



# GRADUATION TO A FINANCIAL HUB – A DREAM TO BE REALIZED\*

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## **Executive Summary**

*“This paper highlights the level of financial sector performance in Sri Lanka as compared to other countries in the region, possible contribution to economic development from the financial sector developments, current status of Sri Lanka’s environment for a financial hub and future requirements to develop Sri Lanka’s financial sector to be a “financial hub”. Paper concludes that commitment and hard work would contribute to realize the dream of creating a “financial hub” in Sri Lanka”.*

## **1. Introduction**

Financial sector being a promising sector in the economy, could contribute to a faster economic growth. The accessible capacity in the financial sector could easily be utilized for economic development, provided the necessary incentives are made available. The contribution from the financial sector in the GDP of Sri Lanka accounts for 9.7 per cent (2009). Although this percentage is low when compared to developed countries such as USA (33.1 per cent), UK (27.6 per cent), Japan (18.8 per cent), Singapore (24.5 per cent) according to 2006 and 2007 data, Sri Lanka is ahead of most of the developing countries, i.e., Bangladesh (9.0 per cent), Thailand (6.2 per cent) according to 2007 data. The financial sector contribution to GDP has been increasing rapidly in Sri Lanka signaling that this sector has a potential for economic development.

The increased per capita income of Sri Lanka has contributed to graduate Sri Lanka as a middle income country according to World Bank’s classification, although the per capita income in Dollar terms in the year 1989 which stood at US\$ 500, took 13 years to reach US\$ 1000 in 2004. However, it took only four years from the level of US\$ 1000 to double the per capita income of US\$ 2000 in 2009. The financial sector growth, based on the potentials and developments that had taken place over the years, as explained towards the latter part of this article, could contribute immensely to fast track the prosperity of Sri Lanka. These developments would convert Sri Lanka’s financial market into a “financial hub”.

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“Financial hub” is a place where there is a high trading volume of equities, bonds, other financial instruments including commodity contracts, good presence of global banking and financial services and exchange of high volume financial flows. For these functions, it is required to have a conducive political and legal framework, economic stability, ease of doing business, facilities to ensure financial flows and a business centre with knowledge creation by professional talents supported by efficient information flows.

Section 2 of this paper presents an explanation as to how the financial sector developments could contribute to promote Sri Lanka’s Financial Market to a status of a “financial hub”. Section 3 identifies the historical developments that have taken place in the Sri Lankan economy, enhancement of which could lead to create a “financial hub” in Sri Lanka. Section 4 discusses some of the other aspects required for creating a financial hub. Section 5 draws some conclusions.

## **2. Possible Contributions from the Financial Sector**

One of the advantages of financial sector development is the increase in monetization. At the initial stages, with the financial sector developments, it is expected that the Barter System would convert into a monetary system in which currency and notes in use are increased. At present, almost all countries in the world have moved away from a Barter System to a system where money is in use. At a higher level of monetary development, it is expected to increase the usage of bank money. With these developments, in the advanced countries, the definition of money has been expanded to cover of M3, ....., M6 etc. In the context of broad money (M2), the usage of time and savings deposits would increase with the financial sector developments.

Financial sector developments would also contribute to increase assets held by financial Institutions. It is expected that the developments in the financial sector would enhance the activities of financial institutions. The varieties of assets and the volume of assets compared to GDP are expected to grow as a result of financial sector developments. In the history of financial sector developments, it has shown that there has been a substantial increase in the assets held by financial institutions resulting from increased financial transactions. At present, different types of new financial instruments that are introduced by financial institutions are in use, worldwide. Developments in the levels of assets held by financial institutions could be measured by composition of assets, as well as assets expressed as a percentage of GDP.

Another advantage of financial sector developments is the increase in the number of financial institutions and their branches. When the activities are grown as a result of financial sector developments, number of financial institutions and their branch network in the remote areas may increase. At the initial stages of economic development, increase in the financial institutions would take place as a result of “supply leading” phenomenon. The increase in the monetization in the economy may contribute to extend the activities of financial institutions to the grassroot level.



Financial sector developments lead to increase volume of credit granted by financial institutions. The increase in monetization and the increase in number of financial institutions and their branches would contribute to expand the volume of credit granted by financial institutions. Along with the establishment of financial institutions, finance rather than currency and notes would be required for the activities taking place in an economy. Therefore, bank money by way of credit expansion will play a greater role in the economy.

Financial sector developments would promote not only the volume of credit but also the credit granted to private sector, a sector which is expected to play an important role in an economy. Private sector activities are expected to grow along with the economic development. Finance from the financial institutions is required to conduct private sector activities. Financial sector developments and the increase in the financial sector institutions would promote credit granted to private sector. The financial needs of the private sector are expected to be met by way of expanding credit.

It is expected to increase financial markets and instruments through financial sector developments. In advanced economies, a variety of markets and instruments could be found. New financial instruments will play a greater role in an economy along with the development of financial sector. Some instruments are developed in response to demand from the public, whilst creating greater risks at times. However, these risks have generated more gains and advantages to the financial institutions as well as to the players in the markets.

Promotion of competition among institutions is expected from developments in the financial sector, creating advantages to the institutions as well as the general public. Further, enhanced competition would reduce transaction cost and risks and promote variety of markets and instruments. At present, financial institutions compete with each other to get their share increased in the financial market. This has resulted in introducing a variety of financial instruments in different financial markets. When there is a healthy competition, there is a possibility for the financial institutions to take action to promote savings and credit deliveries to the general public.

Enhancement in the external resources is one of the other developments that can be expected from developments in the financial sector and thereby the world economy enhance, along with the expansion of activities of the financial institutions. Expansion in the external sector relationships with the local financial institutions will attract external resources based on new mechanisms emerged to obtain external reserves to the country. Remittances from the workers abroad, foreign direct investments directed to the economy, the debt related activities and expansion in the foreign trade would contribute to generate additional reserves for a country. Accordingly, financial sector developments would create convenient ways and mechanisms to promote external reserves.

Promotion of savings / deposits is another key aspect expected from the financial sector developments. Intenfy in multi-tasked financial institutions and their branches intensify the competition among financial institutions that lead to promote savings and habits of savings among the people. Different types of savings (short term, Long term) will emerge in response to the



increase in the monetization. In the current world, deposits in financial institutions by individuals are some avenues to acquire resources during the lifetime of the people. In addition, an expansion in the financial sector could increase savings by the public.

Finally, financial sector developments would promote economic growth. Availability of savings for investment, which are required for economic growth and creation of different markets and a variety of instruments will contribute to promote economic growth. Economic growth is the final outcome which is to be expected from a financial sector development.

### **3. Positive Signs in Sri Lanka Towards Achieving a Financial Hub**

Nature of the structure of the financial institutions is an important aspect that contributes to a financial hub. The number and the composition of financial institutions in a country would determine the extent of financial sector developments. In Sri Lanka, the number of financial institutions, and their sizes have grown over time. Of the 22 commercial banks functioning, a one half represents foreign banks. The branch network of all banks consists of 5014 branches as at end of 2009. In addition to commercial banks, there are 16 specialized banks, with 689 branches and Thrifts and Credit Societies with more than 8,400 branches. The number of financial institutions has increased rapidly in the country specially to satisfy the financial requirements at the grass root level. The table 1 indicates the variety of financial institutions which are functioning in Sri Lanka. Subsequently, almost all types of financial institutions functioning in the country at present are paving the way for a financial hub.

**Table I**

**Variety of Financial Institutions in Sri Lanka**

Prior to 1960	
A Central Bank, Commercial Banks, Two specialized Banks, National Savings Institutions, Insurance Corporation and Employees Provident Fund.	
<ul style="list-style-type: none"> <li>▪ At Present</li> </ul>	
A Central Bank	Leasing Companies
Commercial Banks	Cooperative Banks
Development Banks	Samurdhi Banks
A Savings Bank	Janashakthi Banks
Rural Banks	Sarvodaya Banks
Regional Development Banks	Thrifts Societies
Merchant Banks	Primary Dealers
Investment Banks	Approved Provident Funds
Insurance Companies	Approved Money Exchangers
Venture Capital Companies	Mortgage Companies
Unit Trusts	Credit Agencies Approved by the Government
Foreign Currency Banking units	Housing Development Finance Corporation
Employees' Provident Fund	Share Market
Finance Companies	Money Brokers
Credit Information Bureau	Credit Rating Institutions

Almost all banks are connected to global banking networks and these banks offer all types of financial services that are available internationally. Table II indicates a list of services offered by banks functioning in Sri Lanka at present.



**Table II**

**Services Provided by the Banking Sector**

<b><u>At Independence</u></b>		<b><u>Today</u></b>
<b>Exchange Banking</b>	<b>Domestic Banking</b>	<b>International Banking</b>
Mobilizing Savings	Mobilising savings	Mobilising foreign savings
Loans	Loans and advances	Loans in foreign currency
Transfer Payments	Financial advice	Financial advice
Money Transfers	Payment Systems	Legal services
	Money Transfers	Electronic fund transfers
	Standing orders	Foreign trade financing
	Trustee/administrative Services	Mail/telegraphic transfers
	Legal services	Inward remittances
	Electronic fund transfers	Guarantees
	Corporate services	Status reports
	Cheque imaging system	

Services have rapidly grown with globalization and opening of the economy compared to a few traditional services which were available at independence.

Technological developments have promoted a wide variety of instruments in the area of payments. These include credit cards, debit cards, internet banking and phone banking etc. Table III below shows volumes and the values of transactions under these services as at end 2009. These types of services were not available in Sri Lanka at independence, but have come into existence along with global developments, confirming that Sri Lanka is at par with global developments and is ready to introduce any type of new financial instruments that the world would introduce.

**Table III**

**Usage of New Financial Instruments**

	Type of Instrument	At Independence	2009	
			Volume(in thousands)	Value (Rs. Mn)
(a)	Usage of Credit Cards	-	840	31,375
(b)	Usage of Debit Cards	-	5,699	247,000
(c)	Internet Banking	-	3,818	3,509
(d)	Phone Banking	-	322,000	
(e)	Total on Commercial Bank Accounts(2008)	<b>n.a</b>	28.8(mn)	

There is a rapid growth in number of financial institutions in the country. The banking density index (number of branches per 100,000 persons) has increased from 4 in 1979 to 28 in 2009, resulting in a decline of the number of people served by a commercial bank branch from 25,430 in 1979 to 3,586 in 2009. These developments would positively contribute towards the establishment of a financial hub in Sri Lanka.

The increase in the number of institutions and activities of banks have contributed to increase the assets held by financial institutions over time. For instance, assets of financial institutions as a per cent of GDP have increased from 44 per cent in 1960 to 121 per cent in 2007(prior to crisis). This figure was more than 100 per cent in 2009 showing that there is a conducive environment in Sri Lanka for the financial institutions to grow. The past performances would guarantee a favourable condition for the financial industry to grow in the country, paving the way towards creating a financial hub.

Technological developments have contributed to introduce sophisticated payment and settlement systems in the country. A Real Time Gross Settlement System (RTGS) along with Scripless Securities Settlement System (SSSS) was introduced to banks in 2003/2004 establishing an effective high value payment system and a securities settlement system, dominating the South Asian countries. This network is presently functioning efficiently and whole payment and settlement system has been connected to an electronic platform which could handle any large value payment in seconds. This system has provided instantaneous money and securities transactions among the financial institutions. Currently, if anyone needs to buy or sell a government security, he/she can



effect the transaction instantly through the electronic network. This system shows that Sri Lanka is ahead of all countries in South Asia, in systems in payments and settlements, thus Sri Lanka would soon acquire the capabilities required for a financial hub. The volume and value of payments handled by the RTGS system in 2009 amounted to 233,000 payments and Rs. 33,155 bn respectively, representing 86 per cent of the total value of non-cash transactions. This payment system could be developed to a cross boarder system accessing global network of payments which is currently being addressed by the authorities in collaboration with SAARC finance countries.

Currently, a wide range of markets and a variety of instruments have been developed. There are additions to the list of current markets and instruments as compared to that of 1960s'. Table IV indicates the currently available market/instruments in Sri Lanka in comparison to 1960s'.

**Table IV**

<b>In 1960's</b>	<b>2009</b>
Treasury Bills	Treasury Bills
Rupee Securities	Rupee Securities
Central Bank Securities	Central Bank Securities
Stock Market	Treasury Bonds
	Corporate Bonds
	Foreign Currency denominated Bonds
	Derivatives
	Commercial papers
	Primary Market
	Secondary Market
	Stock Market
	Certificates of Deposits

## **Markets and Instruments**

Market and instrument developments are essential for an efficient functioning of a financial market. Developed financial markets have gone in an extensive way by developing new markets and instruments following which Sri Lanka too has been able to introduce a variety of instruments, although not to the level of sophistication in the developed countries, showing that Sri Lanka is capable of becoming a financial hub in the South Asia.

Since the liberalization of the insurance business in 1985, the insurance industry is open to every citizen in Sri Lanka and presently, 18 insurance companies are in operation. In 1960's Sri Lanka had a state owned Insurance Corporation functioning. With the opening-up of insurance business, the number of companies engaged in insurance industry increased. Out of these, six





insurance companies have foreign collaboration. In addition, there are 43 insurance broking companies engaged in general insurance business and selling life insurance products. This industry has a profitable business, which is an encouraging factor that contributes to financial sector developments. It is heartening to note that in the insurance industry the international underwriters have lowered the risk ratios and removed the war risks.

With the issuance of sovereign bonds, Sri Lanka's securities market has broadened towards the international markets. Sri Lanka's international bond issues are attractive and is a forward step to develop securities market. The recent issuance of sovereign bonds has been over-subscribed and major international investors have invested in them. This would increase the inflow of foreign funds to the country.

Stock markets play a vital role towards an efficient financial centre. The equity market prices surged upward during 2009 reflecting positive market sentiments. According to the Bloomberg newswire, the performance of Sri Lanka's stock market in 2009 made it the second best performing market in the world. The market capitalization was more than doubled and crossed the Rupees one trillion mark and the share of foreign investors was recorded as 30.5 per cent in 2009. The peace after the war has positively contributed to improve and enhance the activities of the share market, paving the way towards a financial centre.

Sri Lanka's current legal and favourable political framework would also contribute positively towards the creation of a financial hub. Attempts have been made by three regulators of the financial sector i.e. the Central Bank of Sri Lanka, the Securities Exchange Commission and the Sri Lanka Insurance Board to maintain a robust legal framework for financial business in the country. The resilience of Sri Lanka's financial sector to recent world crisis was partly due to robust legal framework available in the country where no financial institution collapsed due to recent global financial crisis. The strength of the regulatory framework eased the tasks of regulators in supervising financial institutions. This is an encouraging situation that contributes favourably towards the development of a financial hub. The long-awaited peace was achieved after the conclusion of the war in Sri Lanka and the democratic process has ensured the political stability which is one of the prime requirements for a financial sector development. Many advantages arise from a sound political stability which would promote investments from both foreign and domestic sources, leading to an accelerated growth in the economy. The authorities are presently engaged in providing more facilities and incentives to enhance the business activities. Further liberalization in policies and the use of private sector for growth promotive activities will create a conducive environment for setting up a financial hub.

Massive projects, such as construction of new roads, expansion of aviation activities, ports and telecommunication developments are under way to improve the infrastructure facilities which are basic requirements for financial sector developments. Infrastructure development, liberalization of policies and further relaxation of regulatory barriers for business will contribute towards developing a financial centre. Among other things, Sri Lanka's education system can be used to fulfill human capital requirements of businesses. Sri Lanka has 16 universities and they offer a wide range of courses which are relevant to financial sector developments. Sri Lanka's



literacy ratio is as high as 92 percent which will be immensely helpful for financial sector developments. The Universities and other academic institutions in the country offer a range of courses relevant to financial sector activities and this human capital can be used to develop the financial sector. Human resources, i.e, the talents of the students can be applied to train personnel for the needs of financial institutions. The existing framework and the steps expected to be implemented will open the way to private education which will in turn improve professionalism with talents, a vital requirement for the sector's developments.

Advanced technologies in Sri Lanka have positively contributed to financial sector developments aiming at establishing a financial centre. At present, there is a good crowd of students who are willing to undertake technical courses, especially in the area of Information Technology (IT). It must be noted that a wide variety of courses relating to IT is presently offered at educational centers and in schools to meet the demand of students and professionals. Government institutions are undertaking massive projects to reform their information flows. The government has undertaken to develop a well spread national grid facilitating IT services. Exchange of information domestically and internationally is a necessity for a developed financial system to be in operation. Worker migration after obtaining the training in the country is one of the problems that this county is facing. If the political and economic situations are favourable, the qualified and the literate segment will certainly remain, and the establishment of a financial hub will further encourage them to remain in the country.

Sri Lanka's location provides a unique advantage in creating a financial hub. The location of the land is favorable not only for financial sector developments but also for promoting international trade and tourism industry. Sri Lanka has many advantages in this infrastructure as far as SAARC countries are concerned. There are many favorable conditions in Sri Lanka as compared to some of the SAARC countries towards developing a financial centre.

The prevailing sound economic conditions also provide a conducive environment for financial sector developments. Currently, there is a low inflation, low interest rate and a stable exchange rate structure that could be helpful for financial sector developments. The economic stability will promote confidence among investors and businessmen. The economic stability and political stability are the two most important requirements for a country not only to develop the financial sector but also for promoting living standards of the people.

#### **4. Further Requirements for a Financial Hub in Sri Lanka**

Most of the financial hubs are located in developed countries. London, New York, Zurich, Tokyo, Seoul, Chicago, Frankfurt, Paris, Madrid and Milan have the most active financial hubs in the world. Toronto, Luxembourg, Sao Paulo, Shanghai, Hong Kong, Singapore, Johannesburg and Dubai are some of the emerging financial centres. Sri Lanka would take time to reach up to this standard and needs a complete set of reforms, despite the achievements it has made so far in many areas to reach the levels of most sophisticated financial hubs in the world.

Ready access to capital by investors and a liquid financial market are required for a financial hub. It is required to encourage financial inflows, particularly the Foreign Direct Investments (FDI) volume the of which at present is not sufficient for an active financial sector in Sri Lanka. FDI the in Sri Lanka accounts for 1.9 percent of GDP, compared with 4.3 per cent in China, 15.0 per cent in Singapore, 3.9 per cent in Thailand and 4.5 per cent in Malaysia according to 2007 data. Further liberalization of policies for foreign fund flows and creation of investor confidence are required, in order to encourage FDI to Sri Lanka. Current economic and political stability would provide a favourable ground for increasing FDI flows.

A strong pool of professional talents is required for a financial centre to function. Sri Lanka needs reforms in education and training in order to provide improved professional talents. English education and advanced technical education are required to meet the demand arising from the financial markets. Adjustment to course curricula and changes in attitudes of students and teachers are some of the requirements in achieving the targets in these areas. Lessons from global developments aiming at providing a more talented workforce would fulfill the requirements of an advanced financial market.

There is a growing demand for infrastructure facilities when approaching towards the status of a financial hub. These have to be developed based on the state-of-the art technology as available in the sophisticated markets. Technological improvements and developments to communication systems are required as basic requirements to uplift financial markets. Different types of firms engaged in communication industry (i.e. Computers, Telephones, etc.) can contribute to uplift the requirements of the financial industry thereby pushing towards a financial centre.

It is required to develop the securities market and various products based on them for a healthy financial sector. Most of the developed financial markets are dealing with very sophisticated financial products that may be required for an emerging market. Although Sri Lanka's government securities market is active, activities of other financial instruments, such as securitization, corporate bonds and derivative products are yet to be developed. The infrastructure required for those and macro economic conditions such as long term stability in interest rates and inflation are required to provide a conducive environment for financial instruments to be developed.

Continuous stability in the major prices such as prices of goods and services, interest rates and exchange rate is one of the other major economic conditions for financial market developments. The foreign exchange transactions which determine the level of exchange rates at present are limited to commercial banks and money changers. A tradable and convertible currency which is available in most developed financial centers is required for developments in a financial market. In order to go for this, Sri Lanka needs to strengthen the foreign reserve position and required steps in this regard have to be gradually implemented.

Private sector activities are required for economic development. There is a requirement to improve Public Private Partnership (PPP) for activities in the financial sector. Private sector has to be used as an engine of growth and facilities have to be provided to private sector activities



enhancing investment, for which assistance is required from the international community. Sri Lanka will not be able to achieve the status of a financial centre, if it does not receive support from international community, specially from the neighbouring countries. Emerging financial centres such as Bombay and Singapore in the neighbouring countries would be the competitors, the lessons from whom have to be learnt for Sri Lanka's financial sector developments. Therefore, maintenance of favourable international relationships is a key requirement for a positive development not only in the financial sector but also for development of other sectors in the country.

Developed financial markets have grown with sophisticated technical applications. If we are to develop a financial centre, there is a requirement for application of advanced technology. Further developments in the areas of manpower trainings and software and hardware applications have to be considered as priority areas in infrastructure developments for a healthy development in the financial sector. For application of advanced technology, support from infrastructure facilities is a sine-qua-non.

The dream of converting financial sector in Sri Lanka to the status of a financial hub in South Asia can be realized provided that commitment towards it is maintained and necessary infrastructure is developed. The present status of Sri Lanka's financial industry and resource availability such as human capital and infrastructure facilities, may not be sufficient to convert it to a financial hub. However, if there is a determination, the currently available status in the financial sector can be converted into a well developed financial centre as available in most of the developed countries.

## **5. Conclusion**

Converting Sri Lanka in to a financial hub is a long term dream which is expected to be realized as a part of the project in achieving prosperity to Sri Lanka. Financial sector developments give many advantages to Sri Lankan economy in terms of monetization, increase in assets held by financial institutions, increase in number of financial institutions and their branches, increase in credit disbursed for economic development, particularly the private sector credit, development of financial markets and instruments, promoting competition among financial institutions, enhancing external reserves of the country , promotion of savings and savings habit of the public, and finally achieving economic growth. There are signs that could be observed from Sri Lanka's financial sector on marching towards the status of a financial hub. The historical developments, specially after Sri Lanka gained independence, in number and size of financial institutions, variety of banking services offered by the financial institutions, acquired technological developments, developments in financial markets and instruments, improvements in Banking Density Index, increase in volume of assets held by financial institutions, achievements in technological applications, stock market developments, reforms in legal framework which is conducive for financial sector developments and infrastructural developments provide a positive background for the Sri Lankan financial sector to be a financial hub in South Asia. However, these aspects have to be further developed if we



are to go forward on the line of converting Sri Lanka's financial sector into a financial hub in the South Asia.

Further developments are required in the areas of acquiring foreign fund flows, creating a group of professionals with required talents, developing infrastructural facilities that are required for a well functioning financial market, developing new financial instruments as available in advanced financial markets, maintaining more stable prices, interest rates and exchange rates, getting support from the private sector, removing limitations in infrastructure such as technology and communication that facilitate an efficient functioning of the financial sector, maintaining international relationship and getting support from international community, specially from the neighbouring countries, to become a financial hub.

Becoming a financial hub in the Asian region is a long term dream for Sri Lanka. However, this dream may come true with the passage of time and Sri Lanka has to work hard with determination and commitment towards achieving it. The lessons that could be learnt from developed financial market would be useful in this attempt.

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