserves in the Balance Sheet) until the investment is sold, collected or otherwise disposed of, or until the investment is determined to be impaired, at which time the cumulative gain or loss previously reported as equity is included in income.

6.3 Trading Securities- Gold

Gold securities held with foreign counter-parties is initially stated at cost. Changes in market value are recognised as an increase or decrease in the value of the gold in the Balance Sheet.

Gains and losses arising from changes in the market value of gold are recognised in the Income Statement. Where the gold is still owned, the gain or loss is reported as gain (loss) from unrealised price revaluations. Where the gain or loss has been

CENTRAL BANK OF SRI LANKA

Income Statement

For the Year ended 31 December 2004

	Note	2004 (Rs. '000)	2003 (Rs. '000)
OPERATING INCOME :			
Income from Foreign Currency Financial Assets			
Interest Income	15	6,021,254	5,103,780
Gain (Loss) from Unrealized Price Revaluations		185,631	(1,873,732)
Gain (Loss) Realized from Price Changes		1,769,157	1,411,203
Total Income from Foreign Currency Financial Assets		7,976,042	4,641,251
Expenses on Foreign Currency Financial Liabilities			
Interest Expenses	16	(1,236,140)	(919,300)
Total Expense on Foreign Currency Financial Liabilities		(1,236,140)	(919,300)
Net Foreign Exchange Revaluation Gain		18,453,354	6,903,079
Foreign Currency Investment Income		25,193,256	10,625,030
Income from Local Currency Financial Assets			
Interest Income	15	4,339,104	4,329,656
Interest Expense		(506,938)	(986,032)
Total Income from Local Currency Financial Assets		3,832,166	3,343,624
Other Income	17	813,015	739,697
Total Net Operating Income		29,838,437	14,708,351
OPERATING EXPENSES :			
Personnel Expenses	18	(1,547,601)	(1,822,266)
Depreciation		(359,677)	(422,530)
Cost of Inventory		(1,089,207)	(1,064,409)
Administration	19	(522,883)	(383,845)
Bad & Doubtful Debts and Net Sundry Write Offs		(46,753)	(8,598)
Total Operating Expenses		(3,566,121)	(3,701,648)
Profit from Operating Activities before Income Tax		26,272,316	11,006,703
Income Tax		(589,029)	(188,397)
Net Profit from Ordinary Activities		25,683,287	10,818,306

CENTRAL BANK OF SRI LANKA

Balance Sheet

As at 31 December 2004

	Note	2004 (Rs. '000)	2003 (Rs. '000)
ASSETS			
Foreign Currency Financial Assets			
Cash Balances	1	143,510,890	77,940,229
Foreign Currency Trading Securities	2	44,768,751	84,932,644
Trading Securities Denominated in Gold	2	7,620,907	6,654,602
Foreign Currency Available For Sale Securities	2	21,377,058	49,329,149
Other Foreign Receivables		151,423	82,670
IMF Related Assets	3	67,177,196	59,486,061
		284,606,225	278,425,355
Local Currency Financial Assets			
Investment Portfolio – Sri Lanka Government Securities		82,839,235	33,182,981
Loans to Government	4	34,791,100	31,203,900
Loans to Other Institutions	5	29,878	29,878
Other Local Receivables		696,755	705,415
Investments in Financial and Other Institutions	6	501,641	599,529
		118,858,609	65,721,703
Other Assets			
Inventory	7	950,789	497,491
Gold Inventory		59,766	59,766
Sundry Assets		1,399,073	1,324,063
Property, Plant and Equipment	8	8,238,062	8,554,160
		10,647,690	10,435,480
		414,112,524	354,582,538
LIABILITIES AND EQUITY			
Foreign Currency Financial Liabilities			
Amount Payable to Bank and Financial Institutions	9	4,758,324	5,616,874
Amount Payable to Asian Clearing Union		37,899,263	17,603,949
IMF Related Liabilities	10	101,645,332	100,784,234
Other Foreign Liabilities		128,346	31,668
		144,431,265	124,036,725
Local Currency Financial Liabilities			
Balances with Banks and Financial Institutions		55,051,087	42,641,572
Balances with Government and Government Entities	11	892,435	1,024,913
Securities Sold under Agreement to Repurchase		7,213,000	20,974,201
Balanced with Employee Benefit Plans	12	7,525	152,168
Other Local Payables		717,364	891,686
		63,881,411	65,684,540
Other Liabilities			
Currency in Circulation		115,908,969	98,784,636
Deferred Government Grants		429,459	588,781
Provisions	13	465,334	1,012,795
Miscellaneous Liabilities		99,464	331,364
		116,903,226	100,717,576
Shareholders Equity			
Capital	14	15,000	15,000
Reserves		88,881,622	64,128,697
		414,112,524	354,582,538

AUDIT OPINION

The accounts of the Central Bank of Sri Lanka for the year ended 31 December 2004 were audited under my direction in pursuance of provision in Article 154 of the Constitution of the Democratic Socialist Republic of Sri Lanka read in conjunction with Section 13 of the Finance Act, No.38 of 1971 and Section 42(2) of the Monetary Law Act (Chapter 422).

I am of opinion so far as appears from my examination and to the best of my information and according to the explanations given to me, the financial statements have been prepared and presented in accordance with the Sri Lanka Accounting Standards and the stated accounting policies as set out in Notes 01 to 24 to the financial statements and give a true and fair view of the financial position of the CBSL as at 31 December 2004 and the financial results and cash flow for the year then ended.

In terms of Section 42(2) of the Monetary Law Act, my observations on these accounts are contained in my report of even date addressed to the Minister of Finance.

Auditor-General's Department
Colombo 7.
12 April 2005

S. C. Mayadunne
Auditor-General

S. Mendis
Governor

D. L. Katuwawala
Chief Accountant

CENTRAL BANK OF SRI LANKA

Cash Flow Statement

For The Year Ended 31 December 2004

	Note	2004 (Rs. '000)	2003 (Rs. '000)
CASH FLOW FROM OPERATING ACTIVITIES :			
Source:			
Interest Received – Foreign Currency		6,429,721	4,352,505
Interest Received – Local Currency – Others		43,641	68,740
Liquidity Management and Trading Income		1,769,157	1,411,203
Realised Exchange Gain / (Loss)		(35,947)	(359,933)
Fees, Commission and Other Miscellaneous Income Received		304,009	761,815
		8,510,581	6,234,330
Disbursements:			
Interest Paid – Foreign Currency		1,166,276	921,403
Interest Paid – Local Currency		335,991	986,032
Payments to Employees		989,528	975,045
Payments to Suppliers		3,525,649	1,161,205
Income Tax Paid		567,029	188,397
		6,584,473	4,232,082
Net Cash Flow from Operating Activities	20	1,926,108	2,002,248
CASH FLOWS FROM INVESTING ACTIVITIES :			
Source:			
Net (Increase) / Decrease in Other Local Currency Financial Assets		(75,484)	(65,576)
Principal recoveries from the Loans and Advances to Other Institutions		79,258	121
Disposal / Redemption of Investments in Financial and Other Institutions		119,685	43,563
Sale of Property, Plant and Equipment		267	567
Income on Investments in Financial and Other Institutions		86,412	117,953
Net Increase in Securities Purchased under Agreement to Re-sell		(13,761,201)	9,818,516
		(13,551,063)	9,915,144
Disbursements:			
Net Increase / (Decrease) in Foreign Currency Marketable Securities		(77,194,471)	38,025,386
Net Increase / (Decrease) in Other Foreign Currency Financial Assets		(58,635)	(170,732)
Net Increase / (Decrease) in Other Foreign Currency Financial Liabilities		(18,507,734)	(9,948,239)
Net Increase / (Decrease) in Other Local Deposits & Payables		144,643	41,680
Purchase of Property, Plant and Equipment net of Grants		42,421	260,702
Net Increase / (Decrease) in Gold Inventory		74,272	–
		(95,499,504)	28,208,797
Net Cash Flow from Investing Activities		81,948,441	(18,293,653)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Source:			
Issue of Circulating Currency		115,993,628	108,826,986
Withdrawal of Circulating Currency		(98,869,295)	(98,350,124)
Net Issue of Circulating Currency		17,124,333	10,476,862
Less:			
Net Issue / (Withdrawals) of Circulation Currency on Government Transactions	21	49,237,087	(23,867,571)
Net Issue / (Withdrawals) of Circulation Currency on Bank and Financial Institutions Transactions	22	(12,409,516)	(4,555,797)
Net Issue / (Withdrawals) of Circulating Currency		(19,703,238)	38,900,230
Additional Foreign Currency Term Liabilities		–	7,197,831
		(19,703,238)	46,098,061
Disbursements:			
Repayment of Foreign Currency Term Liabilities		(11,456,546)	(2,869,497)
Payments of Surplus to Government		(1,000,000)	(10,000,000)
		(12,456,546)	(12,869,497)
Net Cash Flow from Financing Activities		(32,159,784)	33,228,564
Net Increase in Cash and Cash Equivalents		51,714,765	16,937,159
Plus Exchange Rate Effect on Cash and Cash Equivalents		13,855,896	5,129,963
Cash and Cash Equivalents at 1 January		77,940,229	55,873,107
Cash and Cash Equivalents at 31 December	23	143,510,890	77,940,229

CENTRAL BANK OF SRI LANKA

Notes to the Financial Statements

As at 31 December 2004

	2004 (Rs. '000)	2003 (Rs. '000)
Note 1 – Cash and Bank Balances Abroad		
Balances with Overseas Banks	1,070,545	1,172,891
Foreign Notes and Coins Account	1,611	1,081
Time Deposits with Overseas Banks	96,686,319	44,433,079
Fixed Deposits Contracted in	4,485,742	5,439,958
Repurchase Agreement Account with FRB	41,266,673	26,893,220
	143,510,890	77,940,229
Note 2 – Foreign Currency Securities and Gold		
Foreign Currency Trading Securities	44,768,751	84,932,644
Gold Current Accounts and Fixed Deposits	7,620,907	6,654,602
Foreign Currency Available-for-Sale Securities	21,377,058	49,329,149
	73,766,716	140,916,395
Note 3 – IMF Related Assets		
Holding in Special Drawing Rights with IMF	19,539	59,811
IMF Quota	67,157,657	59,426,250
	67,177,196	59,486,061
Note 4 – Loans and Advances to the Government		
Loans and Advances to the Government	34,791,100	31,203,900
	34,791,100	31,203,900
Note 5 – Loans to Other Institutions		
Capital Outstanding	2,547,400	2,626,658
Interest Receivable	4,732,762	4,349,153
Gross Receivable	7,280,162	6,975,811
<i>Less</i> : Provision for Doubtful Debts	(2,517,522)	(2,596,780)
Suspended Interest	(4,732,762)	(4,349,153)
Net Receivable	29,878	29,878
Note 6 – Investments in Financial and Other Institutions		
Regional Development Banks	430,113	517,469
Credit Information Bureau Ltd.	12,278	12,310
National Development Bank Ltd.	26,250	26,250
Fitch Ratings Lanka Ltd.	3,500	3,500
NDB Bank Ltd.	–	10,500
LankaClear (Pvt) Ltd.	29,500	29,500
	501,641	599,529
Note 7 – Inventories		
Notes for Circulation	518,834	286,002
Coins for Circulation	184,325	248,723
Coins in Transit	287,501	–
	990,660	534,725
<i>Less</i> : Allowance for slow moving items	(64,700)	(64,700)
	925,960	470,025
Stationery and Sundry Inventory	24,829	27,466
Total inventories at lower of cost and net realisable value	950,789	497,491

Note 8 – Property Plant and Equipment						
Carrying Value	Land and Buildings	Equipment	Office Furniture & Fixtures	Others	Total 2004	Total 2003
	(Rs. '000)	(Rs. '000)	(Rs. '000)	(Rs. '000)	(Rs. '000)	(Rs. '000)
At 1st January, net of Accumulated Depreciation and Provision for Impairment	7,683,178	713,625	151,447	5,910	8,554,160	8,127,448
Additions	791	18,588	20,066	2,976	42,421	849,484
Disposals, net of Accumulated Depreciation			(61)		(61)	(205)
Effects of Changes in Accounting Estimates					–	(79,789)
Reversal of Allowance for Impairment				1,219	1,219	
Depreciation charge for the year	(114,600)	(216,300)	(25,871)	(2,906)	(359,677)	(342,778)
At 31st December net of Accumulated Depreciation	7,569,369	515,913	145,581	7,199	8,238,062	8,554,160
					2004	2003
					(Rs. '000)	(Rs. '000)
Note 9 – Amount Payable to Banks and Financial Institutions						
Payable to Banks				4,485,742	5,439,958	
Payable to Others				272,582	176,916	
				<u>4,758,324</u>	<u>5,616,874</u>	
Note 10 – IMF Related Liabilities						
Foreign Currency IMF Related Liabilities						
Interest Bearing Loans – Non-Current				26,548,718	33,525,734	
Interest Bearing Loans – Current				4,197,354	4,519,140	
Allocation of Special Drawing Rights				11,512,648	10,187,275	
Other amounts payable to IMF				30,552,522	27,037,469	
Quota Liability				28,834,090	25,514,616	
				<u>101,645,332</u>	<u>100,784,234</u>	
Note 11 – Balances with Government and Government Entities						
Balances with the Government				522,673	568,906	
Balances with Government Entities				369,762	456,007	
				<u>892,435</u>	<u>1,024,913</u>	
Note 12 – Balances with Employee Benefit Plans						
Provident Fund				2,701	107,466	
Pension Fund				2,067	38,767	
Widow and Orphans Fun				2,757	5,935	
				<u>7,525</u>	<u>152,168</u>	
Note 13 – Provisions						
Credit Guarantees				–	168,673	
Employee Retirement Pension Scheme				306,374	712,006	
W& OP Plans				148,860	121,624	
Gratuity				10,100	10,492	
				<u>465,334</u>	<u>1,012,795</u>	

	2004 (Rs. '000)	2003 (Rs. '000)
Note 14 – Equity		
Capital	15,000	15,000
Medium and Long Term Credit Reserve	4,925,000	4,925,000
Surplus	985,000	985,000
Capital Contribution Account	577,859	577,859
Fixed Asset Revaluation Account	662,382	662,382
Market Valuation Reserve – Securities Available for Sale	(185,717)	(275,356)
Control Account Reserve	13,026,726	42,760,506
Profit for the Year	25,683,287	10,818,306
International Reserve Revaluation	43,207,085	3,675,000
	88,896,622	64,143,697
Note 15 – Interest Income from Financial Assets		
Cash Equivalents	2,656,598	1,386,721
Trading and Available for Sale Securities	3,302,531	3,665,204
International Monetary Fund	62,125	51,855
Total Interest Income from Foreign Currency Financial Assets	6,021,254	5,103,780
Net Interest Income from Local Currency Financial Assets		
Investment Portfolio – Sri Lanka Government Securities	4,254,941	3,901,213
Interest Income on Debentures in RRDBs	40,522	45,901
Other Loans and Advances	43,641	382,542
Total Net Interest Income from Local Currency Financial Assets	4,339,104	4,329,656
Total Interest Income from Financial Assets	10,360,358	9,433,436
Note 16 – Interest Expenses on Financial Liabilities		
Asian Clearing Union	179,811	92,070
International Monetary Fund	1,054,075	823,282
Other	2,254	3,948
	1,236,140	919,300
Note 17 – Other Income		
Dividend Income	45,890	78,169
Gain on Disposal of Property, Plant and Equipment	207	363
Gain on Disposal of Investments in Financial and Other Institutions	21,797	213,257
Amortisation of Deferred Grant	159,730	148,710
Miscellaneous Income and Over Provisions Reversals	585,391	299,198
	813,015	739,697
Note 18 – Personnel Expenses		
Wages and Salaries including PAYE paid by the employer	854,362	850,530
Pension Costs	446,518	627,852
Other Defined Benefit Plan Costs	115,484	211,070
Defined Contribution Plan Costs	131,237	132,814
	1,547,601	1,822,266
Note 19 – Administration		
Repairs and Maintenance	272,048	210,125
Information	77,322	57,639
Operational Travel	21,630	–
Rental Expenses	–	15,633
Printing	32,326	36,147
Audit Fees	9,300	825
Remuneration to members of the Monetary Board	795	560
Miscellaneous	109,462	62,916
	522,883	383,845

	2004 (Rs. '000)	2003 (Rs. '000)
Note 20 – Reconciliation of Operating Profit with Operating Cash Flow		
Reported Net Profit from Operating Activities	25,683,287	10,818,305
Add (Subtract) Non-Cash Items		
Depreciation	359,677	422,567
Interest Received – Local Currency – Investment Portfolio	(3,239,803)	(4,807,971)
Bad Debt Write-Off / (Written Back)	(79,258)	8,598
Net Provision for Defined Employee Benefits Plans	358,252	676,991
Net Unrealised Foreign Exchange (Gain) / Loss	(18,489,302)	(7,263,012)
Other Provisions	(906,932)	–
Add (Subtract) Movements in Other Working Capital Items		
(Increase) / Decrease in Inventories	(453,299)	262,854
(Increase) / Decrease in Interest Receivable	(647,192)	155,484
Increase / (Decrease) in Miscellaneous Liabilities	(483,074)	195,448
Increase / (Decrease) in Interest Payable	262,810	(3,162)
Increase / (Decrease) in Other Receivable	(26,213)	–
Add (Subtract) Investing and Financing Activities		
Income from Investments	(67,893)	(337,585)
Net Unrealised Market Value Changes	(185,630)	1,873,731
Deferred Government Grants	(159,322)	–
Net Cash Flow from Operating Activities	<u>1,926,108</u>	<u>2,002,248</u>
Note 21 – Issues / (Withdrawals) of Circulation Currency on Government Transactions		
Maturity of Government of Sri Lanka Securities Portfolio	(78,680,476)	(66,146,340)
Purchases of Government of Sri Lanka Securities for Investment Portfolio	127,281,072	47,376,541
Interest Received – Local Currency – Investment Portfolio	(3,199,282)	(4,807,971)
Increase / (Decrease) in Loans and Advances to GOSL	3,587,200	170,900
(Increase) / Decrease Balances with Government and Government Entities	248,573	(460,701)
	<u>49,237,087</u>	<u>(23,867,571)</u>
Note 22 – Net Issues / (Withdrawals) of Circulation Currency on Bank and Financial Institutions Transactions		
(Increase) / Decrease in Balances with Banks and Financial Institutions	(9,387,516)	(7,577,797)
(Increase) / Decrease Intra-day Liquidity Facility to Banks and Financial Institutions	(3,022,000)	3,022,000
	<u>(12,409,516)</u>	<u>(4,555,797)</u>
Note 23 – Closing Cash Balances		
Foreign Currency Assets		
Cash Balances with Other Foreign Banks	143,510,890	77,940,229
Closing Cash Balances	<u>143,510,890</u>	<u>77,940,229</u>

realised (through selling the gold), this is reported as gain (loss) realised from price changes.

6.4 International Monetary Fund Balances

The Bank transacts with the International Monetary Fund (IMF) in its own right rather than as an agent for the Government of Sri Lanka. All transactions by the Bank with the IMF have been included in these financial statements on that basis.

Quota with the IMF is recorded by the Bank as an asset and the amount payable to the IMF for quota is recorded as a liability of the Bank. The cumulative allocation of SDRs by

the IMF is treated as a liability. Exchange gains and losses arising from revaluation of IMF assets and liabilities at the exchange rate applicable at balance sheet date as published by the IMF are recognised in the Income Statement.

All other charges and interest pertaining to balances with the IMF are recorded immediately in the Income Statement.

6.5 Cash and Cash Equivalents

Cash and cash equivalents comprise cash at foreign banks and financial institutions and short-term deposits with an original maturity of three months or less.

As a part of local currency activities, CBSL generates certain income and incurs expenses, which do not involve in movement of cash. Those activities result in certain assets and liabilities as well and mainly comprise the transactions with GOSL, domestic banks and financial institutions. Transactions with GOSL basically represent the purchase of un-subscribed portions of Treasury bills at the auctions, lending operations as a banker to the government including the provisional advances mentioned under 6.8 of this section. Such purchases, disposals or interest thereon are reflected as mere book entries in the records of CBSL. These are disclosed separately in Note 20, Note 21 and Note 22 to the Financial Statements.

As the sole statutory authority, CBSL issues currency to the public in line with Monetary Law Act. Currency issued by CBSL represents a claim on the bank in favour of the holder. This is a liability on the part of the CBSL while it is an item of cash in the hands of the holder. Movement in circulation currency is included as part of financing activities in line with prevailing industry practice among those central banks which present cash flow statements.

CBSL through the cash/pay order process disburses cash in the form of Notes and Coins or cheques drawn on CBSL, to various drawees including suppliers and employees for goods and services obtained, which are either added to the currency in circulation or Balances with Commercial Banks. Such forms of utilisation of currency for the purposes of CBSL's payments form part of cash outflows of CBSL.

For the purposes of the Cash Flow Statement, cash and cash equivalents consist of cash and cash equivalents as defined above, net of cash pay order outflows.

6.6 Repurchase and Reverse-Repurchase Transactions

Securities sold under agreements to repurchase continue to be recorded as trading or available-for-sale securities in the Balance Sheet. The obligation to repurchase (securities sold under agreements to repurchase) is disclosed as a liability. The difference between the sale and repurchase price in repurchase transactions and the purchase price and sale price in reverse-repurchase transactions represents an expense and income respectively and recognised in the Income Statement.

Securities held under reverse repurchase agreements are recorded as an asset in the Balance Sheet (securities purchased under agreements to re-sell). Both repurchase and reverse repurchase transactions are reported at the transaction value inclusive of any accrued income or expense.

6.7 Investment Portfolio – Sri Lanka Government Securities

The Bank's investment portfolio consists of Treasury bills purchased from Government of Sri Lanka. The portfolio is recorded in the Balance Sheet at amortised cost since they represent loans originated by the Bank.

6.8 Loans to Government

Loans to Government represents direct provisional advances made to Government of Sri Lanka under Section 89 of the Monetary Law Act, No. 58 of 1949 of Sri Lanka, as amended.

6.9 Loans to Other Institutions

Loans granted to other institutions are recognised and carried at the original granted amount less an allowance for any uncollectable amounts. An allowance for doubtful debts (for loan impairment) is established if there is objective evidence that the Bank will not be able to collect all amounts due. The amount of the provision is the difference between the carrying amount and the estimated recoverable amount. Bad debts are written off when identified.

6.10 Foreign Currency Term Liabilities

Foreign currency term liabilities are subsequently reported at the amortised cost of the liabilities. Changes in the value of these liabilities are recognised as an increase or decrease in the value of the term liabilities in the Balance Sheet. Gains and losses arising from changes in value of foreign currency term liabilities are recognised immediately as expenses in the Income Statement. Where the liability is still owed, the gain or loss is reported as (gain) loss from unrealised price revaluation. Where the gain or loss has been realised (through repayment of the liability), this is reported as (gains) losses realised from price changes.

6.11 Derivative Instruments

The Bank's involvement in derivative instruments mainly is in forward foreign exchange contracts. Such derivative financial instruments are stated at fair value. The fair value of forward exchange contracts is calculated by reference to current forward exchange rates for contracts with similar maturity profiles.

All derivative instruments in a gain or loss position, if any, are reported within the balance of foreign currency trading or available-for-sale securities in the Balance Sheet.

6.12 Other Financial Assets and Liabilities

Local and foreign currency cash, deposits and short-term advances are recognised on trade date.

(7) Investments in Associates

The Bank's investments in associates, together with the ones that are held for subsequent disposals are accounted for under cost method.

(8) Gold Inventory

Gold inventory, which is a highly liquid commodity is carried at cost.

(9) Inventories

Inventories are carried at lower of cost or realisable value. Cost is determined on a weighted average basis. Allowance is made for slow moving inventories.

(10) Property, Plant and Equipment

All items of property, plant and equipment are initially recorded at cost. Land and buildings are subsequently re-valued, on an asset-by-asset basis, to their fair values. Revaluations are made with sufficient regularity to ensure that their carrying amount does not differ materially from their fair value at the balance sheet date.

The carrying amounts, of both those revalued and those measured at cost, are reviewed at each balance sheet date to assess whether they are recorded in excess of their recoverable amount, and if carrying values exceed this recoverable amount, assets are written down.

When an asset is revalued, any increase in the carrying amount is credited directly to a revaluation reserve unless it reverses a previous revaluation decrease relating to the same asset which was previously recognized as an expense. In these circumstances the increase is recognized as income to the extent of the previous write down. When an asset's carrying amount is decreased as a result of a revaluation, the decrease is recognized as an expense unless it reverses a previous increment relating to that asset, in which case it is charged against any related revaluation reserve, to the extent that the decrease does not exceed the amount held in the revaluation reserve in respect of that same asset. Any balance remaining in the revaluation reserve in respect of an asset, is transferred directly to retained earnings on retirement or disposal of the asset.

Except for the freehold land, Depreciation is calculated on a straight line method over the following estimated useful lives.

TABLE II – 2
Depreciation of Fixed Assets

Class of Asset	Rate of Depreciation
Freehold Building	Over 50 Years
Leasehold Land & Buildings	Over the lease period
Equipment	5 – 20 Years
Office Furniture & Fixtures	4 – 10 Years
Motor Vehicles	5 Years
AS 400 Computer / network	4-5 Years

Expenditure incurred on repairs or maintenance of property, plant and equipment in order to restore or maintain the future economic benefits expected from originally assessed standard of performance, is recognised as an expense when incurred.

(11) Accounts Receivable

Accounts receivable are carried at expected realisable value after making due allowance for doubtful debts.

(12) Sundry Assets

Sundry assets are carried at expected realisable values.

(13) Provisions

Provisions are recognised when the Bank has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where the Bank expects a provision to be reimbursed, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

(14) Currency in Circulation

Currency issued by the Central Bank of Sri Lanka represents a claim on the Bank in favour of the holder. The liability for Currency in Circulation is recorded at face value in the Balance Sheet.

(15) Employee Benefits***Pensions***

The Bank operates a defined benefit pension scheme for employees who had joined the Bank before 01 January 1998. The pension scheme is not open to the new entrants to the Bank from 01 January 1998. This is a non-contributory pension scheme, where the cost of benefits is wholly borne by the Bank. Contributions are made by the Bank to a separately administered fund. The cost of providing benefits under this plan is determined using the projected unit credit actuarial valuation method. Actuarial gains and losses are recognised as income or expense when the cumulative unrecognised actuarial gains or losses for each individual plan exceed 10 per cent of the higher of defined benefit obligation and the fair value of plan assets. These gains or losses are recognised over the expected average remaining working lives of the employees participating in the plans.

Retirement Gratuity

The retirement gratuity is a defined benefit plan. The Bank is liable to pay gratuity for the employees who are not eligible for pension scheme. In order to meet this liability, a provision is carried forward in the balance sheet, equivalent to an amount calculated using a formula based on a half month's salary of the last month of the financial year of eligible employees for each completed year of service, commencing from the first year of service. The resulting difference between the brought forward provision at the beginning of a year and the carried forward provision at the end of a year represents a charge to the Income Statement. The gratuity liability is neither funded nor actuarially valued. This item is grouped under provisions in the Balance Sheet.

Employees' Provident Fund and Employees' Trust Fund

Employees are eligible for Employees' Provident Fund contributions and Employees' Trust Fund contributions in line

with respective statutes and regulations. The Bank contributes 24 per cent and 3 per cent of employees' gross emoluments to Employees' Provident Fund and Employees' Trust Fund, respectively, which are separately administered defined contribution plans.

(16) Grants

Grants recognised at their fair value where there is a reasonable assurance that the grant will be received and all attaching conditions, if any, will be complied with, are shown under equity. When the grant relates to an expense item it is recognised in the Income Statement over the periods necessary to match them to the expenses it is intended to compensate on a systematic basis. Where the grant relates to an asset, the fair value is credited to a deferred government grant account and is released to the Income Statement over the expected useful life of the relevant asset on a systematic basis consistent with the depreciation policy of the related asset.

(17) Personnel Expenses

Personnel expenses include the full cost of all staff benefits. Salaries, related expenses and leave accrued at year-end are included in other local payables.

(18) Operating Leases

Where the Bank is the lessee, the lease rentals payable on operating leases are recognised in the Income Statement over the term of the lease on a basis consistent with the expected benefits derived from the leased assets.

(19) Income Tax

The income of the Bank other than dividend or interest or discount payable or allowable by the Bank on any deposit of money including Treasury bills, Treasury bonds is exempt from tax under section 8 (a) xxii of the Inland Revenue Act, No. 38 of 2000. As per the Inland Revenue (Amendment) Act, No. 10 of 2002, such dividend or interest or discount payable will be liable to 10% withholding tax at the time of payment or crediting of such interest.

(20) Trust and Custodial Activities

Amounts administered by the Central Bank of Sri Lanka under custodial and administration arrangements are not included in these financial statements.

(21) Revenue and Expenses

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Bank and the revenue can be reliably measured. Expenses are recognised in the income statement on the basis of a direct association between the cost incurred and the earning of specific items of income. All expenditure incurred in the running of the business and in maintaining the property, plant & equipment in a state of

efficiency has been charged to income in arriving at the profit for the year.

The following specific recognition criteria must also be met before revenue and expenses are recognised:

21.1 Interest

Interest income and expense are recognised in the income statement for all interest bearing instruments on an accrual basis using the effective yield method based on the actual purchase price unless collectibility is in doubt. Interest income includes coupons earned on fixed income investment and trading securities and accrued discount and premium on treasury bills and other discounted instruments. Interest income is suspended when loans become doubtful of collection. Such income is excluded from interest income until received.

21.2 Dividends

Dividend income is recognised when the shareholder's right to receive the payment is established.

21.3 Miscellaneous

Miscellaneous income and expenses are recognised on an accrual basis.

Net gains and losses of a revenue nature on the disposal of property, plant & equipment have been accounted for in the income statement, having deducted from proceeds on disposal, the carrying amount of the assets and related selling expenses. On disposal of revalued property, plant & equipment, any amount remaining in revaluation reserve relating to that asset is transferred directly to accumulated profit.

Gains and losses arising from incidental activities to the main revenue generating activities and those arising from a group of similar transactions which are not material, are aggregated, reported and presented on a net basis.

(22) Reporting Format

The Bank presents financial assets and financial liabilities, and their associated income and expense streams, by distinguishing between foreign currency and local currency activities. The Bank considers that this reporting approach provide appropriate reporting of the Bank's activities, which are more fully described under nature and extent of activities.

(23) Contingencies and Commitments including Off Balance Sheet Items

All guarantees of indebtedness, forward foreign exchange transactions and other commitments, which represents off balance sheet items are shown under respective headings recognised as off balance sheet items.

(24) Nature and Extent of Activities

The Monetary Board of the Central Bank of Sri Lanka shall, in addition to determining the policies or measures authorized to be adopted or taken under Monetary Law Act, No. 58 of

1949 of Sri Lanka as amended, be vested with the powers, duties and functions of the Central Bank and be generally responsible for the management, operations and administration of the Bank. The Bank is primarily responsible for the administration supervision and regulation of monetary, financial and payment systems in Sri Lanka and also acts as the fiscal agent of the Government. The activities of the Bank mainly include:

- Implementing monetary and exchange rate policies.
- Issuing currency.
- Facilitating free competition and stability in the financial system.
- Licensing and supervision of defined financial institutions.
- Organisation and management of the inter-bank settlement system and promotion of the smooth functioning of the payments system.
- Providing loans and advances to the Government, bank's and financial institutions under various facilities.
- Acting as a depository of the Government under specific arrangements with Government and agencies acting on behalf of the Government.

The activities carried out in order to achieve its objective of economic, price and financial system stability with a view to encouraging and promoting the development of the productive resources of Sri Lanka, can be broadly segregated into foreign currency and local currency activities.

Foreign Currency Activities

Foreign currency activities result mainly from the Central Bank of Sri Lanka's holdings of foreign currency assets under its foreign reserves management function. The foreign reserves management portfolio comprises foreign currency assets held for foreign exchange intervention purposes ("foreign reserves") and other foreign currency assets held for trading purposes.

The foreign currency assets are held in various currencies. The majority are denominated in United States dollars, Euros, Sterling pounds and Japanese yen. The financial instruments held within these foreign currency portfolios consist mainly of sovereign securities, securities held under reverse repurchase transactions or balances held with other central banks, commercial banks and settlement institutions.

The Central Bank of Sri Lanka also holds, from time-to-time, foreign currency assets and liabilities that arise from domestic market operations.

Local Currency Activities

Local currency activities arise as follows:

- (i) Liquidity management operations: Liquidity management largely involves the Central Bank of Sri Lanka offsetting the daily net flows to or from government or market by advancing funds to or withdrawing funds from the banking

system. Most of this business is undertaken through daily open market operations.

- (ii) Holding an investment portfolio comprising Sri Lanka government securities to support the liability for currency in circulation and representing the investment of the Central Bank of Sri Lanka's net equity. The Bank's policy is to hold these investments for open market operations.

Bank Supervision

The regulatory and supervisory function of the Central Bank relating to banks licensed by the Monetary Board of the Central Bank is carried out by the Bank Supervision Department (BSD), with a view to ensuring the safety and soundness of the banking system and safeguarding the interests of depositors. As at end of 2004, 36 licensed banks, *i.e.*, 22 licensed commercial banks (LCB) and 14 licensed specialised banks (LSB), were in operations under the supervision of the Central Bank. The operations of the BSD in 2004 mainly included the following:

(a) Issue of Prudential Regulations

The BSD issued several prudential regulations and guidelines to the licensed banks in 2004 covering the areas of capital adequacy ratios, credit ratings, external auditors, statutory liquid assets ratio, professional valuation reports on property mortgaged to banks, single borrower limit, classification of bad and doubtful debts, shipping guarantees issued by banks, withdrawal from savings accounts and accounting for properties acquired by foreclosure of collateral as part settlement of debts. These regulations and guidelines appear in detail in another part of this report.

(b) Approvals for Banks, Branches and Other Banking Outlets

During the year 2004, the BSD continued to process requests made by LCBs and LSBs for approval for the opening and relocation of branches in terms of the Banking Act. During the year, approvals granted in this regard included 22 new branches, relocation of 50 branches, 20 new other banking outlets such as pay offices, pawning centers and student savings units, 11 relocations and 4 up-grading of such other banking outlets, 9 off-site Automated Teller Machines (ATMs) and one relocation of ATM. Accordingly, there were 1,481 branches, 970 other banking outlets and 829 ATMs in operations as at the end of 2004. The setting-up of the SME Bank Ltd. as a LSB by the Government in terms of a Budget proposal of 2005 was approved by the Monetary Board and a license was issued.

(c) Off-Site Surveillance of Licensed Banks

The BSD monitors the financial condition of LCBs and LSBs on the basis of periodic information provided by the banks on their operations. The information gathered is analysed to

ascertain the risk exposure of individual banks and of the banking system as a whole. It helps in identifying significant and critical changes in the financial condition of banks and serves as an early warning system to indicate vulnerabilities of particular banks or areas that require further investigation and examination. In order to upgrade the current off-site surveillance system, a decision was made in 2004 to implement a new system of on-line central database in the Central Bank covering the banking industry and registered finance companies to monitor fully their operations with a view to promoting the stability of the financial system as a whole. In 2004, this database was at the testing stage.

(d) Statutory On-site Examinations of Licensed Banks

In terms of the provisions of the Monetary Law Act, all LCBs are subject to statutory examinations, at least once during each examination period as determined by the Monetary Board, which at present is two years. Statutory examinations on LSBs are conducted in terms of the provisions of the Banking Act. The BSD has now fully adopted the new approach – the risk based examination process, which focuses on identification of banking risks, the management of these risks and the assessment of the adequacy of resources to mitigate these risks. In 2004, the BSD undertook 31 statutory examinations, which included 20 examinations that commenced in 2004 and the completion of 11 examinations that commenced in 2003. The examinations of 10 banks out of 20 that commenced in 2004 were completed and other 10 examinations await completion. Accordingly, the BSD completed 21 examinations in 2004.

(e) Suspension of Business of Pramuka Savings & Development Bank Ltd. (PSDB)

Following the suspension of the business of PSDB in October 2002, the Monetary Board decided to cancel the banking license of the PSDB and to issue an order in terms of the provisions of the Monetary Law Act to the Director of Bank Supervision to take action to wind up the PSDB. This decision was conveyed to the PSDB on 18 December 2002. However, in terms of subsequent judgments of the Court of Appeal and the Supreme Court on Court cases filed by groups of depositors and the management of the PSDB challenging the decision of the Monetary Board, the Central Bank considered further the options to resume the business of the PSDB in terms of the law. In this regard, several parties expressed interest in restructuring the PSDB and to resume its business.

The Central Bank had discussions with the parties who furnished proposals/concept papers in this regard. Messrs. Ernst and Young were appointed as the Central Bank's Consultants for this purpose. The Monetary Board considered the proposal

made by the consortium of investors led by Asia Capital Ltd. (Consortium). The Monetary Board was of the opinion that despite certain concerns, and the fact that the implementation of this proposal involves the fulfillment of several conditions precedent, the feasibility of the proposal could not be completely ruled out. In arriving at this decision, the Monetary Board also took cognizance of the fact that even though the depositors may finally receive a sizable amount of the capital of deposits in a liquidation, there were other creditors such as those who have invested funds in money market bills of the PSDB who would not have qualified for any repayment in a liquidation, as they would not be treated as depositors in a liquidation. Pending the Consortium carrying out a due diligence to finally determine whether they would undertake the restructuring of the PSDB to enable it to continue to carry on business, the Monetary Board decided that the PSDB be permitted to resume limited business with effect from 22 January 2004, in terms of Section 30(3) of the Monetary Law Act, subject to specified conditions.

The Central Bank had several discussions and correspondence with the Consortium and provided the financial information necessary to proceed with the proposal. In the process, the Consortium revised its proposal three times since the initial proposal that was submitted on 24 December 2003. The Monetary Board directed the Director of Bank Supervision to obtain an independent opinion from Messrs. Ernst and Young on the merits of the proposed settlement of deposits by the Consortium vis-a-vis the liquidation option. Accordingly, the Consultants opined that liquidation would be a better option in the interest of the depositors. An independent evaluation by the Central Bank also revealed that the depositors would be better off under liquidation rather than under the proposal submitted by the Consortium. According to the estimates made by the Central Bank on the basis of a conservative valuation of the assets of PSDB, the liquidation could result in the repayment to 70 per cent of depositors compared to 63 per cent to be repaid by the Consortium over a period of 10 years. Further, the Consortium was requested to obtain the consent of the depositors and creditors of the PSDB for the proposed repayment of deposits and debts. However, the Consortium could not obtain the consent for 31 per cent of deposits and debts.

Taking into account, inter alia, the above matters, the Monetary Board decided on 3 August 2004 to suspend the business of the PSDB in terms of Section 76M(1) of the Banking Act and to cause the Director of Bank Supervision to make application to the competent court to wind up PSDB under Section 30(3) of the Monetary Law Act and to cancel the banking license of PSDB in terms of Section 30(10)(b) of the Monetary Law Act. Accordingly, the Director of Bank Supervision filed action bearing No.168/CO in the District Court of Colombo for the winding-up of PSDB. Subsequent to the filing of the action for liquidation, a depositor of the

PSDB filed action bearing no. 1955/2004 in the Court of Appeal seeking to quash the decision of the Monetary Board to liquidate the PSDB and to cancel its license. An interim order was issued by the Court of Appeal staying the winding up proceedings until the hearing and final determination of the Court of Appeal application. The Central Bank informed the general public of the above decision of the Monetary Board with the relevant details through the print and electronic media.

(f) Administration of the Deposit Insurance Scheme

The BSD continued to administer the voluntary Deposit Insurance Scheme, which commenced operations in 1987. This scheme was opened to banking institutions licensed by the Central Bank and co-operative societies registered under the Co-operative Societies Law, No.5 of 1972, which accept deposits. At present, only three Multi-Purpose Co-operative Societies have obtained insurance cover under the scheme in respect of deposit liabilities of their rural banks. The deposit insurance fund consisting of the premium collected and Rs.50 million allocated by the Central Bank in 1997 stood at Rs.171 million as at 31 December 2004. These funds have been invested in Treasury bills and Treasury bonds of which the value has now risen to Rs.193 million. In addition, the BSD has submitted a policy paper and had discussions on the proposal for a mandatory deposit insurance scheme which would replace the current voluntary scheme. The proposal has been forwarded to the Financial Sector Cluster of the National Council for Economic Development (NCED) for further decision.

(g) Meetings with Banking Industry

The BSD arranged the following meetings in 2004

- i. Monthly meetings of the Governor with Chief Executive Officers of Banks:** These meetings serve as a forum for exchange of views on issues and policies relating to banking operations and help to establish a rapport between the banks and the Central Bank. Some of the major issues that were discussed at the meetings included constraints faced by customers in obtaining facilities from banks, unauthorized use of international credit cards for network marketing pyramids and adherence to “know your customer rules”, the high intermediation cost of the commercial banking sector and the need for appropriate action by the banks to reduce the interest spread, obtaining credit ratings and the proposal for implementation of the Basel II Capital Accord. In addition, the CEOs were regularly apprised of economic and monetary developments in the country with a view to providing information useful for making more informed business decisions.

ii. Meetings of two Committees on Financial System Stability and Reforms

- 1. Financial Sector Reforms:** The Financial Sector Reforms Committee (FSRC) established by the Central Bank in March 2002 to undertake actions necessary to initiate, coordinate and implement financial sector reforms had 10 meetings in 2004 until it was discontinued in June 2004, when the Financial Sector Cluster (FSCL) was set up under the National Council for Economic Development (NCED) appointed by H.E. the President in June 2004. Two key objectives of the FSCL were the formulation of policies to promote financial stability and to increase access to finance by local entrepreneurs, Small and Medium Enterprises (SMEs) and the rural sector. The FSCL, co-chaired by the Deputy Governor of the Central Bank and Deputy Secretary to the Treasury, has 11 members. Heads of Departments of the Central Bank and representatives of relevant institutions who are involved in the financial reform process are also invited to attend meetings as and when necessary. The FSCL had 8 meetings since its commencement in June 2004.
- 2. Financial Stability Committee:** The Financial Stability Committee (FSC) of the Central Bank had 11 meetings in 2004. The remit of the FSC was the assessing of risks and vulnerabilities leading to major financial system instabilities in the country and recommending policies to promote financial system stability, which is one of the two statutory objectives of the Central Bank. As at end of 2004, the FSC consisted of 13 members who are the Heads of Departments whose functions have a direct bearing on financial system stability. During the year 2004, the FSC was involved in reviewing the first Financial Stability Report (FSR), which is to be published in due course, preparation of a pamphlet series for public awareness on the financial system, formulation of a proposal for a mandatory deposit insurance scheme as a financial safety net instrument, implementation process for a central database for monitoring on-line information of banks and finance companies and developing a mechanism for oversight of the payments system, which is crucial to financial stability.

(h) Public Awareness of Financial Institutions

In 2004, the BSD issued three publications with a view to increasing public awareness about the financial system.

- i. Publication of a one-page advertisement on “A Guide to Interest Rates and Fees of Banks” in all major newspapers during the last week of May 2004.*

- ii. Publication of a half-page press notice titled “*Institutions Legally Permitted to Accept Deposits from the Public*” in all major newspapers during the last week of September 2004.
- iii. Publication of the revised edition of the booklet, “*A Guide to Financial Services in Sri Lanka*” in December 2004.

Currency Issue

The Central Bank of Sri Lanka as the sole currency issuing authority in Sri Lanka, continued to perform the function of issuing legal tender currency for the use of domestic transactions during the year 2004. The volume of currency notes and coins in circulation by the end of 2004 stood at Rs.116 billion, as against Rs.99 billion at the end of 2003. This has been the highest ever recorded currency in circulation in the country. Notes in circulation comprised 97 per cent of the total currency in circulation. The quantity of coins issued to commercial banks during the year amounted to 112 million pieces with a total value of Rs.272 million compared to previous year’s 103 million pieces at a total value of Rs.264 million. The quantity and value of coins issued to commercial banks during the period 2000 - 2004 are given in Table II – 3.

Detection of Counterfeit Notes

The Department worked in close cooperation with the Counterfeit Currency Bureau of the Criminal Investigation

Department to contain and minimise counterfeiting attempts. The number of counterfeit notes detected in the country and referred for certification to the Central Bank, as required by the Monetary Law Act, increased from 1.75 notes per million notes in circulation in 2003 to 4.46 notes per million notes in circulation in 2004. During the year the two currency verification counting and sorting machines processed 124 million serviceable and unserviceable notes.

Sale of Notes and Coins

The Department continued to sell commemorative notes and coins to numismatists and collectors. The selling prices of gold and silver commemorative coins were determined on the basis of prevailing daily market prices of gold and silver from October 2004. The selling prices of gold and silver commemorative coins are displayed at the counter section of the Currency Department daily and on the Central Bank web site. Details of other commemorative notes and coins available for sale at the Central Bank together with their selling prices are given in Table II – 4. Under the coin collecting program 5.2 million coins with a face value of Rs.27.3 million were collected by the Department from places of religious worship *etc.* during 2004.

Training and Awareness Programmes

The Currency Department conducted awareness programs on the identification of counterfeit notes and on the clean note

TABLE II – 3
Quantity and Value of Coins Issued to Commercial Banks, 2000 – 2004

Year	Quantity (No. of coins, in thousands)										Total Value (Rs. '000)	
	Rs. 10	Rs. 5	Rs. 2	Re. 1	cts. 50	cts. 25	cts. 10	cts. 5	cts. 2	ct. 1		
2000	10,693	15,413	16,186	4,876	6,936	4,320	1,955	1,287	75	430	62,171	226,057
2001	6,136	20,726	22,668	19,328	4,286	5,996	2,380	399	60	205	82,184	233,557
2002	10,965	16,820	19,968	11,991	8,466	5,752	1,770	396	185	425	76,738	251,553
2003	5,735	23,512	27,187	29,160	8,276	5,964	2,905	294	195	220	103,448	264,384
2004	5,670	24,677	25,218	34,093	9,220	9,184	2,785	549	105	80	111,581	271,829

Source : Central Bank of Sri Lanka

TABLE II – 4
Commemorative Coins and Notes Available for Sale

No.	Description	Year of Coin	Face Value (Rs.)	Metal / Material	Selling Price (Rs.)
1.	3rd Anniversary of the Induction of President R Premadasa (Capsule)	1992	1	Cupro / Nickel	250
2.	50th Anniversary of the UNO (Capsule)	1995	5	Nickel Brass	200
3.	50th Anniversary of Independence of Sri Lanka (Folder)	1998	200	Polymer Note	400
4.	50th Anniversary of Sri Lanka Army – Proof (Pr. Box)	1999	1	Nickel Plated Steel	400
5.	50th Anniversary of Sri Lanka Navy – Proof (Pr. Box)	2000	1	Cupro / Nickel	500
6.	50th Anniversary of Sri Lanka Navy – Brilliant Uncirculated (Pr. Box)	2000	1	Nickel Plated Steel	200
7.	250th Anniversary of Syamopali Maha Nikaya (Coin Folder)	2003	Rs. 5 x 10	Nickel Brass	100

policy for bank officials, school children, government employees and the general public, through public lectures, print and electronic media. The Currency Department conducted an oratory contest in Sinhala medium amongst school children in the age group of 15 – 19 years in order to create an awareness on the proper use of currency without defacement or mutilation, identification of counterfeit notes and adverse effects of holding coins in tills and collection boxes.

During the year under review, the Department organized two seminars in June 2004 to create awareness and knowledge on bank notes on the subject 'Know your Own Bank notes – What Security Features to look for and How to Recognise a Counterfeit'. The seminars were conducted by De La Rue, U.K. in collaboration with the Central Bank. The first seminar was conducted for commercial banks and law enforcement officers and it was held at the Anuradhapura Regional Office, while the second seminar was conducted at the Central Bank Head Office for officers handling currency functions in the Central Bank and commercial banks.

In October 2004, two seminars were conducted with the auspices of Royal Mint, U.K. on 'Re-coinage for Sri Lanka'. The first seminar was conducted for commercial banks and central bank officials at the Bank's Head Office and the other in Kandy for commercial bank officials.

Training opportunities were made available to the officers of the Department to enhance their professional capabilities. Accordingly, 4 staff officers and 36 non-staff class officers underwent training conducted by the Centre for Banking Studies of the Central Bank while 2 staff officers and 2 non-staff class officers received foreign training.

Participation at Exhibitions

The Department also participated in the following exhibitions :

1. National Arts Festival organised and conducted by the Ministry of Cultural Affairs and National Heritage held in Colombo from 20 to 26 September 2004.
2. Exhibition organised and conducted by the Department of Economics of the Kelaniya University during 19 - 21 October 2004.

The Central Bank stall at the above two exhibitions was well patronised by school children and members of the public. Nearly 7,000 students and members of the public visited the Bank's Currency Museum during the year.

Domestic Operations

The Domestic Operations Department continued to perform its dual function of implementing the Bank's monetary policy mainly through Open Market Operations (OMO) and enforcing Statutory Reserve Requirement (SRR) and functioning as the banker to both commercial banks and the government. In

addition, as an ancillary service, the department also provided intra day liquidity facility (ILF) to commercial banks and primary dealers to ensure the smooth functioning of country's electronic payment and settlement system, code-named LankaSettle.

1. Implementation of Monetary Policy

(i) Open Market Operations (OMO)

OMO was conducted during the year as a part of the system of market based monetary policy operations introduced by the Bank in 2003^{1/}. Under this system, OMO included several operations: (a) conducting daily auctions either for repurchase (Repo) transactions to absorb excess liquidity or reverse repurchase (reverse Repo) transactions to inject liquidity, if there is a shortage of liquidity, on a daily basis (b) provisions of Repo and Reverse Repo facilities under standing facilities and (c) outright sales of Treasury bills or purchases of both Treasury bills (in the primary and secondary markets) and Treasury bonds (in the secondary market only) at the discretion of the Central Bank to absorb or inject liquidity on a long term basis. Treasury bills were used as collateral for Repo transactions, while both Treasury bills and bonds were used for Reverse Repo transactions. All commercial banks and primary dealers continued to be participating institutions (PIs) under the system.

With the implementation of the Scripless Securities Settlement System (SSSS) in respect of government papers in February 2004, OMO was also automated and conducted in Scripless Government Securities by introducing an interface linking OMO Front Office with the Back Office and LankaSettle. This has improved the efficiency of operations, while eliminating the risks involved in dealing in securities in scrip form. Further, an 'On Line Electronic Reporting and Monitoring System for Money Market Operations' was introduced in July 2004, which enabled the Central Bank to monitor on line, the transactions in inter bank money market and take action if deemed necessary to maintain the stability in interest rates.

The Repo and reverse Repo rates of the Central Bank at which standing facilities were provided to PIs remained unchanged at 7 per cent and 8.5 per cent until they were revised upward by 50 bps to 7.5 per cent and 9.0 per cent respectively, on 12 November 2004.

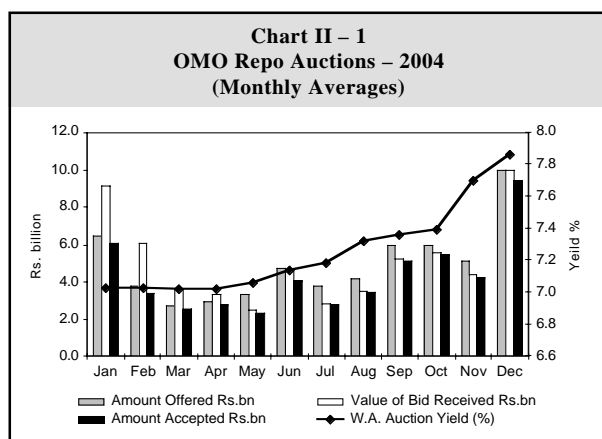
(a) Repurchase (Repo) Transactions

Auction System

During the year, on average, there was an excess liquidity of around Rs.6.6 billion per day. Therefore, auctions for Repo transactions were conducted every working day to absorb excess liquidity. On average, Rs.5 billion per day was offered

^{1/} For details see Box Article No. 20 of the Central Bank Annual Report 2002.

at the auction and bids were received for the entire amount auctioned. However, during the most of the second half of the year, more or less the total estimated excess liquidity was offered to the auction as emerging macroeconomic conditions warranted a containment of monetary expansion. Consequently, the weighted average auction rate which remained within a narrow range of 7.02-7.05 per cent during January – mid May 2004 moved up gradually to 7.41 per cent by 10 November 2004. With the upward revision of the Central Bank Repo and Reverse Repo rates by 50 bps on 12 November 2004, the auction rate moved up to 7.86 per cent. The auction rate remained at around 7.88 per cent on average during 12 November – 24 December 2004. During the balance period of the year, the amount absorbed through the auction was reduced substantially to facilitate smooth functioning of money markets and the payment and settlement system under difficulties caused by the Tsunami disaster.

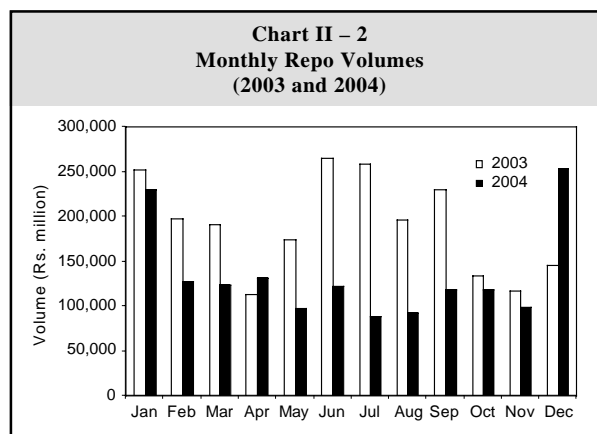


Standing Facilities

The PIs that were unable to meet their requirements at the auction resorted to standing facilities at the Repo rate of the Central Bank. Accordingly, there were Repo transactions to an average of Rs.2.3 billion per day under standing facilities. This amounts to an average of 34 per cent of the total liquidity absorbed on a day. However, with the absorption of a larger volume of excess liquidity through the daily auction, the relative importance of absorption through standing facilities declined to about 15 per cent during the second half of the year.

Total Volume

The total value of Repo transactions (overnight equivalent), both under the auction system and the standing facilities decreased from Rs.4,331 billion in 2003 to Rs.2,512 billion in 2004. Almost all of these transactions in 2004 were with PIs whereas in 2003 internally managed funds of the Central Bank accounted for about 22 per cent of these transactions. With effect from 30 January 2004, internally managed funds have



made their investments through commercial banks and primary dealers.

(b) Reverse Repurchase (Reverse Repo) Transactions

As the market was liquid in 2004, there was no need for the Central Bank to inject liquidity on a daily basis through auctions. Despite there being excess liquidity in the market, there were several days in which a few participants resorted to borrow through Reverse Repo transactions under standing facilities mainly due to self imposed limits of banks on their lending to other banks. However, these borrowings were marginal and did not entail any serious threat to macroeconomic stability.

(c) Outright Transactions in Government Securities

As the excess liquidity was quite high around Rs.19 billion at the beginning of the year 2004, an auction as well as direct sales were conducted to sell Treasury bills outright, out of the Central Bank holdings to reduce excess liquidity on a long term basis. The total value of Treasury bills sold through the auction and direct sales in January 2004 was Rs.2.3 billion. Further sales were not required as the excess liquidity declined with the maturing of Treasury bills out of the Central Bank holdings and sales of foreign exchange by the Central Bank.

(ii) Statutory Reserve Requirement (SRR)

The Department continued to enforce SRR which remained at 10 per cent of rupee denominated deposit liabilities of commercial banks.

(iii) Bank Rate

The Central Bank's rate of interest (Bank rate) on short term advances to licensed commercial banks, stipulated under Section 87 of the Monetary Law Act, remained unchanged at 15 per cent. However, this rate was inoperative since no bank resorted to borrow from the Central Bank at the Bank rate.

2. Functioning as Banker to commercial banks and Government

(i) Accounts of Financial Institutions

Facilitating the Central Bank to operate as the Banker to banks, the Department continued to provide current account facilities to commercial banks and primary dealers to ensure an efficient inter bank payment and settlement system. These accounts were operated on a Real Time Gross Settlement basis within the automated general ledger system of the Bank.

(ii) Government Accounts

Facilitating the Central Bank to serve as the Banker to the government, the Department continued to maintain accounts of government departments, government agencies and institutions and certain statutory boards, providing them with required banking facilities. The total number of such accounts maintained by the bank stood at 55 at end 2004. Four new accounts were opened in 2004 while 70 accounts were closed at the request of the government. In terms of Section 89 of the Monetary Law Act, the Bank continued to provide provisional advances to the government. The limit on such advances (10 per cent of the estimated government revenue) was increased by Rs.2.6 billion to Rs.35.6 billion in 2004. There was no interest charged on these advances.

3. Provision of Intra Day Liquidity Facility

The Department continued to provide intra day liquidity facility (ILF), a responsibility which the department assumed in 2003, to commercial banks and primary dealers to ensure smooth and efficient operations of LankaSettle. The discharge of this responsibility included prompt dealing with requests of participating institutions for intra day liquidity and their reversals and promptly charging default interests on those who failed to settle ILF before the close of business of LankaSettle on the same day. ILF was continued to be provided free of

charge against the collateral of government Treasury bills and bonds. Securities were valued at their current market prices with a sufficient 'hair cut' to cover possible variations in prices during the day.

The total value of ILF drawn during the year was Rs.654 billion. This amounted to ILF drawings of Rs.2.7 billion per day on average, which was lower than the average of Rs.3.2 billion drawn in December 2003. There was only one occasion of an ILF default by a participant in 2004. The measures in place, including penalty interest at the Bank Rate and the suspension of the facility for repeated defaults has ensured the prompt reversal of ILF before the daily close of business of LankaSettle.

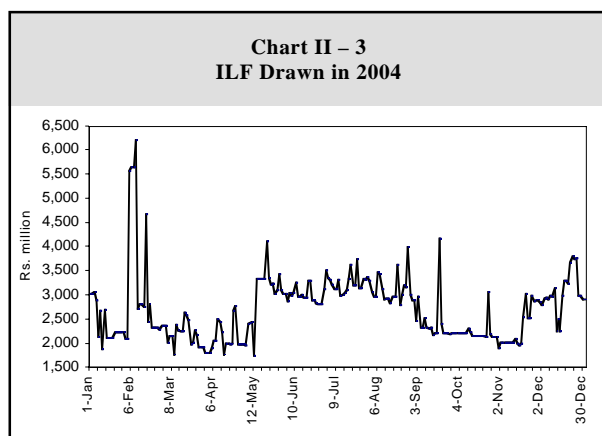
Economic Research

Research Activities

The Central Bank's primary function of conducting monetary policy and associated functions of adding knowledge through economic research, dissemination of economic and financial information, regular assessment of the state of the economy and advising the government on economic issues are discharged by its Economic Research Department (ERD). The work involves numerous activities relating to economic analysis; at the primary level, collection and compilation of economic data, at the secondary level, analysis of data for Bank's own policy formulation and at the tertiary level, publishing such analysis for the benefit of the public.

In 2004, while discharging these primary functions, further efforts were made by ERD to strengthen the monetary policy formulation framework. In this connection, a vital role was played in facilitating the Monetary Policy Committee (MPC) deliberations every month by providing comprehensive economic analysis and inputs. The monetary policy decisions of the Bank were disseminated by ERD through press releases, as per a pre-announced calendar.

ERD staff continued to undertake research projects, in addition to research done for preparing policy reports. For this purpose, ERD obtained the services of Prof. William Branson, Professor of International Affairs of the Princeton University, to conduct several research workshops for the benefit of Central Bank staff. Under his guidance, ERD staff initiated 12 research projects in 2004. Several studies have been selected for publication in the Bank's Staff Studies. Staff was also engaged in conducting joint research with international organizations, in particular research projects organized by the SEACEN Centre in Kuala Lumpur in Malaysia. The services of staff of the Department were made available for training of post graduate degree aspirants of the Bank and for providing guidance in their research. A financial programming model interlinking all four macroeconomic sectors of the economy was developed for the purpose of analysing policy simulations and



projecting macroeconomic variables under different policy scenarios. ERD also prepared a report on the impact of the devastating Tsunami on the economy soon after it occurred and later prepared analytical documents providing necessary information for coordinating foreign assistance granted by the IMF and other donor agencies for relief, rehabilitation and reconstruction work in Tsunami affected areas.

Policy advice was regularly provided by ERD on various issues to the Monetary Board and the management, other departments in the Bank and to government institutions. Many senior officers in ERD served on various important committees, both within the Bank and outside. They also served on the Boards of several institutions, and as resource persons in training programmes conducted by the Bank's own Centre for Banking Studies and other foreign and local organizations. Further, ERD continued to provide inputs to and participated in various committees within the Bank such as the Market Operations Committee (MOC), the Domestic Debt Management Committee (DDMC) and the Foreign Reserves Management Committee (FRMC).

The primary responsibility of preparing Bank's statutory reports and other special reports in all three languages lies mainly with ERD. It coordinated the publication of the Bank's Annual Report for 2003, and Recent Economic Developments – Highlights of 2004 and Prospects for 2005. In addition, it was responsible for the preparation of the September 15th Report, a confidential report submitted by the Bank to the Minister of Finance prior to the preparation of the government budget.

It also continued to improve and expand the dissemination of information, while making available information through its statutory publications, weekly and monthly selected economic indicators, CBSL website, and through press releases. The CBSL website was updated daily by ERD.

ERD also continued to promote relationships with other international organizations. It coordinated Sri Lanka's relations with the IMF, the inter governmental Group of Twenty Four (G-24), the SEACEN centre for research and training, the SEANZA group and the SAARCFINANCE grouping of Central Bank Governors and Finance Secretaries. In 2004, ERD assisted the Ministry of Finance to coordinate the work with the World Bank, the Asian Development Bank and other multilateral and bilateral donors. CBSL hosted the 39th SEACEN Governors' Conference and 23rd Board of Governors Meeting in February 2004. ERD was primarily responsible for organizing the conference and the meeting. In 2004, ERD completed preparatory work of SEACEN Executive Committee meeting (EXCO meeting) held in January 2005. ERD continued to host the SAARCFINANCE Cell of Sri Lanka, a mechanism for all SAARC countries to exchange staff, share experiences and learn from each other.

Employees' Provident Fund

The Monetary Board, as the custodian of EPF, continued to discharge its responsibilities, in terms of the EPF Act, of receiving contributions, surcharges, and income from investments, maintaining proper accounts of registered employments, members and the Fund, investing of excess monies in suitable investments, and paying benefits to the members of the Fund. These activities were carried out with the close co-ordination of the EPF Division of the Department of Labour.

System Modifications

Moving forward with the modernization programme, several modifications to the EPF IT system were introduced during 2004. The collection of member contributions through electronic media was further expanded with more than 200 large-scale employers opting for this method during 2004. The introduction of a computerized "Refund Workflow System" enabled the EPF to improve the efficiency and the accuracy of the refund process.

Public Awareness and Member Disclosure

An awareness programme initiated in the previous years continued in 2004 focusing all stakeholders of the Fund. It covered their rights and responsibilities pertaining to EPF, correct procedures to be followed, and the significance of EPF for the members' well-being after retirement. The Help Desk of EPF, which was set up in 2003, attended to member inquiries promptly. In addition to conducting mobile service counters at various locations in the country, a special mobile service was initiated in 2004 targeting the estate sector. In this programme, the four key stakeholders – member, employer, Department of Labour and Central Bank meet at the employer's premises and clear up the discrepancies real-time. These events helped to make an effective outreach of members in remote areas and thereby giving them an opportunity to have their problems resolved instantaneously. The production of a documentary film on EPF and participation in several television programmes during 2004 were effective tools used by the Fund for its public awareness campaign.

Capacity building in the EPF

Skills development of the staff is a major component in the modernization agenda of the Fund. In line with the Central Bank's philosophy of establishing a "Learning Organization", continuous learning and knowledge sharing were promoted within the Fund. An environment to practice the acquired knowledge was also provided. Officers were trained in the areas relevant to existing duties and responsibilities and in the areas of their career path. A key element of the capacity building was the two-year comprehensive training in fund management,

which was instituted in November 2003 with 14 young professionals. This programme was successfully carried out during the year under review. These capacity-building activities would enrich the Fund with necessary competent human resources for its modernization activities and to be competitive in a rapidly changing environment.

Housing Loan Facilities

The housing loan scheme which was introduced in 1988 continued during the year under review too. Under this scheme, an EPF member could obtain a loan for housing purposes from an approved lending institution, pledging the member's balance up to a maximum of 75 per cent. A second loan was also available upon the successful settlement of the first. During 2004, EPF issued 14,307 member balance certifications relevant to a total approved amount of Rs.2,452 million to lending institutions.

The apparent feature is the increasing tendency of members to default in paying the loan instalments to the lending institutions, thereby, misusing the facility as a means of premature withdrawal of their EPF balances. However, this mode of premature withdrawal has been extremely costly for those members since lending institutions charge a penal rate averaging to 36 per cent per annum on the amounts defaulted. Retirement savings of the member would drastically erode due to the housing loan defaults and the second loan will not be made available for the defaulted members. Table II – 5 shows the increasing trend of the housing loan defaults.

TABLE II – 5
Details of Housing Loan Facility for the EPF Members

Year	Member balance certificates issued (No.)	Amount of credit approved (Rs. mn.)	Housing loans defaulted (No.)	Amount paid by EPF on housing loan defaults (Rs. mn.)
2000	12,938	1,648	19,944	262
2001	16,066	2,091	24,202	381
2002	19,502	2,673	31,574	541
2003	18,689	2,792	40,085	670
2004	14,307	2,452	50,000*	750*

* Estimated

Source : Employees' Provident Fund

Investment Activities and Returns

During the year, the total investment portfolio of the Fund grew by 12.3 per cent, recording a cost value of Rs.359 billion as at end 2004. Sustaining the last 7-year trend, the total investments of the Fund in Treasury bonds – a long-term market oriented investment instrument, further expanded to a level of 77 per cent of the total investment portfolio as at end 2004, as against 56 per cent in the previous year. Correspondingly, the share of

investments in Government Rupee securities – an off-market instrument, continued to drop further from 41 per cent of the portfolio in 2003 to 20 per cent as at end 2004. This is in accordance with the EPF investment policy of diversifying its investments with market-oriented instruments and the active fund management.

The long term Bull-run in the equity market, which started in the latter part of 2001 continued further in 2004, with short-term oscillations. The market was resilient to the Tsunami devastation under the withheld investor confidence of a recovery of the Tsunami affected sectors and the economy as a whole. The EPF increased its equity portfolio selectively investing in fundamentally sound stocks, which revealed future prospects. In addition, the short-term oscillations in the market provided short-term profit opportunities to the EPF. The listed equity portfolio increased during 2004 by 45 per cent to record a value at cost of Rs.1,534 million as at end 2004. However, it marked only a fraction of 0.5 per cent of the total EPF investment portfolio as at end 2004. The total realized return generated by the EPF equity portfolio amounted to Rs.456 million or 43 per cent on the average portfolio for 2004 (as depicted in Table II – 6). During the overall holding period of seven years from 1998 to 2004, it generated an annualized realized rate of return of 24 per cent on average, which could rationalize the equity market as an investment avenue for the

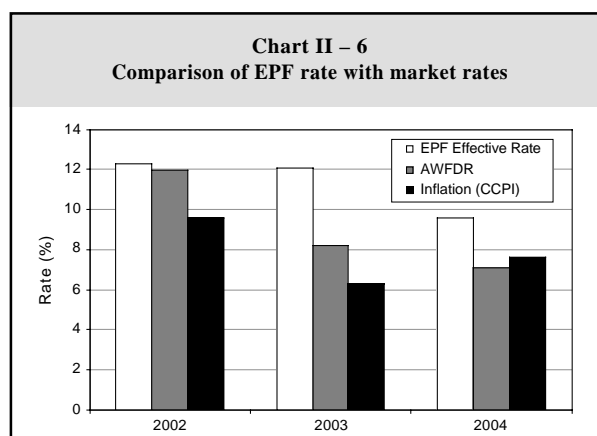
TABLE II – 6
EPF : Performance of Equity Portfolio during 2003 and 2004

Item	Rs. mn.	
	2003	2004
Average Portfolio	1,223	1,064
Total Dividend Income	96	112
Total Capital Gains	614	318
Bonus Shares Received (valued at the end of the period)	143	26
Total Dividends, Capital Gains and Bonus Shares	853	456

Source : Employees' Provident Fund

Fund, though limited, under a prudent investment approach.

The rate of return of the EPF's total investment portfolio continued to be highly sensitive to the yields on government securities with 98.2 per cent of the total portfolio being invested in government securities as at end 2004. One-year Treasury bills traded in the primary market in a range of 7 per cent - 8 per cent during the year. Accordingly, due to the impact of the last three-year downturn in the government securities rates (Chart II – 4), the rate of return on the average investment portfolio of the EPF in 2004 declined to 11.56 per cent from 13.68 per cent in the previous year.



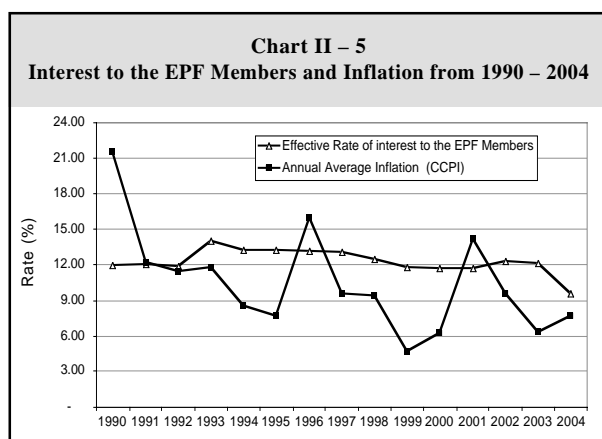
Total Member Balance and Rate of Interest for 2004

The total member balance of EPF marked a growth of 11.8 per cent to a value of Rs.373 billion as at end 2004 after accounting for the declared interest rate of 9.5 per cent for 2004. In accordance with the statutory requirement of the Fund of declaring the rate of interest at the year-end member balance, this budgeted interest rate turns out to be an effective rate of 9.59 per cent yielding a real effective rate of 1.99 per cent over the average inflation of 7.6 per cent measured by CCPI. On a

further positive note, when compared with the commercial banks' Average Weighted Fixed Deposit Rate (AWFDR) of 7.09 per cent, the EPF's effective rate yields a positive margin of 2.5 per cent to members in 2004.

Outsourcing of Activities

EPF continued with its cost reducing method by outsourcing of services. Functions to be outsourced are recognized carefully after a cost-benefit analysis. It takes in to account all the explicit and implicit costs and benefits, which would incur in the short run as well as in the long run. It considers all possible risks and quality improvements in service to members. Outsourcing was a major factor, which enabled the Fund to manage its Recurrent Expenditure to Gross Income ratio at a level less than 1 per cent, even though the volume of work had increased during the recent past. Maintaining the ratio of Recurrent Expenditure to Gross Income at this extremely competitive level would be a challenge in the future under a scenario of falling market interest rates, increasing volume of work and inflationary pressure, thus making cost reducing methods more attractive. The ultimate aim of these cost minimization and quality improvement efforts is the delivery of a maximum benefit to the EPF members. The salient features of the EPF are presented in the Table II–8.



**TABLE II – 7
EPF : Secondary Market Activities during the year 2003 and 2004**

Item	Volume Purchased (a)		Volume Sold (a)		Capital Gain	
	2003	2004	2003	2004	2003	2004
Treasury Bonds	33,165	13,311	33,567	20,094	3,124	1,225
Treasury Bills	158	2,572	245	6,634	2	5
Central Bank securities	–	–	1,875	–	3	–
Equity Shares	437	847	690	380	614	318
Total	33,760	16,730	36,377	27,108	3,743	1,548

(a) At cost values

Source : Employees' Provident Fund

TABLE II – 8
EPF : The Salient Features

Item	2003	2004
Total Number of Members Accounts	9,813,870	10,175,000*
Currently Contributing Members Accounts (CCMA)	1,872,073	2,001,000*
Currently Non-contributing Members Accounts (CNMA)	7,941,797	8,174,000*
Contributing employers	50,880	51,824*
Total Contributions (Rs.mn.)	20,188	23,330
Total Refunds (Rs.mn.)	17,032	16,617
Number of Refunds	89,342	98,666
Total Investment Portfolio (Rs.bn.)	320	359
Government Securities Investments as a % of Total Investments	98.3	98.2
Private Sector Investments as a % of Total Investments	1.7	1.8
Realized Rate of Return on Average Portfolio (%)	13.68	11.56
Total Members Balance (Rs.bn.)	334	373
Total Gross Income (Rs.mn.)	41,313	39,315
Income Tax (Rs.mn.)	1,448	4,735
Administration Expenses (Rs.mn.)	299	360
Administration Expenses as a % of Gross Income	0.72	0.91
Annual Interest Rate Declared on Member Balances (%)	12.00	9.50
Effective Interest Rate Declared on Member Balances (%)	12.07	9.59

* Estimated

Source : Employees' Provident Fund

Exchange Control

The management and regulation of receipts and payments of foreign exchange into and out of the country is the key function of the Exchange Control Department (ECD). In the year 2004, all foreign exchange payments and receipts relating to current transactions continued to be freely released through commercial banks appointed as authorised dealers (ADD) in foreign exchange at their own discretion subject to exercising due diligence. In addition to authorised dealers, money changers, tourist hotels, travel agencies, and duty free shops continued to deal in foreign exchange for specific purposes such as exchanging and accepting foreign currency notes and issuing foreign exchange in the form of Travellers' Cheques, *etc.* The Department, in carrying out its regulatory functions, continued to issue operating instructions and guidelines to authorised dealers, conduct on-sight and off-sight examination and monitor their foreign exchange transactions.

1. Major Developments in 2004

One of the major developments in 2004 was action taken by ECD under the provisions of the Exchange Control Act (ECA) to stop large scale drain of foreign exchange on a pyramidal

network-marketing scheme that operated *via* the Internet in the absence of a preventive legal framework. ECD after conducting a comprehensive investigation into the scheme and related activities of its local promoters, imposed penalties to the extent of US dollars 88 million on those who used their Electronic Fund Transfer Cards (EFTCs) in violation of Exchange Control regulations in making payments to the scheme. At the same time, the Central Bank carried out a public awareness programme to educate the public of the dangers of participating in pyramidal network marketing schemes and its consequences to the economy in general and the financial sector in particular.

The Department also proceeded to strengthen its supervisory and monitoring activities during the year under review in view of large-scale abuses of credit cards for making payments to the above scheme. Action was also taken to educate EFTC holders through card issuing banks of the permitted uses of their cards; and, the Exchange Control offences they might be committing when making foreign exchange payments for unauthorized purposes. Another development of the monitoring activities of the year was the collection of data on the utilization of export proceeds on a quarterly basis.

In the area of enforcement of the provisions of the ECA, the dismissal by the Court of Appeal of applications filed by two directors of a reputed company to set aside penalties imposed on them by the Department was a significant development. ECD imposed penalties on these persons for offences committed by them for transferring shares of the company to non residents in contravention of Section 11(2) of the Exchange Control Act. During the year under review the Attorney General's Department filed 8 more indictments in the High Court of Colombo for prosecution of several persons based on investigations conducted by the Department on massive foreign exchange frauds.

2. Capital Transactions

(a) Investments

During the year 2004, the existing Exchange Control regulations relating to investments in Sri Lanka remained unchanged. The Hon. Minister of Finance permitted 13 cases of investments abroad in 2004 on recommendations made by ECD amounting to US dollars 5.8 million. These were in areas of manufacture and marketing of coir products, promoting of Sri Lankan exports and hospital services.

(b) Foreign Currency Borrowings

Borrowing abroad by resident companies other than companies approved by the BOI under Section 17 of the BOI Law with full exemption from the Exchange Control Act, requires the prior approval of ECD. During the year under review, 2 private companies

were permitted by ECD to borrow from abroad to a total sum of US dollars 40 million, while Sri Lanka Telecom was permitted to raise 5 year international bonds in overseas markets to an extent of US dollars 100 million.

(c) Issue of Bank Guarantees in favour of Non-residents

During the year under review, permission was granted to a resident company for issuance of corporate guarantee to the value of US dollars 35 million.

3. Trade Transactions

ECD continued to monitor import of goods for which payments had been made in advance with a view to ensure their arrival in the country. During the year following changes were made on procedure relating to trade transactions.

- (a) Authorized dealers were permitted to sell foreign exchange upto US dollars 15,000 (of which currency notes upto a maximum of US dollars 5,000 and balance in the form of Travellers' Cheques (TCs) or a bank draft to a registered gem dealer to carry with him on his person when travelling to Madagascar for the purpose of purchasing rough gemstones from Madagascar and importing into Sri Lanka. This facility was later extended to registered gem dealers for payment in advance for the import of rough gemstones from Myanmar. These facilities were granted to assist the development of gem and jewellery industry in the country.
- (b) Another major change in the area of trade transactions in 2004 was the amendment to the regulations made under Import and Export (Control) Act published in the *Gazette* No. 1022/6 of 8 April 1998 in respect of payment terms for imports. The amendment was effected by a regulation made under the same Act published under *Gazette* No. 1363/27 of 21 October 2003 restricting imports of almost all motor vehicles on Letters of Credit (LCs) subject to terms and conditions stipulated by the Central Bank of Sri Lanka. Accordingly, in terms of the Monetary Law Act, the Central Bank imposed a condition stipulating a margin of 100 per cent to be deposited with the LC opening bank at the time such LCs are opened in respect of certain categories of vehicles.

4. Registration of Freight Forwarders and Issue of Permits to engage in Foreign Exchange Transactions

ECD continued to register freight forwarders, grant travel agencies the authority to issue Travellers' Cheques and issue licenses to money changers and other establishments such as

hotels, duty free shops, travel agencies etc. to accept foreign currency.

Registration of Freight Forwarders

During the year 2004, 5 new companies were registered as freight forwarders, bringing the total number of companies registered as freight forwarders to 131 at the end of the year. ECD continued to monitor credits and debits made to the Rupee accounts maintained by shipping and airline agents as well as freight forwarders on behalf of their foreign principals/agents during the year.

Issue of licenses to Money Changers

ECD issued 08 new money changing licenses to companies that fulfilled the criteria laid down by the Monetary Board in 1999 for the issuances of such licenses. This brought to the number of money changing companies operated in the year 2004 to 47. Their total foreign currency purchases, which were subsequently tendered to authorised dealers, amounted to US dollars 180 million in 2004.

Monitoring

The restrictions-free current account transactions regime that started in 1994 continued in 2004 as well. As in the past, all authorised dealers and approved travel agents are required to report to ECD their sales and purchases of foreign exchange on regular basis for monitoring purposes. Foreign exchange sales over US dollars 5,000 per person are required to be reported daily while sales less than US dollars 5,000 per person are to be reported on weekly basis. In the case of foreign exchange releases through Electronic Fund Transfer Cards (EFTCs), card issuing banks are required to provide detailed monthly reports on EFTCS where monthly cumulative foreign exchange expenditure per person exceeds US dollars 5,000 per month. Releases of foreign exchange are monitored with a view to detect unauthorised capital transfers; and, funds linked to financing of terrorism or money laundering activities.

At present only the head offices and few outstation branches of commercial banks are electronically linked to ECD for the transmission of data on their foreign exchange transactions. During the year 2004, the Department had a series of discussions with the officials of IT Departments of the banks for the formulation of a mechanism to include outstation branches of all commercial banks into this data transmission network. Once this is accomplished, monitoring activities of the Department could be speeded up and used more effectively for early detection of any abuses on the part of the dealers as well as the users of Foreign exchange.

Investigations

ECD continued with investigations into alleged violation of the provisions of the Exchange Control Act. Total of 310 cases were investigated during the year and, penalties amounting to Rs.91.9 million were imposed on persons accused of violating

the provisions of the Act. Among the cases investigated by the Department was an investigation into a pyramidal network marketing scheme where a large number of Sri Lankans had made payments in foreign exchange on their credit cards for participation in the scheme. The investigation revealed that many cardholders had used their cards to make foreign exchange payments to enable third parties to join the said scheme. Investigations into foreign exchange payments made by 150 such cardholders were also carried out during the year 2004.

Information

The Information Department of the Central Bank is responsible for providing information on macroeconomic, Banking, Finance and Socio Economic developments with a high degree of accuracy and reliability within the Bank, among financial markets and to the general public. During the year 2004, the Department introduced measures to improve its strategy in disseminating of information using modern technology such as e-mail, intranet and the Internet in order to facilitate access to information.

With a view to keep the Bank staff updated on current events, the Department published 'Kauluwa', the monthly feature magazine consisting of policies adopted or to be adopted and other relevant news and events. The Department continued to update daily the departmental website with a wide range of local and international financial information as well as the developments within the Bank. The electronic version of the Annual Report and the Recent Economic Developments, which was introduced by the Department in 2003, was improved in 2004 by including the Sinhala electronic version. During the year the Department continued to engage in educating the public through advertisements / notices and also publishing articles on the risks and dangers associated with 'pyramid schemes' in the absence of legislation, taking into consideration their potential threat to the country's financial stability.

The Department handled the publicity operations of the Bank by transmitting 527 press releases, 9 *Gazette* Notifications and publishing 161 advertisements in the newspapers in 2004. The Department also organized 11 press conferences during the year on economic policies and developments and a meeting for the heads of the media institutions. It also handled the media coordination for the public lecture series organised by the Centre for Banking Studies.

The Department continued to publish economic periodicals in all three languages - the monthly "Satahana", the quarterly "News Survey", and "Kurippedu" the Tamil version of "Satahana".

As in previous years, the majority of the Bank's printing requirements and publications were done at the Bank's printing press. The regular printing assignments included the Annual Report, Monthly Bulletin, Economic & Social Statistics, Sri

Lanka Socio-Economic Data, Staff Studies, Satahana, News Survey, Kauluwa and the Bank Diary. A special publication 'The Heritage of Kandurata' (in Sinhala and English) was also issued during the year. The printing press undertook a total of 294 printing assignments in 2004. The Department also provided photographic and artistic design services to the Bank.

The Department continued to handle the distribution and sales of all Bank publications through the sales counter located at the Centre for Banking Studies, Rajagiriya and bookshops, island-wide. The Department participated for the first time in the Colombo International Book Fair 2004, which was held at BMICH in September, 2004. This was a huge success both in terms of sales and in enhancing public awareness about the Bank's publications.

The Department conducted a free distribution of old Central Bank publications, books and journals (published prior to 2002) in October 2004. Over 5,000 persons received free publications and books during the one week programme.

The Department involved organizing a schools lecture programme conducted at the Centre for Banking Studies and in the outstations for students and teachers on subjects covering the Sri Lanka economy and the role and functions of the Central Bank. The Department also produced an educational tele-drama for the Employees' Provident Fund Department (EPF) to educate the public on EPF operations.

Library and Information Centre (LIC)

The Library and Information Centre (LIC) continued to provide library services for the Bank staff and others on request. It increased its collection of books from 14,562 to 17,194, reports from 9,627 to 11,887, CDs from 843 to 900 and maps from 22 to 99 and added 944 bound volumes to the collection during the year. The Library at the Centre for Banking Studies too increased its collection from 4,637 to 4,896.

In addition, a major part of Deshamanya N U Jayawardene's library collection was received by the Central Bank Library and the collection was maintained in a separate section of the Library, named as the late Mr. N U Jayawardene Reading Room since October 2004.

Further, LIC subscribed to 195 journals with online access to six more online services in addition to the existing services. During the year under review LIC continued to compile electronic publications such as Recent Additions *i.e.* (new books), List of selected Articles, News on Central Banking, News Alert and disseminated them via intranet. The book circulation was further automated by introducing a bar-coded membership card, which increased the circulation distinctly.

During 2004, LIC was linked to the network of Central Bank Librarians group which has membership of 112 librarians of 36 central banks in the world.

Information Technology

The Information Technology Department (ITD) continued its efforts in expanding the IT facilities of the Central Bank (CBSL) and improving IT skills of the Bank staff. Functions of the Department were mainly focused on the following areas during the year under review.

1. Implementation of the Scripless Securities Settlement System (SSSS).
2. Uplifting the IT knowledge of employees of CBSL.
3. Implementation of possible remedial measures recommended by IT Auditors to mitigate operational risks in IT operations.
4. Enhancing the IT infrastructure to provide improved facilities to users and to strengthen the IT security aspects.
5. Automation of functions handled by user departments through implementation of software development projects.
6. Maintenance of the computer network and all critical systems meeting the specified availability standards.

1. Implementation of SSSS

The Real Time Gross Settlement System (RTGS) and SSSS projects were undertaken by CBSL to automate the payments and settlements system and the government securities settlement system of Sri Lanka. The RTGS project was implemented in September 2003 and system is maintained by the IT Department since its implementation. The SSSS was successfully implemented on the 3 of February 2004. The software for SSSS was provided by LogicaCMG and is running on AIX 5.1 operating system and Informix database. To facilitate the implementation of the SSSS project, IT Department developed the following major interface programs.

- (a) Electronic bidding system for the CBSL Open Market Operations System.
- (b) Facility to dematerialize scrip securities to scripless form.
- (c) Transfer of securities portfolio of weekly Treasury Bill and Bond auctions to SSSS.
- (d) Update the daily prices of securities portfolio and security holdings.
- (e) Uploading of bulk transactions through Matched Trade feed facility.

In addition, IT Department was extensively involved in Systems Acceptance Testing (SAT) and user training of the SSS system.

2. Uplifting the IT skills of employees

ITD continued to provide resource persons to the Centre for Banking Studies to enhance the IT knowledge among the

Central Bank Staff and the banking community. Furthermore, regular meetings and training sessions were conducted for CBSL Departmental Liaison Officers to educate on improved security methods and to provide guidelines on computer use. ITD also conducted an 'IT Satisfaction Survey' within CBSL to identify the IT related areas that need improvement.

3. Implementation of recommendations of IT Audit

An IT Audit was conducted by M/s. Ernst & Young, which identified the areas that needed strengthening in order to protect information assets of CBSL and ensure a secure environment for information systems users. The following measures were taken with a view to mitigate the risks that were highlighted in the report:

- (a) All critical applications including RTGS, SSSS and General Ledger were tested from the Disaster Recovery site to ensure that the applications could run during an emergency from the DRS.
- (b) Implementation of Software development guidelines addressed in the report including documentation standards.
- (c) Preparation and circulating the IT Security Policy Document.
- (d) Preparation of Business Continuity Plan for RTGS/SSSS/GLS systems by identifying possible contingency events and the respective fall back operations, to ensure Business Continuity.
- (e) Implementation of router level data encryption policies to mitigate the communication risks in data transmission.
- (f) Established an IT help desk, which operates from 7.30 a.m. – 5.00 p.m. for the benefit of users of IT applications.
- (g) Conversion of all applications using dBase as the database to move secure DB/400 or SQL server databases.

4. Expanding the IT Infrastructure

ITD was involved in providing technical assistance to all IT related purchases and services through active participation in Technical Evaluation Committees (TEC), Tender Boards, and preparation of TEC reports. In addition, the following infrastructure enhancements were made to the network.

- (a) Internet connectivity increased from 128 kbps to 256 kbps to increase the Internet usage at the Bank.
- (b) Migration of SWIFT from X.25 to SWIFTNET.
- (c) Installation of Etrust Content Manager to control SPAM and junk e-mail.
- (d) Setting up of a Local Area Network (LAN) at Centre for Banking Studies at Rajagiriya.

- (e) Laying of an alternative fiber optic backbone as a backup.
- (f) Encryption of the communication line connecting the Main site with DR site.

The CBSL network was expanded, where the network currently accommodate over 1,000 computers connected directly to the network, of which 904 have been provided with e-mail connections and 275 with Internet connections.

5. Software development projects

ITD continued to develop several computer applications in the AS/400 as well as PC network environment to further automate the functions of the Bank. As a measure to sustain the financial stability of the country, IT Department initiated development of its first web-based interactive application for collection and reporting of required financial returns from the Registered Financial Companies, Licensed Commercial Banks and Primary Dealers. The first stage of the project will be rolled-out for the Bank Supervision Department and will be expanded to facilitate requirements of other Departments such as Economic Research and Domestic Operations. In addition, the following software projects were undertaken by the ITD during the year under review.

- (a) Computerisation of Main Vault, Issue Vault and Guarantee box module for the Currency Department.
- (b) Conversion of Widows' / Widowers' and Orphans' fund systems, Treasury Bills, Treasury Bonds Systems from dBase environment to AS/400 environment with added security features.
- (c) Computation of salary / pension arrears due to the salary increase.
- (d) Automation of welfare loan system with the rescheduling of staff welfare loans.
- (e) Development of websites for CBS and Central Bank Strengthening Project.
- (f) Development of a software for maintenance of Risk Register.
- (g) Development of a Stock control system for staff canteen for Welfare Department.
- (h) Computerization of the medical clinic for Welfare Department.
- (i) Development of a system to monitor expatriation of export proceeds for Exchange Control Department.

Management of IT resources for EPF Department

ITD continued its role of maintaining EPF application system and further automation was undertaken during the year under review. A network was established linking the EPF main server from the new EPF Collections Unit located at the Ceylinco building. ITD also was instrumental in development and implementation of the software for computerization of the

Contributory Pension Scheme for the public sector. A system was implemented to computerize the EPF inquiries counters for on-line recording of all collections. A refund workflow system was also developed in order to further automate the payments. ITD continued to provide information to Labour Department and other related institutions and also was involved in providing access to EPF information through one line connectivity from mobile service centres.

To further modernize the retail payment system, the Central Bank with the assistance of the World Bank funding embarked on a Cheque Imaging and Truncation Project for LankaClear (Pvt) Ltd. ITD played a major role in the preparation of bid documents and Technical Evaluation of bids for the two tenders for procurement of application software and hardware and continues to provide technical assistance by participation in the project teams and steering committee.

International Operations

Report on Activities During 2004

I. Foreign Exchange Reserve Management

International Operations Department (IOD) manages the official international reserves of the country and monitors the exchange rate movements, while providing management information on international and domestic foreign exchange market to facilitate policy making. In terms of the Monetary Law Act, the Central Bank should maintain an adequate international reserve in liquid currencies and a nuclear reserve in gold, among its assets, in order to maintain the international stability of the Sri Lanka rupee and to assure the greatest possible freedom of its current international transactions.

In order to add value to the foreign exchange reserves, IOD invests these reserves in the international money and capital markets. It is carried out with utmost care through approved counterparties within the limits authorized by the management, paying due consideration to safety, liquidity and the return on such assets as it manages the wealth of the nation. A major part of the international reserve is invested in fixed income securities. The balance in money market instruments namely fixed deposits, call deposits and in gold. Current accounts with overseas banks (with overnight investment facilities) are maintained for day-to-day requirements.

In the discharge of its duties, IOD reviews the changes in interest rates and exchange rates among major currencies and underlying factors regularly. The main currencies in which the reserve was held during 2004, were euros, sterling pounds and US dollars. Appropriate changes to the composition were introduced from time to time taking into account the emerging developments in world's financial markets. Further, IOD continues to maintain a small portion in other convertible currencies in the assets portfolio as a part of its risk diversification strategy, whilst maximising returns. The Bank's

debt service requirements and the income generating capacity of the currencies and securities were also considered in determining the currency composition. The total net foreign income generated through the foreign exchange reserve management operations during 2004 was US dollars 77 million or Rs.7.8 billion. This was an increase of US dollars 9.5 million or Rs.960 million over the earnings from this source in 2003. This was mainly due to the adjustment in the currency distribution of the foreign assets portfolio and comparatively better prices of fixed income securities.

The main risks associated with the Bank's investments of the official foreign exchange reserve are market risk (foreign exchange rate risk and interest rate risk), credit risk, liquidity risk and operational risk. Measures were introduced to mitigate all these risks.

Foreign exchange rate risk is the risk of capital losses as a consequence of fluctuations in exchange rates. The Bank attempts to limit exchange rate risk by spreading its holdings of foreign reserve assets among different currencies and this currency distribution of the portfolio is reviewed periodically. Interest rate risk or the exposure of the bank's investments to movements in interest rate is assessed at portfolio levels in various currency segments and against an internally constructed benchmark. The deviations of the investment portfolio from the internally constructed benchmark are assessed periodically and compared against the approved levels.

To minimize the credit risk, *i.e.*, the risks of losses resulting from the failure of issuers of securities or counterparties, IOD uses the Counterparty Credit Risk Management System (CCRMS), comprising an extensive limit structure on eligible issuers and counterparties based on counterparty creditworthiness (assessed on a credit rating based framework). Credit risk is managed by establishing eligibility requirements, confining exposures to high quality instruments, giving individual credit risk limits to issuers, counterparties and financial instruments.

Liquidity risk is defined as the risk of having to incur unnecessarily high transaction costs in the event of forced liquidation of a part of a portfolio. Liquidity risk is managed by establishing liquidity requirements to financial instruments and investing the major part of the international reserve in highly liquid financial instruments with shorter maturities.

The operational risk originates from human error, flawed systems, and inadequate procedures and controls. The bank limits operational risk through a range of measures; segregating the different functions of transaction processing and monitoring; having a clear decision-making committee charged with the function of the management of foreign reserves (Foreign Reserve Management Committee), building controls into the dealing activities, restricting physical access to different operational areas, *i.e.*, middle office and settlement areas; introducing and maintaining automated and manual backup procedures; enforcing comprehensive guidelines on reserve management activities and introducing controls and procedures.

II. Monitoring the Domestic Foreign Exchange Market Developments

IOD closely monitors the developments in the domestic foreign exchange market, foreign exchange transactions by commercial banks and overnight net foreign exchange open positions of commercial banks in order to ensure smooth functioning of the domestic foreign exchange market and orderly adjustment of the exchange rate of the Sri Lanka rupee. It provides exchange rate of the Sri Lanka rupee on various currencies to Government Departments and Corporations and other relevant parties on request.

The Sri Lankan rupee stood at 104.6050 per US dollar at the end of 2004 compared to end December 2003 level of Rs.96.1382 indicating a depreciation of 7.52 per cent. Given the relative strengthening of other major currencies in the international market, the rupee depreciated against these currencies as well. The volumes of inter-bank foreign exchange transactions have increased by 17 per cent or US dollars 632.5 million to US dollars 4,279.5 million in 2004 compared to the volume of US dollars 3,647.0 million in 2003.

Legal

As in previous years, the Legal Department of the Bank continued its services in advising the Bank on legal matters, representing the Bank in courts and other legal fora and contributing to the legal reforms in the banking and financial sector.

In 2004, the Legal Department worked closely with several departments to prepare amendments to legislation, rules, regulations and other legal documents. In particular, the Legal Department prepared amendments to several laws relating to the financial sector including Local Treasury Bills (Amendment) Act, No.1 of 2004 and Registered Stock and Securities (Amendment) Act, No. 2 of 2004, which were enacted in 2004 and the Banking (Amendment) Act which was passed by Parliament in December 2004. Regulations and other documentation for the Real Time Gross Settlement and Scripless Securities Settlement Systems were also prepared during 2004.

The Department was also involved in a project undertaken by the Bank with the technical assistance of the World Bank and IMF to draft new Central Banking and Banking legislation. A draft Payments and Settlements Systems law, too, was drafted in 2004 to address issues relating to payments and settlements systems.

Management Audit

During 2004, the Management Audit Department, while initiating its independent audit, made suggestions for improving and adding value to Bank's operations and systems of controls so that the Bank would achieve its strategic objectives.

As in the previous year, the Board's Audit Committee continued to oversee the annual Audit Plan, audit process, financial statements of the Bank, the related financial reporting practices and the systems of internal controls.

In accordance with the Audit Charter and the Annual Audit Plan 2004, several audit assignments were completed, while continuing compliance auditing to maintain established internal controls. Follow-up audit reviews were also undertaken in order to verify the implementation of audit recommendations.

The major audit activities undertaken during the year included the Final Accounts of IBRD grant received for the Project on promotion of forward markets for agricultural commodities in Sri Lanka, liquidated damages that had arisen on account of purchases made by Secretariat and Premises Departments, Credit Guarantee Schemes implemented by the Regional Development Department, a comprehensive review of printing and sales process of Bank's publications, allocation and usage of telephone lines and usage of SIDA grant (SEK 4.5 million) for high level training programmes under the Management Development Centre of the Bank.

During 2004, the Department initiated action on developing a Central Bank-wide risk assessment system. For

this purpose, a preliminary risk assessment framework with numerous generic risk factors involved was completed. In order to implement this risk management system, a multi-departmental Risk Management Committee was appointed and the Department functioned as the Secretariat to this Committee.

Management Development Centre

The Management Development Centre (MDC) continued to conduct its High Level Training programmes in the year 2004 with the financial support from the Swedish International Development Agency (SIDA) by engaging the services of eminent resource persons with experience in their respective fields of specialisation. This programme was aimed at updating and improving knowledge and competency of the senior staff of the Central Bank. The training opportunities under this scheme were made available to other organizations such as Ministry of Finance and the staff of universities to provide an opportunity for them to upgrade their knowledge and to create a forum for exchange of views.

TABLE II – 9
High Level Training Programmes conducted during 2004

Course Title	Duration	Resource Persons
1. A. Policy Discussion on "The Relation Between Public Finance and Monetary Policy of the Central Bank"	19 – 20 January, 2004 (02 days)	Professor Amit Bhaduri Formerly Professor of Economics Jawaharlal Nehru University, India
B. Course on "Role of the Price System and of Structural Change and Economic Development"	21 – 30 January, 2004 (08 days)	– do –
2. Course on "Designing Fiscal Policies for a Federalist Public Sector"	19 – 25 February, 2004 (05 days)	Professor Robert Paul Inman University of Pennsylvania, USA
3. Management Development Programme for Senior and Middle Level Officers	24 – 26 May (2 1/2 days)	1. Mr. Sunil S. Wijesinghe CEO, Merchant Bank of Sri Lanka 2. Mr. Ranjan de Silva Partner, SENSAI Lanka International
4. Workshop on Leadership	09 July, 2004	Mr. Dian Gomes, CEO MAS Holdings Ltd.
5. Research Workshop on "Inflation and Monetary Policy in an Open Economy"	01 – 14 September, 2004 (10 days)	Professor, William Branson Princeton University, USA
6. Research Workshop on "Exchange Rate Regimes and Policy"	04 – 15 October, 2004 (10 days)	– do –
7. Research Workshop on "Fiscal Policy and Debt Sustainability"	15 – 26 November, 2004 (10 days)	– do –
8. Outward Bound Professional Development Programme for Senior Officers of the Central Bank – 1	22 – 24 October, 2004 (2 1/2 days)	Sri Lanka Business Dev. Centre, Colombo
9. Outward Bound Professional Development Programme for Senior Officers of the Central Bank – 2	05 – 07 November, 2004 (2 1/2 days)	– do –
10. Outward Bound Professional Development Programme for Senior Officers of the Central Bank – 3	03 - 05 December, 2004 (2 1/2 days)	– do –
11. Management Development Programme	October – December, 2004	Merchant Bank of Sri Lanka

During the year 2004, 11 training programmes were conducted under this scheme (Table II – 9). Out of the 11 programmes 2 were on policy issues relating to Monetary Policy, Fiscal Policy, which were conducted by Professor Amit Bhaduri, Jawaharlal Neru University, India and Professor Paul Inman, University of Pennsylvania, USA. Professor William Branson, a renowned Economist with a strong record of research and training conducted 3 workshops covering the areas of Inflation and Monetary Policy, Exchange Rate Regimes and Fiscal Policy and Debt Sustainability.

As training of officers in the area of management is equally important to have an effective staff specially at the senior level, the Bank considered the importance of conducting professional development training programmes to build up the managerial skills of the senior staff. Accordingly, 6 programmes were conducted during the year 2004 were in the area of management development.

Payments and Settlements

The Payments and Settlements Department (PSD), marked a year of notable achievements in its efforts in ensuring of the safety, efficiency and stability of the country's payment and settlement system. The PSD as the operator of the Real Time Gross Settlement (RTGS) System, and backoffices of Central Bank's own payments, discharged the following duties:

- Operating and monitoring the RTGS System;
- Providing help desk services to participants;
- Operating and monitoring the payment gateway for Central Bank's own transactions;
- Processing and effecting payment and settlement instructions related to Central Bank's foreign exchange management operations;
- Processing and effecting payment and settlement instructions related to Central Bank's Open Market Operations (OMO);
- Custodian function of Central Bank's scrip securities portfolio up to the implementation of the LankaSecure System in February 2004;
- Handling SWIFT communications; and
- Effecting transactions under the Asian Clearing Union (ACU).

Payment systems oversight was the main focus of attention of PSD in the year 2004, which included:

- Overseeing the national payments system by collecting, compiling and analyzing data relating to payment instruments, infrastructure, payments and settlements systems in the country and preparing a half-yearly report on payment systems stability;
- Preparation of the Red Book and the quarterly Payments Bulletins;

- Liaising with international organizations in payments system related issues;
- Enhancing public awareness on payment system; and
- Making recommendations on payment system related policy issues.

Handling SWIFT Communications

The SWIFT Communication Division of PSD continued to perform the SWIFT related activities and effected modifications and upgraded the SWIFT system of Central Bank which included the following:

- The SWIFTNet System was implemented by October, 2004 replacing the X.25 system used to connect to the SWIFT Communication network;
- The link between the Central Bank SWIFT System with the SWIFT network was upgraded from 64k economy to 64k standard in order to increase the efficiency;
- The "SWIFT Alliance Access" of SWIFT backup site was upgraded from version release 5.00 to version release 5.5 at the end of December, 2004; and
- The SWIFT Net Link (SNL) was upgraded at the backup site from SNL 4.40 to SNL 5.00.

Transactions under the Asian Clearing Union

The total value of transactions of Sri Lanka effected through the Asian Clearing Union (ACU) mechanism increased by 61 per cent from Rs.100 billion in 2003 to Rs.161 billion in 2004.

PSD conducted a survey in June 2004 to obtain views of all commercial banks and selected exporters / importers on the ACU mechanism and problems encountered by them in effecting payments through the ACU mechanism. The findings of the said survey on bottlenecks and rigidities of ACU mechanism as well as Central Bank's suggestions were forwarded to the ACU Secretariat.

TABLE II – 10
Trade and ACU Transactions of Sri Lanka with other ACU Countries

Item	Rs. billion	
	2003	2004
Total transactions channeled through ACU	100.3	161.1
Sri Lanka's exports to other ACU Countries	31.9	51.0
Sri Lanka's imports from other ACU countries	137.4	199.9
Sri Lanka's total trade with other ACU countries	169.3	250.9
Net ACU settlements	90.6	142.3

Source: Central Bank of Sri Lanka

Oversight of Payments System

The payments system oversight and off-site supervision function performed by PSD focused on benchmarking the national payments system with applicable international standards with a view to ensure smooth, safe and efficient operations. In this exercise, PSD collected information periodically from all important payments and settlements service providers of the country and analyzed data to assess the compliance of such systems with the Ten Core Principles for Payments and Settlements Systems and the Nineteen Recommendations for Securities Settlement Systems published by the Committee on Payments and Settlements Systems (CPSS) of the Bank for International Settlements (BIS). Under its oversight function, PSD was able to cover the RTGS system, LankaSecure, retail clearing systems operated by LankaClear, clearing and settlement of securities transactions done at the Colombo Stock Exchange (CSE) by the Central Depository Systems (Pvt.) Ltd., National Net Settlement System operated by Bank of Ceylon for clearing Visa card transactions and the MasterCard International Services for intra-country settlement operated by Standard Chartered Bank.

Overseeing the activities of LankaClear was strengthened during 2004 by drafting and imposing Terms and Conditions on LankaClear in November, 2004. The PSD prepared the first report on Payment System Stability covering the second half of 2004 to the Financial Stability Committee in early January 2005.

Publications

One of the main targets achieved by the PSD during 2004, was the publishing of the Red Book - Payment Systems in Sri Lanka by BIS. This was prepared jointly by the Central Bank of Sri Lanka and CPSS of BIS. From the inception of CPSS in 1990, BIS has published the Red Books for 15 countries and Sri Lanka has become the sixteenth country in the world to publish its Red Book. In the Asian region, Sri Lanka is the third country in the line, after Singapore and the Republic of Korea. The quarterly Payments Bulletin that the PSD has been publishing since 2001, was continued during 2004. PSD also continued liaising with international organizations such as the BIS, SEACEN, World Bank and IMF as well as the central banks of other countries.

Public Awareness on the Payment System

With the objective of increasing the awareness of general public on payments system and promoting their usage of developed payment instruments, the PSD initiated several measures during 2004:

- PSD initiated action to extend the time of acceptance of third party transactions by commercial banks till 10.45 a.m. from the beginning of 2005 to enable the participation of more third party customers;

- The PSD also launched an awareness program of the RTGS system for the corporate clients of large commercial banks; and
- Several rounds of discussions were held with officers of the government revenue collection departments such as Inland Revenue, Customs and Excise.

Premises

The Premises Department continued to carry out the maintenance and upkeep of the Bank's premises during 2004, in addition to providing support services such as transport and communication facilities to officers of the Bank.

Most of the maintenance work and a part of the transport services have been outsourced with a view to obtaining services more efficiently and at a lower cost. Through improvements introduced to Bank's Energy Management Systems, the cost of consumption of electricity and of air conditioning were reduced. During the year 2004, the Premises Department installed an advanced fire Suppression System at the computer room and the Bank's disaster recovery site.

Public Debt

The achievements made in public debt management and debt market development in 2003 were further consolidated during 2004. The introduction of the Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS) in early 2004 was a milestone in the debt market development in Sri Lanka. This technological advancement in the debt market infrastructure intends to improve the efficiency of the government securities market and enhance secondary market trading by generating liquidity, reducing the risks associated with paper based securities, and finally reducing cost of transactions and cost of borrowing to the government. Further phasing out of the Rupee loan programme, early retirement of high cost callable rupee loans, strengthening the legal, institutional, and market framework for issue and trading of scripless securities, initiatives taken in respect of capital adequacy framework for Primary Dealers (PDs) are some of the key developments in debt management during 2004.

As per section 113 of MLA, the Monetary Board and the Central Bank are vested with the function of debt management. Accordingly, as the agent of the government, the Public Debt Department (PDD) raises resources from the domestic market to meet the budgetary requirements and services both foreign and domestic debt. The main objective of the PDD is to manage the government debt to ensure that financing needs of the government and its payment obligations are met at the lowest possible cost consistent with a prudent degree of risk. An appropriate strategy to achieve these objectives is designed at the Domestic Debt Management Committee (DDMC), which

consists of members from the Ministry of Finance and the Central Bank ensuring effective coordination between monetary, fiscal and debt management policies.

Developments in 2004

Debt Issuance and cost

In terms of the Appropriation Act, No.44 of 2003 approved by the Parliament for 2004, the total gross borrowing limit of the government amounted to Rs.350 billion out of which a sum of Rs.250 billion was to be raised from the domestic securities programme, and PDD, through its well planned borrowing programme, raised Rs.242 billion from domestic sources to fulfil the budgetary needs. Further, the total authorised limit of Treasury bills under the Local Treasury Bills Ordinance was increased from Rs.250 billion to Rs.300 billion in December, 2004 considering the future borrowing requirements of the government.

In line with the strategy adopted to increase reliance on tradable instruments, the bulk of the resource requirement for 2004 was raised through Treasury bills, Treasury bonds and Development bonds. In 2004, PDD conducted 53 Treasury bill auctions. The total amount accepted at these auctions was Rs.304,593 million out of bids amounting to Rs.657,702 million. During the year, issue of Treasury bills, in all maturities (91 day, 182 day, 364 day and other), amounted to Rs.469,973 million, while repayments in all maturities amounted to Rs.445,382 million resulting in Rs.24,591 million net new issue of Treasury bills. Reflecting the market preference towards short term bills of the total gross issues, 42 per cent was on 91 day Treasury bills.

The number of Treasury bond auctions held in 2004 was 33 and in view of further facilitating the trading in the secondary market by way of developing some benchmark securities, the number of series of Treasury bonds issued during the year was further reduced to 78 from 92 in 2003. The total amount of bids received at the Treasury bond auctions was Rs.136,218 million of which Rs.54,336 million was accepted. The total issues of Treasury bonds during the year amounted to Rs.217,198 million, of which 70.3 per cent was issued for 2 year and 3 year maturities. The repayments of Treasury bonds amounted to Rs.56,956 million resulting in Rs.160,242 million of net new issue of Treasury bonds during the year. Due to the market appetite leaning towards shorter end of the long term Treasury bond market, issues of 9 and 6 year maturities were limited to Rs.23,400 million.

The issue of Rupee loans in 2004 amounted to a meagre amount of Rs.564 million. In addition to the compulsory repayments of Rs.24,519 million, in view of reducing the cost of the existing debt, action has been taken to retire callable Rupee loans amounting to Rs.59,700 million which carried interest rates of 11.25 – 13 per cent. Consequently, the net repayment was Rs.83,655 million in respect of Rupee Loans.

In conformity with the debt management strategy, the share of non-tradable securities in the domestic debt stock declined from 25 per cent in 2003 to 15 per cent in 2004.

The issue of Sri Lanka Development Bonds (SLDBs) during 2004, under Foreign Loans Act, No. 29 of 1957 amounted to Rs.25,705 million, while repayments were at Rs.9,344 million resulting in a net issue of SLDBs of Rs.16,361 million.

Table II – 11 provides details of issues and maturity of domestic debt in 2004.

TABLE II – 11
Issue and Maturity of Domestic Debt in 2004

	Maturity	Issues	Repayments	Rs. million
				Net Issues
Treasury Bills	91 day	197,147	185,691	11,456
	182 day	85,605	50,828	34,777
	364 day	114,047	145,863	(31,816)
	Other	73,174	63,000	10,174
	Sub Total	469,973	445,382	24,591
Treasury Bonds	1 year	19,970	–	19,970
	2 year	101,028	21,422	79,606
	3 year	51,700	19,534	32,166
	4 year	9,600	10,000	(400)
	5 year	11,500	6,000	5,500
	6 year	13,400	–	13,400
	9 year	10,000	–	10,000
	Sub Total	217,198	56,956	160,242
Rupee Loans	2/5 year	–	38,419	(38,419)
	2/6 year	564	–	564
	4/8 year	–	3,500	(3,500)
	5/6 year	–	6,000	(6,000)
	5/7 year	–	1,500	(1,500)
	6/7 year	–	33,800	(33,800)
	6/8 year	–	1,000	(1,000)
Sub Total	564	84,219	(83,655)	
Sri Lanka Dev. Bonds	2 year	25,705	9,344	16,361
	Sub Total	25,705	9,344	16,361
Total		713,440	595,901	117,539

Source : Central Bank of Sri Lanka

Debt Service Cost

Total interest payments on account of the debt serviced by the PDD amounted to Rs.119,195 million recording a marginal decline over the previous year which was at Rs.122,455 million. Interest payments in 2004 on domestic debt amounted to Rs.103,554 million. Of the total interest cost on domestic debt, Rs.19,942 million was on Treasury bills, while Rs.54,677 million was on Treasury bonds. Total interest payments on Rupee loans amounted to Rs.28,885 million. There was an estimated interest saving of Rs.5,500 million to the government as a result of early retirement of Rupee loans in 2004, which

amounted to Rs.59,700 million, issued at higher yield rates in the past. In respect of FCBU loans and Sri Lanka Development Bonds (SLDBs) a sum of Rs.1,563 million was paid as interest payments.

Total repayments on account of domestic debt in terms of face value amounted to Rs.141,175 million in 2004. This is in addition to the roll over of Treasury bills amounting Rs.445,382 million. Repayments on account of SLDBs amounted to Rs.9,344 million compared to Rs.15,179 million in 2003.

During the year, PDD serviced 595 foreign loans and the total debt service cost amounted to Rs.44,311 million compared to Rs.37,247 million in 2003. Interest payments on foreign loans in 2004 amounted to Rs.14,084 million compared to Rs.11,826 million in 2003.

Yield Rates of Government Securities

The yield rates on government securities which started to increase towards the end of 2003 continued to increase in 2004 first half and peaked in July 2004. This trend was reversed

during the latter part of the year and yield rates got stabilised at a level below the rates that prevailed at the beginning of the year. The annual weighted average yield rates of Treasury bills fell from 9.07 per cent in 2003 to 8.49 per cent in 2004. The annual weighted average yield rates of Treasury bonds at the Primary Auctions were also lower in 2004 compared with 2003 except in the case of 3 year and 10 year Treasury bonds. Weighted average interest rate of the Rupee loans issued in 2004 was 8.88 per cent per annum. Weighted average yield rate of SLDBs issued in 2004 was 6 month LIBOR + 1.793 per cent per annum.

The secondary market yield rates of Treasury bills increased approximately by 15 – 60 basis points (bps) while that of 2 – 5 year Treasury bonds increased by about 140 – 290 bps as at end 2004 compared to the year end secondary market yield rates of and 2003.

Annualised weighted average yield rates of Treasury bills, Treasury bonds and Rupee loans in Primary market are given in Table II –12.

TABLE II – 12

Annualised Weighted Average Yield Rates of Treasury Bills, Treasury Bonds and Rupee Loans

Instrument	Per cent per annum					
	1999	2000	2001	2002	2003	2004
Treasury Bills (days) (a)(b)						
91	11.69	12.80	16.09	12.69	9.13	8.46
182	12.03	12.94	17.32	12.90	9.04	8.44
364	12.55	14.14	18.34	13.84	9.02	8.55
Overall average	12.06	13.62	17.37	13.23	9.07	8.49
Treasury Bonds (Years) (a)						
2	13.01	16.71	19.82	14.88	10.75	9.78
3	13.31	15.00	15.60	14.29	9.69	9.83
4	13.53	12.52		14.54	9.97	9.61
5	13.78	12.78		14.69	10.97	10.31
6	13.65	12.88		14.83	9.56	9.30
10					8.72	11.11
15					9.01	
20					6.66	
Overall average	13.37	15.10	18.07	14.57	9.59	9.82
Rupee Loans (Years) (c)						
2			15.00			
5			14.03	13.00	11.93	
6		11.00			8.40	8.88
8	12.25					
10	12.50	12.00	13.00			
Overall average	12.36	11.68	14.31	13.00	11.66	8.88

Source : Central Bank of Sri Lanka

- (a) Includes 10% withholding tax. Effective from 3 May 2002, government has imposed withholding tax on interest of Government Securities.
- (b) The issue of Treasury bills with maturities of 91 days, 182 days, and 364 days in place of 3, 6, 12 month maturities respectively, commenced in October, 1999.
- (c) For callable Rupee loans the compulsory date of repayment was considered.

Debt Market Development

Scriptless Securities Settlement System (SSSS) and the Central Depository System (CDS) (LankaSecure)

A pioneering step taken by the Central Bank in 2004 in the sphere of debt market development was the implementation of a Scriptless Securities Settlement System (SSSS) and introduction of a Central Depository System (CDS) for Sri Lankan government securities market. The issuance of Treasury bills and Treasury bonds in scripless form was commenced on the 30th January 2004. The CDS facilitated recording of transactions of government securities to the level of beneficial owners of such securities. With the commencement of issuing scripless securities a procedure was also adopted to convert Treasury bills and Treasury bonds which were in scrip form into scripless form. By the middle of February 2005 all outstanding Treasury bills will be in scripless form.

In the area of technological developments, PDD took action to modify the electronic bidding system to be compatible with the SSSS. It has also been introduced several new electronic interfaces for transferring auction results to CDS, handling securities conversion process and printing statements to be issued to the investors.

Enabling the operations of scripless securities system, the required legal amendments were made to Registered Stock and Securities Ordinance (RSSO) and Local Treasury bills Ordinance (LTBO). In addition, system rules, procedures, directions and guidelines required for the smooth functioning of the system were issued during the year to the participants of "LankaSecure".

The value of Scriptless Securities issued during the year amounted to Rs.436,965 million of Treasury bills and Rs.225,667 million of Treasury bonds. The system made

Rs.26,022 million of coupon payments on account of scripless Treasury bonds and Rs.303,668 million of maturity payments on both scripless Treasury bills and scripless Treasury bonds.

LankaSecure handled 124,150 transactions with a total value of Rs.6,967,753 million during the year. These included transactions of repositioning, delivery vs. payments, Repos / Reverse Repos and Intra-day Liquidity Facility (ILF).

Number of participants in LankaSecure system was 33 comprising of 9 Primary Dealers, 22 Licensed Commercial Banks, Employees' Provident Fund and the Central Bank. The number of investor accounts maintained by these participants in the system as at end 2004 was 23,377. Total number of transaction statements issued by LankaSecure during 2004 was 42,292 while number of payment statements issued was 22,754.

Other Market development activities

The Central Depository System of the Colombo Stock Exchange (CSE) was given a direct participant status in the Scripless Securities Settlement System and the Real Time Gross Settlement System to trade the beneficial interest in government securities.

Regulation and supervision of the Primary Dealer System

With the commencement of operations by NatWealth Securities Ltd., the Primary Dealer (PD) network was further expanded to 12 PDs. During the year, PDD continued to supervise PDs adopting onsite and offsite examinations, spot examinations, one-on-one discussions, risk analysing techniques, *etc.* In view of the volatile market conditions that prevailed during the first seven months of the year, there was an erosion in the capital base of the PDs. Hence, PDD took timely and corrective action to restructure their capital base and strengthen the stability of the industry. In order to counteract high market volatility, a direction was issued to prevent short selling by PDs without actually holding the relevant securities in its portfolio. Another direction was issued to prevent PDs from having adjusted trading or using away prices for recording their transactions. Several seminars and discussions were conducted on proposed risk weighted capital adequacy framework with the assistance of the World Bank. This new framework intends to minimise the market risk faced by the PDs and maintain the stability of the Industry. Meanwhile, PDD continued to monitor the compliance of PDs to the code of conduct introduced in 2003. Trading hours of the Bloomberg Trading System, an exclusive trading platform for PDs were extended to 3 hours from 1 hour in 2004. In view of popularising investment in government securities, PDD conducted several awareness programmes for investors. In addition, an awareness programme on regulatory framework of PDs was conducted for External Auditors. With the objective of giving exposure to the debt market in other countries, PDD arranged a study tour for PD representatives in Sweden in collaboration with Sveriges Riksbank.

Secondary Market Transactions of Primary Dealers

The total value of the secondary market transactions (outright sales/purchases and Repos/Reverse Repos) in Treasury bills and Treasury bonds where a Primary Dealer is a party to transaction amounted to Rs.4,135.5 billion recording a decline of 10.5 per cent compared with the previous year. The decline was mainly due to the drop in Repo transactions in Treasury bills by 74.6 per cent and the drop in outright sales/purchases of Treasury bonds transactions by approximately 50 per cent.

It has been observed that the Primary Dealers have changed their risk appetite to a risk aversion position leading to an increase in short end market transactions such as overnight Reverse Repos in the secondary market.

Overnight Reverse Repos by PDs on account of Treasury bonds rose by more than two and a half times, while on account of Treasury bills it increased by 20 per cent during 2004 compared with the previous year.

The total outright sales of Treasury bills amounted to Rs.317,025 million, whereas the outright purchases amounted to Rs.72,693 million. In value terms these sales and purchases constituted 10 per cent of transactions in the secondary market compared to 7 per cent in 2003. The value of Repo transactions of Treasury bills in 2004 amounted to Rs.268,866 million while Reverse Repos amounted to Rs.289,823 million. In value terms these Repos and Reverse Repos constituted 14 per cent of transactions in the secondary market compared to 28 per cent in 2003.

The total outright sales of Treasury bonds in 2004 amounted to Rs.222,326 million while outright purchases amounted to Rs.173,099 million. In value terms, these sales and purchases constituted 9 per cent of transactions in the secondary market compared to 17 per cent in 2003. Repos and Reverse Repos of Treasury bonds in 2004 amounted to Rs.1,983,963 million and Rs.807,735 million respectively. In value terms these Repos and Reverse Repos constituted 68 per cent of transactions in the secondary market compared to 49 per cent in 2003.

Regional Development

During the year under review, the Regional Development Department (RDD) continued to function as the apex agency for both donor funded and government sponsored development credit schemes. As the apex agency, RDD is responsible for implementing policies and programmes through the participating credit institutions (PCIs) with a view to facilitating micro, small and medium sectors (MSMSs) in the country. In this regard, RDD is responsible for issuing operating instructions to PCIs, disbursement and recovery of refinance under the credit schemes, monitoring and supervision of such projects, arrange awareness programmes with the assistance of line ministries, maintenance of records and provide necessary

assistance to donors and other stakeholders under the development credit schemes. Furthermore, RDD is assigned with the task of assisting missions, donors and government agencies in the formation of new credit lines and review of progress under the on-going projects.

The projects implemented by the RDD during the year 2004 are given in Table II-13.

During 2004, RDD strengthened its regional involvement through the three regional offices at Anuradhapura, Matale and

TABLE II – 13
Credit Schemes Operated by the Regional Development Department during 2004

	Name of the Project	Funding Agency	Broad Mission	Original Allocation	Annual Interest Rate to the Borrowers	Credit Disbursement upto 31.12.2004 (Rs. mn.)	Recovery Rate where applicable (%)
1.	Tea Development Project (1999-2005)	ADB	Increase tea small holders income on a sustainable basis and to improve the natural environment in the project area.	US \$ 28 mn.	On the basis of AWDR + 8.5 - 10.5% (for Field Development) AWDR + 6% (for Factory Development)	2,483	92%
2.	Second Perennial Crops Development Project (1998-2004)	ADB	Increase the production and commercialisation of Perennial Crops, development of nurseries, post-harvest handling and processing activities and marketing.	SDR 11.562 mn.	On the basis of AWDR + 8.5 - 10.5% per annum	1,830	92%
3.	Skills Development Project (Year commenced 2000)	ADB	Improve quality and relevance of skill training programmes to build a high quality workforce and address issue of skills mismatch and unemployment among rural and urban youth.	SDR 0.657 mn.	10%	13	n.a.
4.	North-Central Province Participatory Rural Development Project (1996-2002)	ADB, IFAD, SIDA and WFP	Poverty alleviation, improves food security, nutrition and increase employment opportunities for low-income families.	SL Rs. 153 mn.	AWDR or 10% whichever is lower + 6 percentage points	21	90%
	North-Central Province Rural Development Project (1997-2003)			SL Rs. 43 mn.		21	90%
5.	Poverty Alleviation Micro-finance Project (Year commenced 2000)	JBIC	To establish a cost effective and sustainable micro-credit delivery system to generate employment and improve savings habits.	¥ 1,368 mn.	Market Rates Agri. – 16% Other – 20%	453	98%
6.	Matale Regional Economic Advancement Project (2000-2006)	IFAD	Permanent raising and sustaining of income of small entrepreneurs of rural and farmer families of project area.	SDR 2 mn.	12%	175	95%
7.	New Comprehensive Rural Credit Scheme	PCIs with govt. interest subsidy	Upliftment of rural farmers who cultivate short-term food crops.	–	8%	936	n.a.
8.	Small Farmers & Landless Credit Project (1990-2000)	IFAD, CIDA, and GOSL	To establish a cost effective and sustainable micro-credit delivery system to generate employment and improve savings habits.	SDR 4.85 mn.	Market Rates Agri. – 16% Other – 20%	1,224	97%
9.	Kegalle District Integrated Rural Development (Revolving Fund) Project (1997-2007)	Govt. of Sri Lanka	Uplift the standard of living of the people in the project area by promoting income-generating activities.	SL Rs. 80 mn.	10%	403.1	94%
10.	Southern Province Rural Development (Revolving Fund) Project (from 2000)	PCIs with govt. interest subsidy	To improve the quality of life of the people in the Southern Province.	US \$ 8.1 mn.	12%	50	90%
11.	Urban Development and Low Income Housing Project (Credit Component)	ADB	To provide capital to support lending to low income household groups for housing improvements	US \$ 20 mn.	11.9%	1,875	n.a.

Matara by conducting several programmes in development banking, agriculture productivity, forward sales contracts, promotion of export markets for agricultural produce and micro-irrigation systems.

Forward sales contract (FSC), which is an agreement made between a buyer and a producer to sell agricultural commodities to a buyer on an agreed future date at a pre-determined price, was initiated in 1999 by the Central Bank. The International Bank for Reconstruction and Development (World Bank) supported the initial programme by providing assistance under its Development Marketplace project. The Central Bank implemented this programme by co-ordinating the activities undertaken by participating financial institutions (PFIs) and participatory agencies (PAs) throughout the country. During the year under review, several awareness programmes were held in major agricultural areas in order to extend the system to cover a large geographical area with new crops, such as ginger, sunflower and papaya. In recognition of the impact of the FSC system to stabilise the prices of agricultural commodities, the Central Bank, in consultation with the government, has increased the upper limit of purchasing loans from Rs.5 million to Rs.25 million per borrower during the year under review.

TABLE II – 14
Forward Sales Contracts – 2004

Crop	No. of Agreements signed	No. of Farmers benefited	Forward price determined (Rs. / kg)
Maize	7,048	7,102	14 – 18
Paddy	13,130	13,470	13 – 16
Finger Millet	1,813	1,890	20 – 25
Soya	5,442	5,520	27 – 30
Greengram	5,335	5,443	45 – 50
Other Crops ^{1/}	9,075	9,940	25 – 375
Total	41,843	43,365	

1/ Ginger, sesame, papaya, sunflower, vegetables

Source : Regional Development Department

RDD with the collaboration of the RDBs and its Regional Offices (ROs) implemented a programme for improving the productivity in the agricultural sector on a pilot basis in 2004. The main focus is to introduce new technology, *i.e.*, drip irrigation (micro irrigation) systems, improved post-harvest technologies, application of inputs (fertiliser and hybrid seeds). The selected crops by RDBs under the programme are paddy, other field crops and vegetables, which deserve being treated with priority in view of their significance as main income earners. During the year under review, RDD has conducted meetings with suppliers of new technology and buyers of the agricultural products to enable them to import new knowledge to farmers.

RDD continued to monitor the activities of the six Regional Development Banks (RDBs) with the objective of

strengthening their financial and operational viability. All six RDBs achieved commendable improvement in all financial ratios and achieved budgetary targets during the year under review. The profitability of RDBs also increased and their net non-performing loan ratios declined to a single digit level. Further, the Return on Assets (ROA) has also improved noticeably compared to previous years.

All three Regional Offices (ROs) of the CBSL at Matara, Anuradhapura and Matale, continued to function to meet the objectives of their establishment in the respective regions. The ROs, in association with financial institutions, government departments and NGOs on development lending, carried out several programmes to promote entrepreneurship development, training for students and teachers on banking and other relevant fields. They involved with the activities relating to agricultural development and delivery of rural credit through the financial institutions in the respective regions.

The ROs concentrated mainly on the improvement of marketing facilities for agricultural produce, delivery of agricultural credit under FSC System during the year under review. Accordingly, the ROs were able to facilitate 27,018 forward sales contracts to the value of Rs.1,181 million. During the year, the three ROs conducted 116 awareness programmes on the FSC System, productivity improvement of agricultural crops and credit delivery under NCRCS. All three ROs assisted the Statistics Department of CBSL by collecting data on weekly basis, conducted centre supervision and seminars for the benefit of data collators. Furthermore, the service of checking balances of the EPF accounts and issuing of statements indicating the outstanding balances in the accounts were continued during the year under review.

Secretariat

In 2004, the Secretariat Department continued to carry out its administrative functions such as procurement of goods and services for the Bank, matters relating to foreign and local travel of bank officials, general administration, protocol functions, leave policy matters and other miscellaneous administrative operations such as the disposal of obsolete items *etc.* In addition, with a view to motivating employees' interpersonal relationships and improving their talents in different disciplines, the department organized several social and cultural activities during 2004. The department also effected all payments relating to travel, procurement of goods and services and settlement of advances.

Mail Room operations and data entry operations, which were out-sourced earlier, continued under the same arrangement.

To identify the needs and granting relief to Bank employees / pensioners affected by the Tsunami disaster, a Task Force was appointed on 28 December 2004.

Security Services

Security Services Department is assigned the task of protecting the Bank's employees, buildings, equipment and property and also to provide security for the movements of its assets and currency.

The Department was actively involved in the tasks of developing a Business Continuity Plan for critical IT applications and in strengthening the physical security of IT installations both at the primary site and the Disaster Recovery Site.

In order to equip Fire Wardens and security staff to better perform their duties, the following training was provided to them.

- (a) Fire Classes were held for the Fire Wardens of all department of the CBSL Head Office. This training programme was conducted in liaison with the Colombo Fire Brigade. In addition, there was a fire evacuation drill for all employees of the Central Bank with the participation of security officers. Fire fighting vehicles and equipment were brought for this evacuation drill by the Colombo Fire Brigade.
- (b) Annual weapon training and firing was conducted for the security officers on 13,14,20 and 21 November 2004.
- (c) Fire Classes were held for the employees of Center for Banking Studies at Rajagiriya and Regional Offices. This training programme was conducted by the Fire Officers of the Security Services Department.

Statistics and Field Surveys

In 2004, the Statistics Department (SD) accomplished two main tasks, namely, performing the routine functions of data collection, compilation, analysis and dissemination of statistics on key macro economic variables and completion of the field work on the Consumer Finances and Socio Economic Survey 2003/04 (CFS 2003/04) that was started in the previous year. While the former covers the statistics on national accounts, prices, wages and employment, the latter is intended to generate periodical survey data on a wide array of socio economic variables to assess the quality of life and socio economic developments in Sri Lanka, an exercise conducted by the Bank at regular intervals since 1953.

In the current survey, the field work was completed in October and the data editing and verification were concluded by December 2004. Based on the preliminary findings of the survey, a public seminar was also conducted by the Bank in December. The final report is due to be issued in mid 2005, but the preliminary data could be accessed from the Bank's website, www.centralbanklanka.org.

Consumer Finances and Socio Economic Survey (CFS) 2003/04

The CFS 2003/04 is the 8th in the series of household surveys that commenced over fifty years ago with a view to collecting information on key socio-economic variables at the household level. The field work of the CFS 2003/04, which commenced on 05 October 2003 was completed on 10 October 2004. The field enumeration consisted of four rounds of three months each. In each round, one fourth of the sampled households were enumerated covering 9 provinces in the country, except the 3 districts of Mannar, Killinochchi and Mullativu in the Northern Province. A very successful field programme that covered 11,722 households in 1,508 blocks, resulted in almost 100 per cent coverage for blocks and 99.6 per cent response rate for households. These were the highest ever recorded coverage and response rates in the survey series. Taking advantage of the ceasefire and the expanded coverage of the Census of Population and Housing 2001, the Department was able to cover the Districts of Jaffna, Vavuniya, Batticaloa and Trincomalee for the first time, after a lapse of 20 years, in this survey. Consequently, the data generated in this survey will update the current database on socio-economic conditions at household level, that would serve to assess the living conditions of households in the entire country. Also, the information collected in the survey on prices, wages and household consumption would be used to compile and update indices on prices and wages and to estimate private consumption expenditure in the national accounts of the country.

Country Wide Data Collection System (CWDCS)

Data collection under the CWDCS is accomplished through an island-wide network of school teachers who function as field investigators. In January 2004, there were 93 centres under the CWDCS throughout the country, excluding the Northern and Eastern Provinces. Some improvements were introduced to the system during the year. First, the geographical coverage was increased by establishing 14 new data collection centres in the Northern and Eastern Provinces, where data had not been available for nearly 15 years due to the civil disturbances. Second, a new set of data collection formats was designed, taking into account current developments in markets in the area of product differentiation, vanishing of existing products and trade names, and emerging of new economic activities. Third, the field supervision programme was strengthened and all centres were monitored according to a pre-set timetable. As in the past, four regional seminars in Matara, Kandy, Colombo and Anuradhapura were conducted to provide refresher training to the investigators in order to improve the accuracy, quality, efficiency and timeliness of their data collection and also to educate them on contemporary developments in the economy, so that such knowledge can be transferred to school children

and other members of the society. In addition, a two-day residential training programme was conducted in Trincomalee for the teachers selected as field investigation from the North and East.

National and Regional Income Accounts

The Department continued to compile the annual and the quarterly estimates of Sri Lanka's national accounts. These included the collection of primary and secondary data and the estimation of key parameters in relation to overall production, consumption, savings and investment in the country. The estimates were disseminated to the public through the print and electronic media in 2004 as well. The quarterly estimates were disseminated through 3 media conferences held in accordance with the advance release calendar. The work initiated in 2003 to build a data series on quarterly national accounts by the expenditure method continued throughout 2004 and incorporated further improvements to the methodology. These estimates are expected to be finalised shortly.

As in the recent past, the Department also compiled the annual Gross Domestic Product disaggregated by Province with a lag of one year, for 2002. These statistics were made available to the public as a time series, from 1996 to 2002, in the 2003 Annual Report, for the first time. The series provide comprehensive statistics for policy makers in analysing and identifying regional disparities in economic activities and growth performances in the country.

Prices, Wages and Employment

The Department compiled and analysed six monthly price indices. While the five regional consumer prices indices measured the aggregate price movements in retail prices in five different regions, the Wholesale Price Index measured the same for producer or wholesale prices. The prices necessary for the compilation of all indices were either collected through the CWDCS or by investigators outsourced from a company and trained by the Department.

In addition, the Department continued with the analysis of movements of consumer prices based on the Colombo Consumers' Price Index (CCPI) and the Sri Lanka Consumers' Price Index (SLCPI) which are compiled by the Department of Census and Statistics (DCS). The Department also continued to issue a monthly press release on inflation movements as measured by the CCPI and CDCPI. In addition, a system of quarterly reports to the Monetary Board analysing price and wage movements was established during the year. Also, preliminary work was undertaken from the beginning of the year to compile an Informal Sector Wage Rate Index (ISWRI) for Sri Lanka, based on the CWDCS wage data and the CFS employment structure in the informal sector. This project was completed in December 2004.

The Department continued to conduct its Annual and Quarterly Public Sector Employment Surveys. Information

from both surveys was used in the compilation of the national income accounts. Key findings from these surveys were also reported on a regular basis to the Monetary Board throughout the year.

Dissemination of Statistics

During the year, SD released its two annual publications titled "Socio Economic Data – volume XXVI" in June and "Economic and Socio Statistics of Sri Lanka 2004 – Volume XVI" in December. The statistical tables in the pocket diary 2005 of the Bank were also updated, while new tables were introduced to provide preliminary statistics from the CFS 2003 / 04.

The Department made its regular contributions to statutory as well as several other Bank publications during the year. The Monetary Board was kept informed of the current situation with regard to national income, inflation, prices, wages and the labour market, as and when necessary. The Department continued to routinely update its Departmental website on the local area network, STANET, and to contribute to the Bank's website throughout the year.

The Department's senior staff regularly functioned as resource persons at several seminars, workshops and training programmes organised by the Bank, government ministries and educational institutions. With a view to improving overall productivity, the Department continued training its officers and many Staff Officers and Non Staff Class Officers underwent local and foreign training, during the year.

Supervision of Non-Bank Financial Institutions¹

The Department of Supervision of Non-Bank Financial Institutions (SNBFI Department) continued to carry out its regulatory and supervisory functions in respect of registered finance companies (FCs) with the objective of ensuring that FCs comply with the minimum prudential requirements stipulated by the Central Bank. These functions were carried out mainly through off-site surveillance and on-site examinations. The Department is also entrusted with the task of registering and monitoring finance leasing establishments.

During the year, one new finance company was registered under the provisions of the Finance Companies Act, No.78 of 1988 (FCA). Consequently, the total number of finance companies stood at 27 at the end of 2004. The total number of registered finance leasing establishments (RFLEs) as at the same date was 65.

2. Off-site Surveillance

The Department continued its off-site surveillance of registered finance companies. In this process, periodical returns submitted by FCs were analysed to assess the financial condition of FCs

and monitor their compliance with the provisions of FCA and Directions and Rules issued under it. Returns obtained from FCs included the following :

- Weekly statements of liquid assets
- Monthly statements of large advances
- Assets and liabilities, and cash flow statements
- Quarterly statement of non-performing advances
- Annual audited balance sheets and profit and loss accounts.

Directions issued under FCA included minimum capital and liquidity requirements, provisioning for bad and doubtful debts, single borrower limits and limits on equity investments.

3. On-site Examination

The Department concluded comprehensive on-site examinations of four Finance Companies during the year. Aspects covered in the examinations included capital adequacy, assets quality, management efficiency, earning and liquidity, internal controls and systems and the companies' compliance with the statutory requirements. Meanwhile, spot examinations were conducted on Finance Companies, which were not subject to on-site examinations prior to the issue of annual licences for 2005. These spot examinations covered selected critical areas such as non-compliance with Directions and deficiencies in systems and controls.

4. Registration of Finance Leasing Business

In terms of the provisions of Finance Leasing Act, No. 56 of 2000 (FLA), a certificate of registration is necessary to carry on finance leasing business. During the year, 9 institutions, comprising 2 public companies, 1 commercial bank, 2 finance companies and 4 specialised banks were registered under the provisions of FLA. At the end of 2004, the number of registered finance leasing establishments stood at 65 comprising 11 licensed commercial banks, 8 licensed specialized banks, 27 finance companies and 19 public companies.

5. Failed Finance Companies

Of the finance companies which failed during late 1980s and early 1990s, the administration and management of nine companies were vested in the Monetary Board. Of these, six were under liquidation at the end of 2004. During the year, a petition was filed in Courts for liquidation in respect of one failed finance company and preparatory work was done for filing a petition for winding up of another company.

6. Public Awareness Programme

The Department focussed its public awareness programmes mainly on educating the public on matters relating to unauthorized conduct of finance business and operations of pyramid schemes as shown below :

(a) The following were published in newspapers :

- (i) A list of registered finance companies, in February 2004
- (ii) Names of three companies which were conducting finance business in contravention of the provisions of the Finance Companies Act, in February, May and October 2004, respectively
- (iii) A press release on "Acceptance of Deposits from the Public" in May 2004
- (iv) Detailed notice to the public on pyramid schemes in June 2004 followed by further short notices
- (v) Articles written by officers of the Department on pyramid schemes.

(b) Officers of the SNBFI Department participated in television and radio programmes and interviews with the Press to educate the public on matters relating to unauthorized acceptance of deposits and operation of pyramid schemes by some parties and also participated as resource persons in seminars conducted by outside organizations on investment opportunities available to the public.

7. Investigations in respect of unauthorised conduct of finance business and related matters

The Department conducted investigations into the affairs of several institutions, which were allegedly conducting finance business without any legal authority to do so. In respect of two companies, reports were submitted to the Monetary Board on conclusion of investigations and the Monetary Board made determinations that the two companies were conducting finance business in contravention of the provisions of FCA. Regarding these companies, appropriate action has been taken under the provisions of FCA. In 2004, the Department initiated legal action against a company which failed to comply with the Directions issued by the Monetary Board consequent to a determination made by the Monetary Board that the said company had been conducting finance business without any legal authority.

In 2004, a judgement was delivered by the Court of Appeal dismissing with costs two applications made by two companies against the Monetary Board and the Director of SNBFI Department. The companies filed action objecting on several grounds to the Director requiring information and documents from them in respect of the business carried out by them. In the judgement, the Court of Appeal has enunciated the important principle that the Director is entitled to call for information and documents in order to determine whether the companies are in fact engaged in deposit taking disguised in the name of "credit investments".

The Centre for Banking Studies (CBS)

CBS continued its functions of imparting knowledge and developing the skills of personnel of both the Central Bank and other financial institutions. Such upgrading of skills is necessary for them to meet the new challenges arising from technological advancements and financial innovations, on the one hand, and add value to their institutions through improved productivity on the other. During 2004, CBS conducted 69 short-term training programmes as against 71 conducted in the previous year. Programmes covered a wide range of topics in the fields of Banking Operations and Bank Supervision, Financial Sector Development and Economic Management. Several programmes on Information Technology and Language Competence and Communication Skills were conducted mainly for the CBSL staff. CBS also conducted a few programmes to cater to the needs of the rural sector, which were attended mainly by the staff of the Regional Development Banks and field officers of Non-Governmental Organisations. CBS also conducted 12 special programmes to cater to the requests made by other organisations and institutions. In addition, in its public lecture series, 10 distinguished speakers delivered public commemoration lectures on topics of current interest during 2004.

TABLE II – 15
Training Programmes Conducted by CBS in 2004

Classification	No. of Programmes	Trainees		Total	Total Training Hours
		CBSL	Other		
Banking Operations and Bank Supervision	15	86	350	436	186
Financial Sector Development and Economic Management	5	35	106	141	60
Information Technology	23	311	10	321	738
Languages and Communication Skills	7	172	–	172	436
Management	2	16	43	59	24
Rural Sector	5	–	121	121	78
Special Programmes	12	79	178	257	222
Total	69	699	808	1,507	1,744

Source : CBS, Central Bank of Sri Lanka

Training

The Bank recognizes its staff as its best asset. Therefore, the development of skills and competencies of the staff is a vital factor to work towards the achievement of its objectives in an

TABLE II – 16
Commemoration Lectures and Public Seminars Conducted in 2004

Date	Topic	Lecturer
29 - Jan - 04	Towards a National Policy on General Education in Sri Lanka	Prof. R.P. Gunawardena Chairman, National Education Commission
16 - Feb - 04	Payments System Law Reform: Scope and Components	Prof. Bejamin Geva York University, Canada
26 - Feb - 04	Fiscal Federalism and Democratic Governance (Independence Commemoration Lecture)	Prof. Robert P. Inman University of Pennsylvania, USA
23 - Mar - 04	Old Age Income Security: Pensions	Dr. G. Uswatte-Arachchi Consultant, Central Bank of Sri Lanka
13 - May - 04	State of the Economy as Reflected in the Central Bank Annual Report 2003 (Republic Commemoration Lecture)	Dr. P.W.R.B.A.U. Herat Additional Director, Economic Research Dept. Central Bank of Sri Lanka
17 - Jun - 04	Moving Beyond Islamabad: Towards a South Asian Economic Union	Prof. Rehman Sobhan Chairman, Center for Policy Dialogue, Bangladesh
26 - Aug - 04	Economic Development in South Asia and the Impact of Globalisation (54 th Anniversary Lecture of the CBSL)	Dr. Ishrat Husain Governor, State Bank of Pakistan
23 - Sep - 04	Crop Productivity Food Security and Farmer Income	Dr. U. P. De S. Waidyanatha Director-General, National Agribusiness Council
26 - Oct - 04	Micro Finance as an Instrument for Small Enterprise Development :Opportunities and Constraints (23 rd Anniversary Lecture of the CBS)	Prof. S.S. Colombage Open University of Sri Lanka
09 - Dec - 04	Are Life Styles and Living Conditions in Sri Lanka Changing? Preliminary Findings from the Consumer Finances and Socio Economic Survey 2003/04 of the Central Bank of Sri Lanka	Dr. (Mrs.) Anila Dias Bandaranaike. Director, Statistics Department Central Bank of Sri Lanka

Source: CBS, Central Bank of Sri Lanka

environment of rapidly changing global financial conditions. In order to work towards this end, both the employees and the management are expected to work collaboratively through an active learning and training programme. In this background, the Bank has re-designed its training policy to create an environment conducive for the staff to learn, train themselves and share knowledge, expertise and experience with others. In addition to the development of professional and technical skills, the Bank recognises the importance of training officers in the area of management, specially those who are at the senior level to build up leadership qualities. Recognizing this need, the Bank provided opportunities for the senior staff to participate in "Outward Bound Professional Development Training Programme" to train them in the areas of managerial skills, team work, strategic planning, decision making and challenge facing abilities.

During the year under review, 203 officers were trained in overseas short-term training programmes, while the number trained in local training programmes was 966. The majority of officers trained locally, *i.e.* 545, were in the areas of Information Technology and Communication Skills. 301 officers were trained in programmes conducted by various local training institutions.

TABLE II – 17
Training of Officers:
Short-term Training Programs / Seminars – 2003-04

Department	No. of Officers Trained			
	Foreign		Local	
	2003	2004	2003(a)	2004(b)
1. Economic Research	23	36	57	70
2. Bank Supervision	19	22	48	45
3. Information Technology	7	15	6	54
4. Secretariat	6	12	42	43
5. Employees' Provident Fund	5	7	60	83
6. Public Debt	10	5	22	24
7. Regional Development (c)	9	14	40	47
8. Centre for Banking Studies	–	4	19	24
9. Currency	3	4	28	72
10. Human Resources	–	4	26	33
11. Exchange Control	4	6	24	46
12. Management Audit	3	7	20	70
13. Premises	–	2	26	38
14. Statistics	5	9	31	32
15. SNBFI	3	10	35	27
16. Welfare	1	–	24	21
17. Training	2	2	11	12
18. Security Services	–	–	22	33
19. Legal	2	5	9	28
20. Information (including Library)	–	5	31	48
21. Finance	2	6	24	32
22. Domestic Operations	4	7	12	26
23. International Operations	8	15	13	19
24. Payments & Settlements	5	6	12	36
25. Management Dev. Centre	1	–	–	–
26. Government Audit	–	–	–	3
Total	122	203	642	966

(a) CBS

(b) CBS and TRD

(c) Regional Offices included

Source : Central Bank of Sri Lanka

TABLE II – 18
Training of Officers:
Postgraduate Studies 2003/ 2004

Year	No. of Officers Sent for Post-graduate Studies	No. of Officers who Returned after Postgraduate Studies	No. of Officers pursuing Postgraduate Studies as at end year	
			Docto-ral	Masters / Post-graduate Diploma
2003	6	10	1	10 / 3
2004	3	6	1	6 / 2

Source : Central Bank of Sri Lanka

The Bank continued with its policy to make available funds for officers to undertake postgraduate studies at reputed universities in the UK, the USA, Canada and Australia. Under this programme, 3 officers commenced their postgraduate studies abroad, while 6 officers resumed duties in the Bank after completing their postgraduate studies. The details of the officers trained in short-term training and postgraduate studies are given in Table II – 17 and Table II – 18. The Bank continued with its weekly seminar series during 2005. Under this programme, resource persons with experience in their respective fields of specialisation were invited to address officers on areas of current interest. This programme was also used as a forum for officers who have undergone training under short-term training programmes to impart their newly acquired knowledge to other officers in the Bank. The department conducted 44 seminars during the year 2004, out of which 11 were conducted by resource persons outside the Central Bank and the balance 33 were conducted by the officers of the Central Bank.

Welfare

The Welfare Department continued to provide several welfare facilities to Bank employees, pensioners and their registered dependents totalling 9,083. These facilities included the provision of medical benefits, in-house health clinic, concessionary loan facilities and other ancillary facilities. During 2004 the medical benefit scheme was expanded by introducing additional medical facilities as well as extending certain facilities to pensioners, which were hitherto enjoyed only by the employees. Having considered the increase in the cost of real estate, construction of houses and the reduction in the market interest rates a new package for housing loans was introduced on 01 April 2004. The main changes were:

- increasing the quantum of loan from Rs.1.5 million to Rs. 2.0 million;
- reduction in the interest rate from 3.8 per cent to 2.0 per cent per annum in respect of construction or procurement of a house for dwelling purposes by Bank employees;
- additional loan facilities to obtain a loan to undertake repairs, renovations and construction of an extension to the house occupied by them; and,

- (d) expansion of the Scheme to grant a loan for redemption of a debt incurred by an employee to a recognized lending institution in respect of the above purposes.

Other activities

Computerization of personal data of Bank employees who seek treatment from the Bank clinic was undertaken for the use of future health purposes by the employees.

Catering services was also expanded to enable the Bank to host official functions at the Bank premises, which resulted in reduction of cost.

Action was taken to establish a disaster relief fund and a task force to identify and grant relief to such affected parties on 28 December 2004 to grant relief to families of employees and pensioners affected by the Tsunami disaster.

Human Resources Management and Development

Human Resources Management and Development (HRM & D) functions are carried out by several Departments of the Bank in order to facilitate the achievement of core objectives by maintaining a competent, dynamic and motivated workforce to meet the challenges in the local and global financial environment.

HRM & D cluster comprises of five Departments, *i.e.* Human Resources, Training, the Centre for Banking Studies, Management Development Centre and Welfare. Out of these five departments Human Resources Department (HRD) is responsible for the Human Resources Management functions relating to recruitment, placement, promotion, transfer, performance management and retirement and strategic functions of change management and introducing a “performance culture” in the CBSL. The policies and procedures for all HR initiatives are developed by the HRD.

Performance Management

The new Bank wide Performance Management System (PMS) was successfully implemented for 2003 and for the year 2004, the PMS is expected to be completed during the 1st quarter of 2005. Department goal setting process for 2005 was completed by the respective departments by end 2004, thus paving the way for the performance based evaluation process for the future.

Promotion

In congruence with the new PMS a promotion policy was designed and comments were invited from the employee representatives before implementation. All promotions, which fell due in the year 2003 were considered during the year and the eligible officers were granted their promotions.

Employer - Employee Relations

With the finalization of the salary revision, a collective agreement was signed between the CBSL and the Employee representatives for a period of three years and the agreement will be valid up to 31 December 2005. During the year 2004 industrial harmony prevailed and a healthy dialogue was maintained with the employee representatives.

Recruitment

The competency based recruitment and selection policy and criteria were further improved with the objective of attracting competent and qualified candidates to meet human resource requirements of CBSL. The Staff Class vacancies were advertised by the end of the year 2004 and over 3,750 applications were received. About 2,150 applicants were eligible to sit for the qualifying examination. Arrangements were made to recruit the new Staff Class Officers in March - April 2005.

Manpower Planning

During 2004, a total of 25 employees retired and 3 employees resigned from the CBSL service. By end 2004, there were 416 Staff Officers, 619 Non-Staff Officers and 122 Minor Employees in the Bank service. Most of the clerical and secretarial services and other support services were further outsourced during the year.

Implementation of e-HR System

The HRD endeavored to adopt advanced technology to improve efficiency and productivity through automation of HR functions and processes. The major focus was to provide up-to-date HR information to the management for decision making through a network. The e-HR will be able to streamline and integrate HR processes from recruitment to retirement, with web-based software application.

Meetings Attended by the Governor

The Governor Mr. A S Jayawardena attended the following meetings during January – 30 June 2004^{1/}.

1. SAARC Finance/ BIS Seminar in Nepal from 15 – 18 March 2004.
2. G-24, International Monetary and Financial Committee (IMFC) and Development Meeting – Spring Meetings in Washington, D.C. from 17 – 28 April 2004.

The Governor Mr. Sunil Mendis attended the following meetings during July – 31 December 2004^{2/}.

1. G-24, IMFC and Development Committee Meetings of the International Monetary Fund/World Bank – Annual

1/ Mr. A S Jayawardena retired w.e.f. 30 June 2004.

2/ Mr. Sunil Mendis was appointed as the Governor w.e.f. 1 July 2004.

Meetings in Washington D.C. from 25 September – 11 October 2004.

Appointments

1. Mr. Sunil Mendis was appointed as Governor of the Central Bank of Sri Lanka, for a term of 6 years, by Her Excellency the President under the powers vested in her in terms of the Monetary Law Act, at the end of the tenure of office of the former Governor.
2. Mr. G L Amarasena, who has retired from the Bank Service was appointed as Director of Premises Department with effect from 10 February 2004 on contract basis.
3. Mr. S Wijesinghe, Acting Additional Superintendent of Currency Department was appointed as Acting Superintendent of Currency Department with effect from 26 March 2004.
4. Dr. (Mrs.) R Jayamaha, Assistant to the Governor was appointed as Deputy Governor with effect from 19 April 2004.
5. Ms. C Abeynayake who has retired from the Bank Service was appointed as Secretary to the Monetary Board with effect from 21 May 2004 on contract basis.
6. The following promotions and appointments were effected from 1 June 2004.
 - (i) Mr. K G D D Dheerasinghe, Superintendent and Registrar of Public Debt Department as Assistant to the Governor
 - (ii) Mr. P D J Fernando, Director of Information Technology Department as Assistant to the Governor
 - (iii) Dr. A G Karunasena, Director of Economic Research Department as Assistant to the Governor
 - (iv) Dr. U Vidanapathirana, Additional Superintendent Public Debt Department who is on release as the Secretary of the Ministry of Industry, Tourism and Investment Promotion, as Assistant to the Governor
 - (v) Mr. Y M W B Weerasekera, Director of International Operations Department as Assistant to the Governor
 - (vi) Mr. Y A de Silva, Deputy Superintendent of Employee's Provident Fund Department as Acting Additional Director of the Premises Department
 - (vii) Mrs. P Liyanage, Deputy Director of International Operations Department as Acting Director of the International Operations Department
 - (viii) Mr. A Kamalasinghe, Deputy Director of Domestic Operations Department as Acting Additional Director of the Domestic Operations Department
 - (ix) Dr. W M Hemachandra, Deputy Superintendent of Public Debt Department as Acting Additional Superintendent of the Public Debt Department
 - (x) Mrs. J P Mampitiya, Deputy Director of Information Technology Department as Acting Director of the Information Technology Department
 - (xi) Ms. K Saravanamuttu, Deputy Superintendent of Public Debt Department as Acting Additional Director of the Information Department
 - (xii) Mr. P Samarasiri, Deputy Director of Bank Supervision Department as Acting Additional Director of the Bank Supervision Department
 - (xiii) Mr. D Wasantha, Deputy Director of Statistics Department as Acting Additional Director of the Statistics Department
 - (xiv) Mrs. J A N Dissanayake, Deputy Director of Bank Supervision Department as Acting Additional Director of the Management Audit Department
 - (xv) Mr. A Jeewandara, Deputy Director of Statistics Department as Acting Additional Superintendent of the Currency Department and subsequently appointed as Acting Superintendent with effect from 22 November 2004
 - (xvi) Mr. K B Dissakaruna, Deputy Director of Payments and Settlements Department as Acting Additional Director of the Payments and Settlements Department
 - (xvii) Mr. M V M Fernando, Deputy Director of Centre for Banking Studies as Acting Additional Director of the Centre for Banking Studies
 - (xviii) Dr. P W R B A U Herat, Additional Director of Economic Research Department as Director of Economic Research Department with effect from 1 June 2004.
7. Dr. H N Thenuwara, Additional Director of Economic Research Department was appointed as Superintendent and Registrar of Public Debt Department in addition to his duties as Additional Director of Economic Research Department with effect from 1 June 2004. Subsequently he was reverted to the post of Additional Director of Economic Research Department with effect from 4 August 2004 and was appointed as Director of Economic Research Department with effect from 30 August 2004.
8. Mrs. P T Perera, Director of Welfare Department was appointed as Special Officer, Legal Reforms Project with effect from 2 August 2004.
9. Mr. C K Paranavithana, Additional Director of Welfare Department was appointed as Director Welfare Department with effect from 2 August 2004. Subsequently he was appointed as Superintendent of Public Debt Department with effect from 4 August 2004 and as Additional Director of Centre for Banking Studies with effect from 14 October 2004.

10. Mr. L Y Dharmasena, Additional Controller of Exchange Control Department was appointed as Director of Welfare Department with effect from 04 August 2004.
11. Mr. H M P Herath, Additional Director of Department of Supervision of Non-Bank Financial Institutions was appointed as Additional Controller of Exchange Control Department with effect from 4 August 2004.
12. Mrs. C Premaratne, Additional Superintendent of Public Debt Department, who has been released to the Ministry of Finance on part time basis, reported for duty at the Bank on full time basis and was appointed as Additional Director, Department of Supervision of Non-Bank Financial Institutions Department with effect from 1 September 2004. Subsequently she was appointed as the Superintendent and Registrar of Public Debt Department with effect from 14 October 2004.
13. Mr. R A Jayatissa, Assistant to the Governor, who has been on release to the International Monetary Fund to function as Alternate Executive Director, has resumed duties at the Bank with effect from 11 October 2004.
3. Mrs. C M Ariyaratne, Superintendent, Currency Department retired from the Bank Service with effect from 26 March 2004.
4. Mr. P M Nagahawatte, Deputy Governor, retired from the Bank Service with effect from 19 April 2004.
5. Mr. J M T B Jayasundara, Advisor, Central Bank Strengthening Project, retired from the Bank Service with effect from 20 April 2004.
6. Ms. C Abeynayake, Assistant to the Governor retired from the Bank service with effect from 20 May 2004 and her service as a Secretary to the Monetary Board on contract basis was expired on 20 November 2004.
7. Mr. S Wijesinghe, Superintendent, Currency Department retired from the Bank Service with effect from 21 November 2004.

Officers on Release

Retirements

1. The tenure of Mr. A S Jayawardena, Governor of the Central Bank of Sri Lanka ended on 30 June 2004.
2. Mr. G L Amarasena, Acting Director, Premises Department retired from the Bank Service with effect from 9 February 2004.
1. Dr. U Vidanapathirana, Assistant Governor to the Ministry of Industry, Tourism and Investment Promotion as Secretary.
2. Dr. P W R B A U Herat, Director, Economic Research to the International Monetary Fund as an Alternate Executive Director.
3. Mr. S R Attygalle, Staff Class Grade III officer, to the Ministry of Finance.
4. Mr. M Mahinda Saliya, Staff Class Grade I officer, to the Ministry of Finance.