PN-ABQ-022

AN EVALUATION OF THE ROLE OF NON-BANK FINANCIAL INSTITUTIONS IN SRI LANKA

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SRI LANKA ECONOMIC ASSOCIATION

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Sri Lanka Economic Association
61, Carmel Road, Colombo 3.
March, 1993.

This paper is one of the 18 papers, published under a special series of publications by the Sri Lanka Economic Association (SLEA) with financial assistance from the United States Agency for International Development (USAID). The objective of these publications is to provide economic literature on current and topical themes on the economy of Sri Lanka to a broad audience that is interested in economic issues, but has little or no background in theoretical economics, while maintaining high analytical standards. Hence, the papers have been written in simple language avoiding the use of sophisticated technical terms, mathematical equations and models etc. which are normally found in economic literature.

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Some of the factors that contributed to the growth of finance companies later caused the failure of them. The excessively high interest rates promised on deposits were non-sustainable against the background of feasible rates of return on capital in the Sri Lankan economy. Further, the default charges of most of the finance companies were so high that debt collections were practically impossible even under the best of circumstances if a loan has fallen into arrears for more than 3 months. In other words, the inverse correlation between the lending rates and default charges on one hand and the repayment capacity of borrowers on the other was a major contributory factor for the solvency problems of many of the finance companies. Further, as it would be noted in this study, the companies that gave concessions on lending rates, particularly by waiving the default charges, seem to have managed thelr debt collection problems better. Mismanagements of various nature have significantly contributed to the failure of finance companies. Creative accounting practices and poor auditing standards helped the finance company managements to conceal the true position of their companies from the regulatory authorities as well as from the public. Changing macro-economic conditions and the weak regulatory system too had contributed to the failures of FCs.

The initial problems associated with the 1988 reform programme, such as, issuing of enactment of regulations and the institutional innovations are, by and large, completed. The new regulations issued by the Central Bank cover a wide range of aspects needed for the prudential management of FCs. However, the effective implementation of regulations on a continuing basis appears to be the main challenge of the regulatory authority. Further, the public too should be aware of the risks associated with FCs. Particularly, the depositors and creditors should be vigilant of the changes that take place in FCs in regard to deposit rates, lending rates, borrowings, dividend declarations and changes in management, so that they can take appropriate measures when required.

REFORMS IN THE NON-BANK FINANCIAL SECTOR IN SRI LANKA

N. L. Sirisena

1. INTRODUCTION

Generally, the institutions which are engaged in finance business excluding the commercial banks are considered non-bank financial institutions. According to this definition, development banks and merchant banks come within the category of non-bank financial institutions. In Sri Lanka, however, the financial institutions that use the word 'bank' are considered to be in the banking sector while the rest of the financial institutions are considered non-bank financial institutions. According to the latter definition, the main institutions in the non-bank financial sector are the finance companies, leasing companies, unit trusts, insurance companies and housing and real estate companies. Of these institutions, finance companies which mobilize public funds by way of interest bearing deposits to finance their lending and investment activities have received the most attention in Sri Lanka in the recent past, primarily due to the failure of a large number of finance companies and the consequent loss of depositor funds of over a billion rupees. However, there had been failures of insurance and real estate companies as well in the country. Further, failures of transactions done under the Money Lending Ordinance too have been reported in recent years.

Before the implementation of liberal economic policies in 1977, the operations of the hire purchase companies were limited. They concentrated primarily on providing finance for vehicles on hire purchase agreements using their own funds. As long as company managements were dependent on their own funds or funds borrowed from banks, they were cautious in lending; hence company failures were limited.

The acceptance of public deposits mainly commenced in the post liberalisation period. The liberal economic policies particularly the decision to allow private sector operated public transport created an unprecedented demand for credit from the private sector owned non-bank financial institutions which were known as finance companies. At the time of enactment of the Control of Finance Companies Act (CFCA) No. 27 of 1979, there was a large number of small finance companies. In the first year of CFCA, 54 finance companies (FCs) had been registered and licensed by the Monetary Board of the Central Bank to engage in finance business. By end 1988, there were 72 registered FCs having public deposits amounting to about Rs. 5,000 million. Of these companies, 14 were suspended from doing business and another 6 were unable to meet their financial obligations to depositors and creditors. The value of deposits in these sick finance companies exceeded Rs. 1,000 million. A number of other FCs also faced liquidity and solvency problems of varying degrees. In addition to these registered FCs, there were other individuals and institutions accepting funds from the public. A considerable number of these individuals and institutions too defaulted repaying the funds they accepted from the public.

In 1986, one FC stopped meeting all financial obligations to deposit holders and other creditors on the ground of insolvency and requested the Central Bank to liquidate the Company. There were FC managements which negotiated with the depositors on the repayment of the principal sum requesting the depositors to forego the interest. However, the majority of managements of failed FCs, abandoned their companies, leaving the depositors in a helpless condition. Various measures taken by the Central Bank in response to this crisis including the implementation of a relief payment scheme to depositors, have to be evaluated in this historical context. In other words, the reforms which commenced with the enactment of the Finance Companies Act No. 78 in December 1988, had the immediate objective of meeting the challenges of the crisis situation which prevailed in the FC sector at the time, while promoting the overall stability and efficiency of finance business in the non-bank financial sector in the country.

This paper which primarily aims at providing an analysis of the reforms introduced since December 1988 in the finance company (FC) sector, also provides brief discussions on the risks associated with investments in non-bank financial institutions in general. Inadequate public awareness of the risks associated with the investments in non-bank financial institutions seems to have been one of the primary factors that has contributed to the continuing problems of the non-bank financial sector. The investing public are in search of instruments which give higher returns on invested funds. As non-bank financial institutions promise such higher returns, the public has invested in such institutions without giving adequate consideration to the risks associated with such institutions. Some depositors seem to have thought it safe to invest in high risk instruments of non-bank financial institutions presuming that the regulatory authority could either eliminate or absorb the risks associated with those institutions through stringent supervision.

In view of the above misconceptions of some of the investing public, there is a need to increase the public awareness of the risks associated with new investment instruments, including those of non-bank financial institutions. This is done through the discussion of causal factors of finance company failures in Sri Lanka during 1986-88. This paper will also present discussions on the nature of supervision now in operation in the country and its limitations. The paper will also present an analysis of finance companies in Sri Lanka during 1983/88 and the recent period of 1989/92, so that interested parties can understand the evolution of the finance company sector in Sri Lanka.

2. CAUSAL FACTORS OF FINANCE COMPANY FAILURES IN SRI LANKA

An overview of the finance company sector can be obtained from the consolidated balance sheet given in Appendix Table I. The ratios relating to the period 1983-88 are given in text, Table I.

2.1 An Analysis of Consolidated Balance Sheets - 1983 - 1988

Following observations can be made with regard to the main items in the consolidated balance sheets:-

i. Revenue recognition practice of many of the finance companies was unsatisfactory. Hence a notable general feature was the over estimation of revenue by treating interest and other charges on all loans as accrued income. In other words, only the written-off loans were excluded for the purpose of revenue recognition. According to the consolidated balance sheet of 1987, the capital funds of the finance companies had been 9.7 per cent of total assets/liabilities. However, the paid up and issued capital had been only about 1.4 per cent. Since the capital fund had been built up largely through transfer of profits which had been overstated through liberal revenue recognition, the actual equity capital which could be verified as the net worth was probably less than half of what had been stated. In other words, a considerable number of finance companies in Sri Lanka were under-capitalised. Further, the net worth of the companies was much less than what was shown by the capital funds.

ii. Investments by finance companies in subsidiaries and associate companies were considerable, as much as 4% in the early years. This, later declined because of a regulation issued by the Monetary Board discouraging such investments. However, through indirect means, such as, establishing trusts to own such investments, some finance companies continued to have investments in subsidiaries and associate companies. The basic problem with investments in subsidiaries, associate and connected concerns was that such investments tend to become non-earning assets. Even the principal sum granted for the investment, could not be recovered as some of these investments were either in fictitious or in nominal companies.

iii. Advances portfolio had concentrated on hire purchase lending. Over 70% of the total advances had been granted on hire purchase contracts to the transport sector while other loans which included mortgages had been in the range of about 15%. The lease financing amounted to about 10%. Of the hire purchase loans granted by failed finance companies, over 50% had become non-collectible for numerous reasons. Of the loans, a considerable volume had been granted without security. The documentation available on loans were also unsatisfactory. Therefore on the whole, over 60% of the total advances granted by failed finance companies were non-recoverable assets.

iv. The dues from subsidiaries and associate companies had been shown in the balance sheets, to the value of about 9%, during 1983-85. Later, these dues had shown a decline, as the regulatory authority discouraged lending to subsidiaries and associate companies. However, the main feature to note is that, these funds were generally non-earning assets, as the funds had been granted on current account basis. Further, as many of these subsidiaries and associate companies were either fictitious or existing only by name, they had already become non-recoverable assets.

v. The revaluation of fixed assets had been undertaken by finance companies very frequently, largely for the purpose of borrowing funds from the banking system. From the data given on Table I, one would note that the total borrowings of finance companies had exceeded the value of fixed assets by a substantial margin. In 1987, finance companies borrowings amounted to Rs. 879.0 million, while fixed assets amounted to Rs. 683.0 million. Many of the failed finance companies had borrowed from banks pledging their investments in Treasury Bills as security for borrowings, particularly for over-draft facilities. As a consequence, a good part of the liquid assets shown in the balance sheets was in fact not available to the companies to meet the liabilities of depositors.

i One would note from the data, that the provision made for bad and doubtful debts had been negligible, about 1.3% of assets in 1988, in spite of the large proportion of non-recoverable loans and advances. As a ratio of total advances, the provision for bad and doubtful debts amounted to 2.2% in 1988.

2.2 Distribution of Advances and the Maturity Mismatch

A purpose wise classification of advances would show that hire purchase loans had been granted for financing of the vehicle stock in the transport sector. The advances under leasing had been given largely to commercial and industrial enterprises to purchase their capital stocks. The real estate loans had been granted for the purpose of buying blocks of land for building residential houses. The loans had been given under miscellaneous arrangements, including taking of mortgages.

Against this background it is useful to examine the distribution of commercial banks advances and the maturity pattern of these advances. Of the total advances as at 30/6/1987, 46 per cent have been granted for commercial purposes. The commercial purposes cover a wide range of economic activities which is dominated by the export and import trade. Further, it would be noted that about 79 per cent of commercial purpose advances are short term. In the total advances portfolio, 64 per cent are short term advances while only 18 per cent are long term. This position of commercial banks, compared with what was observed in respect of finance companies, clearly shows that lending activities of finance companies are far more risky than those done by banks in view of the high concentration and higher lending rates. Because of the higher lending rates which were already noted, it was the less creditworthy customers who borrow from finance companies.

The deposits had been accepted largely for one, two and three year periods. On surface, deposit maturity pattern appears to match with the maturity pattern of

Table I

Summaries of Consolidated Balance Sheet of Finance Companies (Percentages) as at end financial years

ASSETS	1983	1984	1985	1886	1987	1988
1. Liquid Assets						
Cash & Due from Banks	7.2	6.74	8.64	11.40	11.85	10.8
Govt. Treasury Bills	—	0.39	1.09	1.76	1.65	1.8
Total Liquid Assets	**7.2**	**7.1**	**9.7**	**13.2**	**13.5**	**12.6**
2. Investments						
Shares in Sub. & Ass.	4.03	3.43	2.30	1.61	1.24	0.8
Shares in Other Cos.	1.63	0.64	1.84	1.87	2.26	3.5
Total Investments	**5.7**	**4.1**	**4.1**	**3.5**	**3.5**	**4.3**
3. Advances						
Loans	8.87	8.65	10.92	17.42	15.91	13.0
Hire Purchase	43.33	41.29	40.41	37.81	37.39	45.3
Leasing	2.04	5.60	5.35	5.19	7.39	0.2
Total Advances	**54.2**	**55.5**	**56.7**	**60.4**	**60.7**	**58.5**
4. Due from Sub. & Ass.	**9.9**	**8.8**	**9.1**	**5.2**	**3.6**	**0.9**
5. Fixed Assets						
Freehold Land & Bldgs	7.33	5.50	5.78	6.41	5.96	5.5
Furniture, Fittings, Fixtures & Other Equipments	1.47	1.27	1.00	1.42	1.11	0.9
Motor Vehicles	1.07	0.75	0.58	0.57	0.58	0.5
Others	0.88	1.05	1.47	1.14	1.24	1.0
Total Fixed Assets	**10.7**	**8.6**	**8.8**	**9.5**	**8.9**	**7.9**
6. Other Assets	**12.3**	**15.9**	**11.6**	**8.2**	**9.8**	**4.5**
GRAND TOTAL	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100 0**

Table I Continued

LIABILITIES	1983	1984	1985	1986	1987	1988
7. Capital Funds						
Issued Share Capital	2.47	2.10	1.85	1.55	1.42	1.7
Capital Reserve	4.66	3.68	4.21	4.74	4.52	4.1
General Reserve	4.35	3.64	2.50	2.83	2.77	3.5
Reserve Fund	—	0.58	0.76	0.59	0.76	0.8
Other Reserves	—	—	—	—	—	0.1
Profit & Loss A/c	0.34	0.21	0.73	0.41	0.30	0.1
Total Capital Funds	**11.8**	**10.2**	**10.1**	**10.1**	**9.8**	**10.3**
8. Prov. for B&D Debts	**0.7**	**0.7**	**1.6**	**2·6**	**2.3**	**1.3**
9. Deposits	66.6	68.0	68.0	68.9	66.8	67.5
10. Borrowings						
Banks	8.8	9.70	6.85	6.25	7.14	6.5
Others	—	0.41	1.15	2.88	4.30	5.5
Total Borrowings	**8.8**	**10.1**	**8.0**	**9.1**	**11.4**	**12 0**
11. Other Liabilities						
Taxation	0.48	0.31	0.37	0.26	0.14	—
Dividends	0.26	0.24	0.21	0.14	0.15	—
Others	11.42	10.47	11.69	8.83	9.40	—
Total Other Liabilities	**12.1**	**11.0**	**12.3**	**9.3**	**9.7**	**8.9**
GRAND TOTAL	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Note: For details see Appendix Table I.

loans and advances as hire purchase and lease purchase loans had been given for periods of two to three years. The advances for leasing purposes were also given for similar periods. Short and long term loans granted by the finance companies were small proportions. However, when the actual loan recovery aspect is examined, it shows that medium term lendings of finance companies had actually become long term loans. Large volumes of the loans granted had to be extended beyond the contracted periods of two and three years as borrowers had failed to pay the loan instalments. Because of these practical problems of recovering debts, a major risk had arisen in the poorly managed finance companies.

2.3 The Effect of Changing Economic Conditions on the Finance Company Sector

During 1978-84, the Sri Lankan economy experienced a period of prosperity. The average annual growth rate of the economy was about 6.2%. The GDP at current factor cost prices increased by over 20% per annum. The value added in the transport and communications sector more than trebled. The import of motor vehicles excluding motor cycles and tractors increased from 1,455 in 1975 to 10,428 in 1978. The number of motor vehicles imported in the following two years rapidly increased to reach 30, 800 in 1983 and 27 826 in 1984. The primary contributor to this phenomenal increase in motor vehicle imports was the Government policy of privatising the passenger transport. However, during 1985-89, the average annual growth rate of GDP in real terms declined to about 3%. In 1987, the growth rate further declined to 1.5%. The value added in the transport and communications sector at current prices was about 8% per annum during 1985-89. The reduced value added in the transport sector indicated the drastically declined profitability of the passenger transport. Further, the import of motor vehicles too had declined drastically.

The finance companies, making use of the expansion in the economy, expanded their lending to the transport sector several times during 1978-84. To provide finance to the expanding transport sector, finance companies offered very attractive interest rates on deposits. The high interest rates offered on deposits helped the companies to increase their public deposits considerably*. Consequently, the public deposits of finance companies which stood at Rs. 410.6 million at 31.03.1980 increased to Rs. 1,437 million by 1983. When the National Savings Bank (NSB) reduced its deposit rates in 1983, 1985 and 1986 respectively, the finance companies managed to collect more and more deposits by offering increasingly attractive interest rates and terms of repayments. By 31.03.1987, the total public deposits of finance companies amounted to Rs. 5,689.7 million or 9% of all fixed and savings deposits in the financial system of the country.

The deposit rates offered by most of the finance companies were about 27% per annum. However a number of companies offered far more attractive

*The interest rates offered on deposits were in the range of 18-48% per annum. Please see Table 2 in Appendix. Further, finance companies promised to pay the interest monthly. The interest rates offered by finance companies were much higher than those offered by the banking sector and the National Savings Bank.

deposit rates, such as, 33%, 35% and 36%. When the economy was expanding rapidly, finance companies managed to service their deposits. However, from 1985 onwards a considerable number of companies serviced their deposits with the funds received through the mobilization of fresh deposits. The first failure in the finance company sector occured in 1986. During 1986-88, about a dozen companies collapsed, while more companies reported of their liquidity problems. In fact the liquidity problems of finance companies reflected the growing insolvency.

In view of the exceptionally high interest rates offered to depositors, the costs of funds of these companies were very high. The monthly payments of interest on deposits which these companies implemented, further increased the administrative costs. Although the lending rates were high as shown in Table (2), many finance companies experienced serious problems of debt recovery. Moreover, high interest rates, along with default charges made it more difficult to recover debts. The economic recession during 1985-89 along with the deteriorated security situation made the difficult task of debt recovery, still more difficult.

2.4 Poor Quality of Management

Various types of mismanagement have been observed in the FC sector and these could be classified into:

(a) technical mismanagement,
(b) cosmetic management,
(c) desperate management and
(d) frauds.

Table 2

Most Prevalent Lending Rates (Interest per Annum) of Failed Finance Companies

Nature of Advance	1986	1987	1988
1. Hire Purchase Loans (Vehicles)	27 - 33	30 - 33.5	30 - 33
2. Hire Purchase Loans (Consumer Durables)	28.5	30.8	30·8
3. Mortgages	24 - 36	30 - 36	30 - 36
4. Other Loans (Promissory Note Based)	36 - 48	36 - 66	48 - 66
5. Loans against Fixed Deposits	36 - 48	36 - 60	36 - 60
6. Leasing	12.5 - 18	12.5 - 18	12.5 - 18
Range*	**24 - 48**	**30 - 66**	**30 - 66**

Notes:

1. *Excluding leasing rates.

2. Default charge of 4% per month is generally imposed on advances in arrears.

3. In hire purchase and lease purchase agreements, effective lending rates are much higher than the rates given in this table as finance companies do not follow the accounting practice of calculating the interest on the reducing balance method. The effective interest of an advance granted at 27 per cent on the full capital basis, works out to 42 per cent per annum on the reducing balance method. Once the default charges imposed on contracts in arrears are taken into account, a loan of Rs. 100,000/- in arrears for a year can double over that period.

A management is considered technically incompetent when concentration of advances, poor lending policies, over-optimistic assessment of borrowers' credit worthiness, and mismatching of assets and liabilities have been observed.

Very often cosmetic managements are involved in concealing past and current losses. Generally, profit and loss statements and balance sheet data are manipulated to show net profits, even if that means having to pay more taxes. Among the tactics used are:

(a) inadequate provision for bad and doubtful debts,

(b) inclusion of uncollectable accruals as income,

(c) too frequent revaluation of assets, and

(d) postponement of payment of bills.

A desperate management in addition to being engaged in cosmetic management tactics may introduce new instruments to attract funds, promising high rates of interest on such instruments. Further, higher lending rates would be charged to borrowers. Aggressive and persuasive advertising is generally used to promote impressions of stability and high profitability.

The management of almost all of the failed and insolvent finance companies had been involved in frauds. Further, it needs stressing that although the supervisors of DSNBFI attempt to evaluate the quality of management, it is necessary to appreciate the problems of detecting frauds since frauds are deliberate attempts to hide facts.

If a financial institution is to be viable and sound, it should have a good earning capacity. Its earnings should be continuous and adequate to service obligations towards depositors and shareholders in addition to meeting expenses and statutory charges. The significance of evaluating the earning capacity of financial institutions is, in addition to assessing the solvency of the institutions it may show how the management siphons off funds if such a thing is happening.

(a) Earnings are underestimated.

When a large proportion of fixed assets are owned by a finance company, it may under-estimate its earnings. In short, earnings of fixed assets are shown at negligible levels, so that the subsidiaries which use such assets are subsidized. Income transfers are realised through this method, particularly in family concerns.

(b) Earnings are overestimated through accrued interest and postponement of payment of bills.

Earnings may be overestimated to show large profits which enables large dividend declarations. Although this method involves paying excessive taxes, yet it is done since shareholders can realise excessive income benefits.

How liquidity is managed by the financial institutions is important. There are at least two methods, i.e., the conventional asset management approach where assets are organised in a manner that they mature according to the liquidity requirements and the more complex method of mixing asset and liability management making use of the money market

Table 3

Distribution of Employment in Finance Companies - March 1989

Size Group	No. of Companies	Senior Management	Qualified Accountants	Part Qualified Accountants	Other	Total
Group A (Large)	10	168	26	31	2,246	2,471
		(6.7)	(1.1)	(1.3)	(90.8)	(100)
Group B (Medium)	04	15	01	02	92	110
		(13.6)	(0.9)	(1.8)	(83.6)	(100)
Group C (Small)	30	48	05	23	206	282
		(17.0)	(1.8)	(8.2)	(73.0)	(100)
Total	**44**	**231**	**32**	**56**	**2,544**	**2,863**
		(8.1)	(1.1)	(2.0)	(88.8)	(100)

Source: Central Bank of Sri Lanka.

Note: Employment Data are based on survey response.

operations. Whatever the method used, a finance company should do so consistently. It has been discovered in Sri Lanka that some finance companies do not realise the need for such matching up of assets and liabilities in running a finance company. Often they request funds from the Central Bank to meet liquidity requirements i.e. the cash flow deficits.

2.5 Accounting Systems, Internal Controls and Procedures

During 1980/88, most of the finance companies did not employ adequately qualified experienced staff. As a consequence, internal controls, accounting systems and the procedures followed were unsatisfactory. C R Registers were used to maintain the cash book. Loan documents were incomplete, authorisation procedures were not laid down. Manual of procedures were not available in most of the companies. A few individuals, often a single individual, has been in charge of all important functions, i.e. maintenance of liquid assets, authorisation of loans, collection of loans etc. The segregation of responsibilities and dual controls, were virtually non-existent in the majority of finance companies.

The technical competence of the staff in finance companies was found inadequate. A good number of the senior management staff in most of the small finance companies had only money lending experience. The industry as a whole had only 1.1 per cent of qualified accountants and 2 per cent of part qualified accountants. As shown in Table 3 over 88 per cent of the staff had no formal training in financial services. The unsatisfactory standard of technical competence of the staff led to poor standards in accounting procedures and internal controls. A large number of finance companies employed auditors whose auditing standards were sub-standard. Put differently, these companies used to employ auditors largely to meet the legal requirements of the Company Law and the Control of Finance Companies Act.

2.6 Defects in the Regulatory System

A satisfactory or adequate regulatory system should have four components, i.e. (i) stipulation of minimum entry requirements, (ii) stipulation of performance requirements or standards, (iii) institutional arrangements to monitor performance and (iv) mechanisms to effectively enforce regulations.

The financial sector regulatory systems in most developing countries are defective in almost all the four aspects which we have referred to above. However, the most glaring defect which was observed in respect of regulations was ineffectiveness of enforcement. The process that was followed in the registration of finance companies under the Control of Finance Companies Act No. 27 of 1979 was unsatisfactory. In 1980, a few months after the passage of the new legislation, 54 companies had been registered and licensed by the Central Bank to engage in finance business. During the period 1981/87, further 28 companies were registered and licensed. The minimum requirements needed for an institution to engage in finance business such as adequate capital, competence of the management, operational arrangements such as the proper maintenance of books of accounts and records and auditing them had not been insisted upon as pre-requisites for entry.

The regulations issued also did not cover important aspects of finance business such as revenue recognition, provisioning for bad and doubtful debts, auditing requirements and single borrower limits. Further, there was no compelling need for the finance companies to submit the information required by the regulatory authority as the registration and licensing had been a once and for all event. As the effectiveness of moral suasion of the regulatory authority over finance company management was limited, many FCs used to freely ignore the regulations issued by the regulatory authority.

Under the Control of Finance Companies Act (CFCA), the regulatory authority could take legal actions only through complaints made to the police. However, this was found an ineffective process of implementing regulations.

The failures on Regulation and Supervision under the 1979 Act has been summarised as follows by Aziz:

> "The Bank Supervision Department of the Central Bank which is responsible for the general supervision of banks, was in charge of the new responsibilities (of implementing the 1979 Act) and had a separate staff to deal with Finance Companies. This unit however due to the shortage of staff and to the newness of the task which was thrust upon them so suddenly in 1979 was not geared to fully perform the role which the Statute had so presumptively given it. To add to this problem, it was found that these companies having operated untramelled for many years free of any regulatory constraints were not lending themselves to easy

control. As it was pointed out, the sole objective of these companies was to maximise short term profitability. There were companies in which the Directors and others who control the companies used the cash coming in, not for the legitimate purposes of granting loans and other forms of financial accommodation on a prudently secured basis and making investments after careful examination of the rates and possible risks, but simply for enriching themselves. They did this by diverting the cash flow into their own beneficially owned enterprises or to themselves as loans or advances with little or no security and/or at derisory interest rates. Until the cheques started bouncing, bank accounts not credited with interest, and cash was not paid to depositors when they called at their respective institutions for their due interests or refunds of matured deposits, almost everybody (including the depositors) took everything for granted. The Central Bank too realised the short comings in the existing law and felt that it lacked sufficient "teeth" to enforce its controls and regulations"*.

In short, the non-bank financial institutions sector as a whole had suffered from financial distress due to a combination of factors, which included the absence of adequate regulations which aimed at preventing falsification of financial statements, through means such as taking into account interest and overdue charges of non-performing advances. Over stated revenues helped the FCs to show higher profits,

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* Aziz, Shibly, Origin and Scope of the 1988 Finance Companies Act, Sri Lanka Economic Journal, April 1989 Colombo.

make large allocations to reserves and also to declare high rates of dividends, while masking the growing financial difficulties in the companies from the regulatory authorities as well as from the public. Therefore, in the reform programme that commenced with the enactment of the 1988 Act, priority was given to providing adequate regulations to improve the accounting practices, capital, risk management and supervisory system of the regulatory authority.

3. THE 1988 REFORMS

3.1 The 1988 Act

The Finance Companies Act No. 78 of 1988 (FCA), which was enacted by the Parliament on 17.12.1988, was the most significant instrument of the reform programme. It enabled the Central Bank to implement a new registration of all finance companies, including those which had been registered under the 1979 Act. The eligibility requirements laid-down in the FCA included, having an issued and paid up minimum unimpaired capital of Rs. 5.0 million, being a public limited liability company and that the Monetary Board of the Central Bank of Sri Lanka is satisfied with regard to the capability of the management to safeguard the interest of the depositors.

At the time of passing the legislation, only a handful of companies had satisfied the first two requirements. Therefore, the 1988 Act provided for a two year transitional period to give time to finance companies that were engaged in finance business to satisfy the new registration requirements of the 1988 Act. Further, this transitional period gave the Central Bank an opportunity to develop its own institutional mechanism to handle new registrations while taking measures to strengthen the regulatory system.

Authority to Regulate

The 1988 Act along with its later amendments has widened the authority of the Monetary Board to regulate the finance company sector, particularly in relation to the following areas:

(a) The terms and conditions under which deposits may be accepted including maximum rate of interest and period of deposit;

(b) the terms and conditions of granting loans;

(c) the maximum chargeable interest on loans;

(d) the minimum initial payment on a hire purchase agreement;

(e) the terms and conditions of investments;

(f) the maximum permissible maturities for loans and investments and the amount of security required;

(g) the form and manner in which accounting system should be maintained;

(h) the exclusion from income the unpaid interest in respect of overdue loans;

(i) the minimum liquid assets ratio to deposits;

(j) the maintenance of cash balances with the Central Bank;

(k) conditions applicable to withdrawal of prematured deposits;

(l) prohibition on further lending;

(m) fixing the lending limits within specified periods;

(n) requiring decrease in lending·

(o) the maximum percentage of share capital ownership;

(p) impose ceiling on remunerations and other payments to directors or any privileged employees;

(q) issue rules for regulation of advertisements relating to any aspect of finance business.

Prevention of Unjust Enrichment

Section 25 of the Finance Companies Act, provides for taking action by the Monetary Board to recover the funds from finance company directors or employees who have fraudulently, wrongfully or unlawfully benefited from company resources by improper utilisation or misapplications. As a result of the enactment of this Section which has created a considerable deterrant effect in the finance company sector, frauds and misuse of funds have, by and large, disappeared. Further, Section 5A has provided opportunities to depositors to seek legal redress against finance companies which unfairly refuse to settle their deposit liabilities.

Examination of Books of Accounts

Under Section 15 (1) of the 1979 Act, the authorised Central Bank officials can examine the books and accounts of any institution. In the 1988 Act, these powers are enlarged to cover appointment of independent auditors. The relevant Sub-Section 12 (3) (d) reads as follows:-

"In any case where there is evidence of mismanagement by a finance company, to require any director, manager or secretary of such finance company to submit the accounts of the finance company for audit by an auditor authorised by the Director and to require the finance company to furnish such information, or produce such books, records or documents and to pay such fees as may be specified or authorised by the Director, to such auditor."

Further,extension of Central Bank's powers can be seen in Sections 12(5)and 12 (6). These two Sub-Sections permit the Central Bank to obtain further necessary information from outside persons and subsidiary and associate companies. Moreover, the failure to furnish the information required by the Director or any officer or auditor authorised by him shall be guilty of an offence as stated in Section 19 of the 1988 Act.

The powers given to the Central Bank to appoint independent auditors are of particular significance in preventing mismanagement and fraud. The absence of such authority under the 1979 Act was a major obstacle to the Central Bank when it wanted to obtain the views of independent auditors.

Accounts of Finance Companies

The 1988 Act is more specific about the need to maintain an adequate accounting system by the finance companies as shown by Sections 14, 15, 16, and 17.

In addition to stating that each company should prepare a balance sheet and profit and loss account, the 1988 Act defines the main areas such as balance sheet and profit and loss account should relate (Section 14). The balance sheet should show:

(a) Capitalised expenses not represented by tangible assets under separate headings, so far as they are not written off;
(b) the market value of investments;
(c) the method adopted to value fixed assets if there had been any valuation of such assets during the financial year;
(d) the aggregate amounts of advances after the provision for bad and doubtful debts;
(e) any increase or decrease in the provision for depreciation, renewals or diminution in the value of fixed assets;
(f) the sources of application of funds;
(g) reserves, provisions and liabilities distinguishable from each other;
(h) except in the case of the first balance sheet after the date of commencement of this Act, the corresponding amounts at the end of the immediately preceding financial year for all items shown in the balance sheet.

Auditing of Finance Companies

Section 17 defines the duties of the auditors as follows:-

"The auditor of a finance company shall inspect the accounts, the finances, the management of the finances and the property of that finance company."

The Auditor shall, as far as possible, and where necessary, examine:

(a) whether the conduct of the affairs of the finance company has been in accordance with the law, rules and directions issued by the Board;

(b) whether records relating to the acceptance of deposits and maintaining of accounts are satisfactory;

(c) whether the accounting systems, procedures, books, records and other documents have been properly and adequately designed from the point of view of financial control purposes and from the point of view of the presentation of information to enable a continuous evaluation of the activities of the finance company and whether such systems, procedures, books, records and other documents are in effective operation;

(d) whether the accounts audited have been so designed as to present a true and fair view of the affairs of the finance company in respect of the period under consideration, due regard had been given to principles of accountancy, financing and valuation.

According to Section 15 of the new Act, the profit and loss accounts should show:

(a) the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets;

(b) liabilities in respect of taxes due for current year or succeeding year;

(c) dividends paid or proposed to be paid;

(d) the amount of remuneration of auditors;

(e) the amount of emoluments of directors;

(f) the amounts set aside for reserves;

(g) under separate heading, profit or loss due to unusual transactions or by change in the basis of accounting;

(h) a comparison of all items with the previous year.

Submission of Balance Sheet and Profit & Loss Account

According to Section 16 (1), every finance company shall transmit to the Director and publish within six months after the close of financial year:-

(a) the profit and loss account;

(b) the relevant balance sheet;

(c) the auditor's report; and

(d) the report by the directors.

Providing of Temporary Financial Assistance

While under the 1979 Act, Central Bank had no powers to provide financial assistance to finance companies which experience short term difficulties, the 1988 Act provides such a provision under Section 21. According to this provision, where the Director is satisfied, that it would be in the interest of depositors to provide temporary financial accommodation to such finance company, the Director shall report accordingly to the Monetary Board and the Board may grant a loan or advance to a commercial bank from the Medium and Long Term Credit Fund for the purpose of lending to such a finance company on such terms and conditions as may be determined by the Board, subject to the provisions of Section 88A and 88E of the Monetary Law Act.

It needs stressing that this financial assistance is available only for viable finance companies that experience temporary liquidity problems and such assistance should be used in the interests of depositors. The repayment ability of the relevant finance company too needs to be evaluated since this is a temporary financial accommodation.

Powers to Reorganise Finance Companies

The managerial capability is of critical importance for the solvency of a financial institution. Where there is evidence that the existing management is incompetent, the Central Bank should have powers to reconstitute such management by appointing suitable persons.

Under the 1979 Act the Central Bank had power only for winding up or permitting the company to resume duties with some restrictions (Section 16). However, under the 1988 Act, additional powers are given to reconstitute the finance company in a wide ranging manner.

"The Board may, as a condition of permitting the company to resume business, remove any director, manager or employee of such company where it is of the view that the continuation of such director, manager or employee in the company is detrimental to the interests of its depositors and appoint any person as director, manager or employee of such company. Provided, however, that the number of persons so appointed as directors, shall not constitute a majority in the Board of such finance company", [19 (4) (a)].

The Board is also given powers in Section 22 to vary contracts entered into by finance companies. Section 24 gives powers to vest finance companies in statutory boards. Section 26 gives powers to the director to issue directions in respect of matters such as-

(a) amalgamation;

(b) increase of capital;

(c) reconstitute the finance company in any such manner as it is considered to be in the interest of depositors;

(d) direct shareholders to divest or transfer ownership.

Powers of the Monetary Board to take over the Administration and Management of Finance Companies

In respect of a finance company where there is evidence of serious mismanagement or mismanagement and fraud, the Central Bank should have the option of implementing a rehabilitation attempt through a management team responsible to the Monetary Board. Unlike the previous Act, the 1988 Act provides such powers to the Central Bank.

If the Monetary Board after review of a report submitted by the Director under Section 18 of the 1988 Act, is of opinion that a finance company may be made solvent and viable, the administration and management may be vested in itself for a specified period by a notice published in the Government Gazette. A copy of such notice needs to be sent to the Registrar of Companies for his record (Section 20(1)). According to Section 20(2), where the Monetary Board takes over the administration and management of a finance company it may discharge its duties either through its own officers or through a management team hired for the purpose. The Monetary Board also has the powers to reorganise the company in a manner it thinks suitable and also to give financial assistance by way of a loan. The Board, however, any time after the take over of the administration and management, is of the opinion that the company cannot be made viable and solvent within a reasonable period of time, it may direct the Director to wind up the finance company.

Enforcement of Regulations

The provisions for enforcing the 1988 Act have been made more effective, as the powers to prosecute the offenders have been granted to the officers of the Central Bank. Further, the maximum penalty and punishment for offence committed under the 1988 Act is 02 years imprisonment or a fine not exceeding Rs. 1,000,000/- or both.

Appointment of Independent Auditors

Another feature in the 1988 Act that deserves emphasis is the enlargement of the powers of the Director of the DSNBFI to examine finance companies through independent auditors appointed by him. The relevant sub section 12(3) (d) reads as follows:-

"In any case where there is evidence of mismanagement by a finance company, to require any director, manager or secretary of such finance company to submit the accounts of the finance company for audit by an auditor authorised by the Director and to require the finance company to furnish such information, or produce such books, records or documents and to pay such fees as may be specified or authorised by the Director, to such auditor".

The powers given to the Central Bank to appoint independent auditors are of particular significance in preventing mismanagement and fraud. The absence of such authority under the 1979 Act was a major obstacle to the Central Bank when it became necessary to obtain the views of independent auditors.

3.2 Institutional Developments

The institutional development which commenced at the end of 1988, had two objectives. One was the upgrading of the regulatory and supervisory capability of the Central Bank and the other was the upgrading of the management capability of finance companies. Institutional developments within the Central Bank primarily involved the establishment of the Dept of Supervision of Non-Bank Financial Institutions (DSNBFI).

The Director of SNBFI is the Head of the Department and he is assisted by three Deputy Directors. The Organisational Chart of the DSNBFI is given in Chart I. For convenience of discussion, the organisation of DSNBFI can be divided into three main branches or sections, viz,

(a) Regulatory and Supervisory Section,

(b) Crisis Management Section, and

(c) Research and Evaluation Section.

The Regulatory and Supervisory Section is headed by a Deputy Director who is assisted by four Senior Assistant Directors and about nine Assistant Directors. The operational finance companies, which were about 45 in number in 1989, have been classified into four groups and are being supervised through on-site examinations, quarterly returns on overdue advances and the Early Warning System (EWS) which collects data on a weekly basis. The combination of on-site examinations which are being done annually and off-site monitoring based on returns has provided a very effective continuous supervision technique on operations of finance companies.

The Crisis Management Section is being handled by two Deputy Directors, assisted by three Senior Assistant Directors and nine Assistant Directors. The main funcuions of this Section are:

i. implementation of the Deposit Relief Scheme in the distress finance companies which are vested in the Monetary Board;

ii. management of these distress finance companies either directly or through management agencies;

iii. taking of legal action against directors of finance companies in consultation with the Attorney-Generals's Department; and

iv. organising of external and internal audits in the finance companies vested in the Monetary Board which are managed by the DSNBFI.

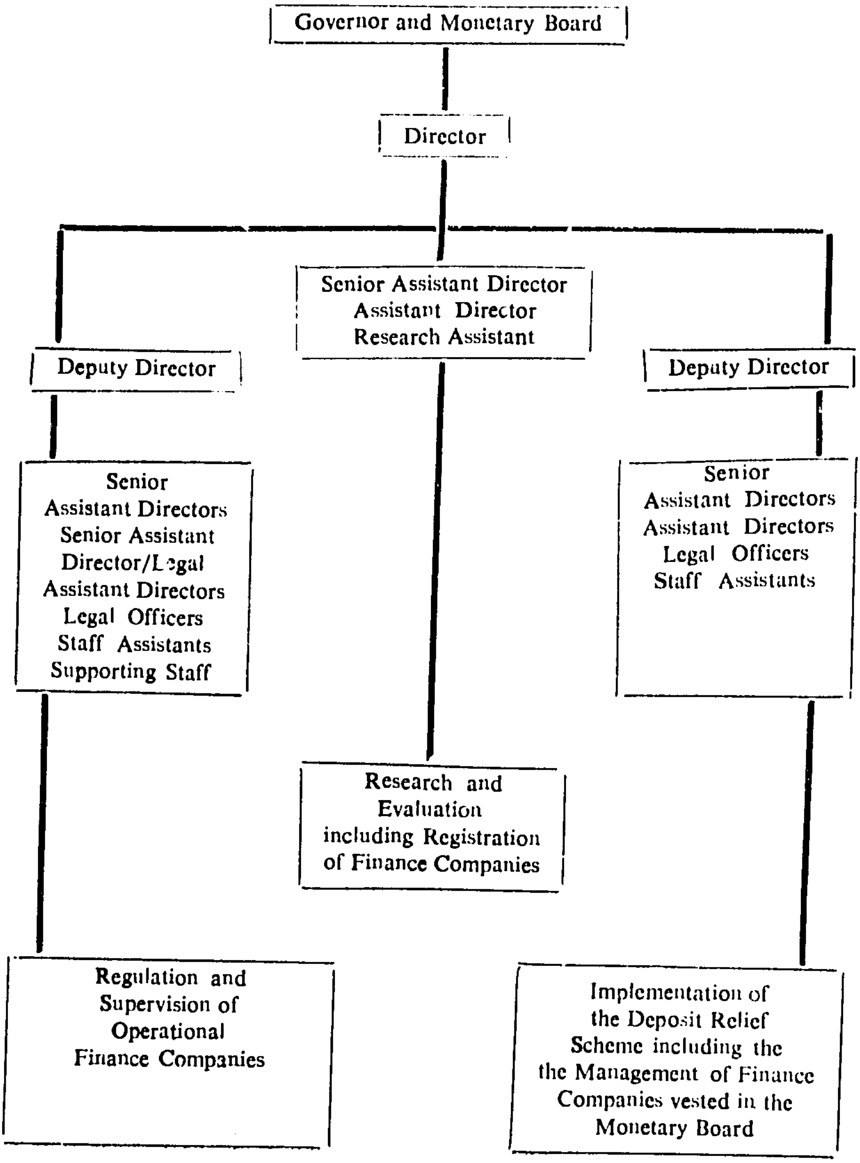
The Research and Evaluation Section, which is the smallest of the three sections, functions directly under the Director of Supervision of Non-Bank Financial Institutions. The Research and Evaluation Section is headed by a Senior Assistant Director who is assisted by an Assistant Director who is in charge of data processing. In addition, there is a Research Assistant who helps in data collection. The Research and Evaluation Section, which is also in charge of the registration of finance companies, provides the co-ordination between the two branches - Regulatory and Supervisory, and Crisis Management. To upgrade the supervisory capability of the staff, the Central Bank also gave priority to training. During April-May 1989, an in-house training programme of six weeks' duration was conducted in the Department of Supervision of Non-Bank Financial Institutions with the guidance of a foreign consultant made available by the United States Agency for International Development (USAID). During January-March 1990, the 15th SEACEN Training Course on Inspection and Supervision of Financial Institutions was held in Colombo, hosted by the Central Bank of Sri Lanka. This training programme, which was attended by 32 participants from SEACEN member countries and conducted by an international faculty of experts, provided an opportunity to train a large number of staff involved in the supervision of banks and other financial institutions. In addition, the Central Bank continues to send participants to training programmes and seminars to upgrade the supervisory capability of the Central Bank staff.

The work of the Crisis Management Section deserves some discussion, since such work does not fall within the normal regulatory or supervisory functions of Central Banks. Under the existing laws, the Central Bank of Sri Lanka has no obligation to pay relief to depositors of failed financial institutions, since at present there is no deposit insurance scheme in respect of finance companies. However, in view of the fact that about 44,000 depositors could lose their savings, the Central Bank introduced the Deposit Relief Scheme on welfare grounds. In addition to implementing the Relief Scheme, the management teams in the distressed finance companies are also engaged in the collection of debts and management of assets in an attempt to rehabilitate these institutions.

The improvement in the management of finance companies was implemented primarily through consultations, which followed the examination of

Chart I

Organisational Structure of the Department of Supervision of Non-Bank Financial Institutions
June 30, 1990



companies. The weaknesses observed in a particular finance company were discussed at length with the management of the company. Further, the management was requested to implement corrective measures within specified periods. The services of foreign management consultants too were offered to the finance companies as part of this exercise of upgrading managements at company level.

3.3 Registration and Licensing

According to the Control of Finance Companies Act No. 27 of 1979, the minimum eligibility requirements for registration were either a capital of not less than one hundred thousand rupees or deposits in excess of five hundred thousand rupees. This allowed the entry of a large number of companies and excessive competition in the industry. Further, the registration procedure was not made clear.

On the other hand, in July 1989, the Monetary Board of the Central Bank of Sri Lanka approved the procedure to be followed for registration of finance companies under the 1988 Act. The prospective applicants for registration were required to furnish inter-alia, the following particulars:

i. the legal status of the company.
ii. details of capital.
iii. particulars of Board of Directors.
iv. auditors (external and internal).
v. Income and Expenditure Statements (actuals)* on the following basis-

* Because of the unsatisfactory accounting practices relating to revenue recognition, it was decided that revenue statements should be evaluated on cash basis. See the discussion in page (40).

Income

(a) Income from advances.
(b) Income from other activities.
(c) Income from investments.
(d) Total income.

Expenditure

(e) Cost of funds/interest payments.
(f) Directors' emoluments.
(g) Staff expenses.
(h) Other expenses.
(i) Taxes.
(j) Dividends paid.
(k) Other expenses (if any).
(l) Total expenditure.

vi Particulars of Loan Portfolio

— Performing advances.
— Non-performing advances.
— Loans to Directors,
— Loans to associate companies.
— Guarantee given.
— Unsecured loans.

vii. Particulars of Borrowings by the Company

— From the banking system.
— From others.

viii. Off Balance Sheet Assets and Liabilities.

ix Particulars of Lending Rates and charges various types of lending.

x. Particulars of Deposits, Deposit Rates and Maturity Pattern.

xi. Particulars about Subsidiary and Associate Companies.

The above information supplied by the applicant companies were used, along with the information collected through on-site examinations, to evaluate the suitability of companies, for granting entry into the finance business. Further, company managements were given opportunities to explain their capabilities in the finance business.

3.4 Improvements in Regulations*

As we noted in Section 2 of this Study, most of the finance companies were in the habit of presenting masked financial statements to supervisors and the public. Therefore, in July 1989, issued a very significant direction to FCs on revenue recognition.

i. **Suspension of Interest on Non-Performing Loans and Advances**

According to this Direction —

(a) No finance company shall take into account as income, any accrued interest on a loan, credit facility or any type of financial accommodation on which interest and or capital repayments are in arrears for six months or more.

(b) Every finance company shall (in the maintenance of the books of accounts) segregate a loan, credit facility, or any type of financial accommodation to

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* Central Bank of Sri Lanka,
Regulations of Non-Bank Financial Institutions:
Directions and Rules issued by the Monetary Board,
Dept of Supervision of Non-Bank Financial Institutions,
Central Bank of Sri Lanka,
Colombo, 1991.

which the above is applicable from other loans, credit facility and any type of financial accommodation under separate control accounts in the general ledger. (Direction 15).

The objective of this regulation is to promote prudential practices on the revenue recognition. Most FCs used to treat all assets as performing, in spite of the fact that they have been non-performing for a long time. As a consequence, the information given in the profit and loss account was not reflective of the true financial position of the financial institution. Income has been overstated as accrued interest of non-performing loans and treated as income, which also means that profits are overestimated. In the event of dividend declarations on overestimated profits, there could be some mismanagement of funds.

ii. **Provision for Bad & Doubtful Debts**

As it was noted in Section 2, although FCs faced serious debt recovery problems, they failed to provide adequately for bad and doubtful debts. Therefore, this direction requires finance companies to make provision for bad and doubtful debts in order to improve the financial strength of the companies (Direction 1 and 2). According to Direction No. 1. every finance company is required to make provision for bad and doubtful debts before any profit or loss is declared, as follows:

(a) 50% of the outstanding value of advances in arrears for a period of 07 to 12 months;

(b) 100% of the outstanding value of advances in arrears for 13 months or more.

In arriving at the provisions required by (a) and (b) above, a company is permitted to deduct the realisable value of the collateral. The Monetary Board has also approved transitional provisioning requirements to enable the weak companies to arrive at the provisioning requirements of Direction No. 1, in a phased out manner.

iii. **Monitoring of Liquidity Position**

According to Direction No. 7, finance companies are required to maintain a minimum holding of liquid assets not less than 15 per cent of the deposit liabilities. The liquid assets may be in the form of cash and balances in current accounts of banks, fixed or time deposits with banks and investments in approved securities. This is also meant to further strengthen the monitoring of the liquidity position of finance companies. Some investigations carried out by the Central Bank revealed that certain finance companies, although they had invested in approved securities, had also secretly taken loans from banks pledging these as security. According to the directions issued on 10th March, 1989, every finance company should have 6 per cent of its deposit liabilities invested in Government Securities, Central Bank of Sri Lanka Securities or Government Treasury Bills, and documents relating to those investments should be lodged with the Chief Accountant of the Central Bank of Sri Lanka.

iv. Monitoring the Management of Loan Portfolio

In financial institutions the largest component of assets is the advances granted. Accordingly, the largest proportion of earnings too should be realised through loan operations. Therefore, prudential loan portfolio management is the basis of solvency of a financial institution. Hence, most of the directions issued relate to the terms and conditions of granting advances. The direction on grant of financial accommodation states that no financial institution shall-

(a) grant loans or advances against security of its own shares or security of shares of any of its subsidiaries;

(b) grant unsecured loans exceeding 10 per cent of capital funds; and

(c) grant loans to any one borrower exceeding 10 per cent of total loans (Direction No. 8).

v. Prevention of Excessive Competition for Deposits

One of the reasons for the failure of finance companies during 1986/88 was the excessive price competition that prevailed through the offer of high interest rates for deposits. Some finance companies offered high interest rates (as high as 36 per cent per annum) to pursuade the public to deposit their savings with them. In order to prevent excessive competition between finance companies on the deposit rates, Direction No. 13 on Rates of Interest and Other Charges were issued in 1988. This direction which is still valid limits the maximum annual rate of interest payable on 12 months deposits to 20 per cent per annum and the maximum interest payable on longer term time deposits to 24 per cent.

vi. Improve the Capital Adequacy

The direction on capital funds and reserve funds are also primarily aimed at providing an adequate capital base which is essential for solvency. According to Direction No. 9 on Capital Funds, every financial institution shall maintain capital funds which are not less than 10 per cent of total deposit liabilities. Direction No. 7 on Reserve Funds states that every financial institution should maintain an adequate reserve fund as specified in the Direction.

vii. Single Borrower Limit

The single borrower limit requires that no single borrower should be given an advance which is more than 10 per cent of the capital fund. The limit for corporate borrower is 15% of the capital fund. The objective of this Direction is to prevent credit concentration (Direction No. 17).

viii. Limits on Acquisition of Fixed Assets

Acquisition of fixed assets utilising public deposits could lead to solvency problems. On one hand, it may not be possible to convert fixed assets into liquid assets as and when required by the finance company. On the other hand, income generation by fixed assets can be easily manipulated to the disadvantage of depositors, creditors and shareholders. This is the rationale of Direction No. 6 which places restrictions on the acquisition of fixed assets. According to this Direction, finance companies should not purchase or acquire any immovable property or any right to title or interest therein exceeding 50 per cent of the capital funds. However, finance companies that are engaged in real estate business are permitted to acquire or purchase immovable property as part of the stock in trade (Direction No. 11).

ix. Prevention of Mismanagement and Fraud

In the finance business, the possibility of mismanagement and opportunities for fraud are considerable. Mismanagement can take place due to inadequate professional expertise, poor internal controls and accounting systems. It can also happen due to lapses and negligence on the part of the management. Fraud is a deliberate act of mismanagement for enrichment at the cost of the company. To prevent these acts of mismanagement and fraud, a number of Directions are issued to finance companies. The requirements that the Profit and Loss Account and Balance sheet need to be audited and such financial information be transmitted to the Central Bank are stated under separate Sections of the 1988 Act. Here, we shall deal only with some of the Directions issued by the Monetary Board to prevent mismanagement and fraud. Direction places restrictions on transactions with directors and connected concerns as follows-

> "No institution shall as from 1st March 1985 grant any loan or advance or financial accommodation of whatever nature including hire purchase financing and inter-company transaction to its directors, subsidiary companies, associate companies or to partnerships in which any of its directors own shares amounting to ten (10) per cent or more of such company's paid-up capital." (Direction No. 8).

Direction No 10 (2) (i) also states -

> "Every institution shall obtain the approval of the Monetary Board before writing-off any loan or advance granted by it to -

(a) any of its directors ;

(b) any undertaking in which any of its directors has an interest as a director, partner, manager, agent, investor or guarantor;

(c) any of its subsidiary companies;

(d) any person who is a director, manager or officer of an institution registered under the Control of Finance Companies Act No. 27 of 1979. For the purpose of sub-paragraph (3) in Direction No. 12 the word "director" includes the wife, husband, mother, father, son or daughter of a "director".

Direction No. 12 (2) states -

"No institution shall as from 1st March, 1985, invest in the shares of any company, an amount of which in the aggregate at any time exceeds five (5) per cent of the capital funds of the institution as at the last balance sheet date. Provided that such investments shall not exceed forty (40) per cent of the issued share capital of such company" (Direction No. 12 (2)).

Where any investment of the nature described at the above paragraph has been made in excess of the limits imposed before the date these Directions come into operation, steps shall be taken to conform to the above Directions before 1st Janury, 1989.

The Direction issued by the Monetary Board received greater recognition after the enactment of the 1988 Act as officials of the Department of Supervision of Non-Bank Financial Institutions (DSNBFI) are given authority to prosecute finance companies which violate the directives. During 1989-90, a considerable number of finance companies was prosecuted by the DSNBFI officials for violating directives issued by the Monetary Board.

3.5 Supervision of Finance Companies

Before the establishment of the DSNBFI, the supervision of finance companies depended largely on off-site monitoring which was done through an analysis of financial statements and returns supplied by the finance companies. On-site examinations of finance companies were undertaken randomly. This approach to supervision was found unsatisfactory, as shown by the experience of failed finance companies. The DSNBFI has reversed the order of priorities in supervision, on the one hand, while introducing new innovations in both on-site examinations and off-site monitoring, on the other. The new methodology of conducting on-site examinations has the following features-

(a) About 75 per cent of data are collected according to a structured questionnaire, while the remaining 25 per cent of data are collected outside the questionnaire depending on the nature of the financial institution. The new methodology places greater attention on loan portfolio management, particularly on the loan recovery record, internal controls and accounting system, quality of management and capital adequacy, with the objective of evaluating the overall viability of the institution. The integrity of the management is particularly evaluated in view of the experience that the failure of finance companies in Sri Lanka was primarily due to the fraud and embezzlement of funds by the directors.

(b) The examinations are designed in such a manner that they can be completed within a period of one month. About eight working days are allocated for data collection and two weeks for data processing and preparation of reports. The findings of these examinations, along with the Department's recommendations, are communicated to the respective finance companies within a month of commencing a particular examination. It is the view of the Department that the timely communication of findings and recommendations of an examination to the relevant company would increase the effectiveness as well as the usefulness of such an examination.

(c) In addition to these on-site examinations conducted by the officials of the DSNBFI, some finance companies have been examined through independent auditors appointed by the DSNBFI where there has been evidence of mismanagement or mismanagement and fraud.

Since February 1989, the DSNBFI has expanded the scope of the finance company monitoring through statistical returns by the introduction of an Early Warning System (EWS). The data collected under the EWS include the weekly position of deposits, new deposits and deposit renewals, deposit withdrawals on maturity and prematurely, loans granted by type of accommodation and the liquid assets. The objectives of the EWS are two fold. On one hand, it helps the DSNBFI to collect data to compile a set of key indicators which would help the Department to identify the finance companies which are likely to fall into difficulties and hence, to advise the respective finance companies about the remedial actions that should be taken. On the other hand, the data requested under EWS could also serve as part of the management information system of the respective finance companies. The DSNBFI has modified the EWS, which was introduced as a crisis management instrument, to form part of a comprehensive off-site monitoring system which would encompass the collection of data on monthly financial statements, including the Profit and loss account and the balance sheet.

In addition to the data which are collected through the EWS, the DSNBFI also undertakes periodic evaluation of finance companies through postal survey questionnaires. In 1989, two postal surveys were conducted, one to evaluate the finance companies in respect of their staff, and the other to collect data on deposit interest rates and lending rates. In 1990, a postal questionnaire survey was conducted on advances for the purpose of collecting detailed information on performing and non-performing accounts. The annual evaluation of finance company profit and loss Accounts and balance sheets are also being undertaken by the Department.

3.6 Improved Disclosure Requirements

The information available to regulatory authority on FCs cannot be divulged to the public even when there is a request for such information because of the prohibition by the secrecy requirement provision of the Monetary Law Act, which governs the operations of the Central Bank. However, the Companies Act No. 17 of 1982 requires every deposit accepting company to make available the balance sheet, profit and loss account, statement of accounts of subsidiaries (if any), directors' report and auditors' report to debenture holders and share holders of the Company. Further, Section 155 of the Companies Act stipulates that a copy of the statement on the financial condition must be displayed in a conspicuous place in the registered office, branch offices and place of business. Section 16 of the Finance Companies Act also stipulates the publication and display of financial statements.

The object of the disclosure regulation is to provide information to the public so as to enable the members of the public to make an assessment of the financial soundness of FCs. However, this objective is not often realised in adequate measure, when the financial statements are not based on appropriate accounting practices. In other words, due to the defects in accounting practices the true position of

FCs are not revealed by the financial statements. This prevents members of the public including depositors from making proper assessment of FCs.

The FCA 1988 states that every registered finance company must display its licence to engage in finance business in a conspicuous place, particularly to caution the depositors from unauthorised deposit accepting institutions. The significance of this disclosure requirement, i.e. licensed to engage in finance business need to be considered in the context of failures of large number of institutions and companies to honour their obligations on the funds they had accepted from the public.

The Central Bank has also issued rules in relation to disclosure requirements in advertisements. There had been numerous occasions where weak financial institutions project images of soundness when they are actually not financially strong, through persuasive advertisements to attract new deposits. The new advertising rule issued, requires FCs to obtain the approval of the Governor of the CB before publishing advertisements which solicit deposits. Further, it was required that every advertisement* should carry basic information such as, Names of Directors, Principal line of business, and Comparative Balance Sheet data for 3 years, giving particulars of capital, borrowings, profit or loss and interest rates and conditions of deposits.

* There have been suggestions that FCs should reveal their effective lending rates to the public. The borrowers of FCs often complained that they did not know the full particulars of the interest and charges they would have to pay on loans.

The object of this disclosure requirement in advertisements is to provide the public with information that would allow them to make a reasonable assessment of the financial strength of individual companies before depositing funds.

3.7 Relief Payments to Depositors of Failed Finance Companies

As we noted earlier, a large section of depositors of finance companies experienced hardships due to the failure of a considerable number of finance companies. In the absence of a Deposit Insurance Scheme, the Central Bank decided to implement a Relief Payment Scheme on deposits to alleviate the economic hardships of the depositors. The funds required for the implementation of the Scheme were loaned to the distressed finance companies from the Medium and Long Term Credit Fund (MLTF) of the Central Bank. As at 31. 02. 1992, about Rs 400.0 million had been released from MLTF.

The Relief Scheme involved the full payment of the principal sum in respect of deposits upto Rs. 10,000/-, and payment of upto Rs. 20,000/- or 50% of principal sum, whichever is lower, in respect of the other deposits. The directors of the failed companies, inclusive of family members and shareholders, were not eligible for these relief payments.

In addition to the above Deposit Relief Scheme, further payments are being made to depositors on the basis of the financial strength of the individual companies. In companies where realisable assets are substantial, the policy is to pay maximum possible proportion to the depositors. The total amount of funds disbursed to depositors of failed finance companies amounted to about Rs. 461.8 million as at 31. 12. 1992.

TABLE 4

Progress of Implementing Deposit Relief Scheme in Failed Finance Companies as at 31. 12. 1992

1.	Total No. of Deposits* (at the time of vesting)			40,590
2.	Total Value of Deposits (at the time of vesting) (Rs.'000')			1,052,428
3.	Relief Payments made -			
	3.1	No. of Deposits Paid		
		1989	6,264	
		1990	16,921	
		1991	9,110	
		1992	3,816	36,111
	3.2	Value of Deposits Paid (Rs.'000')		
		1989	59,700	
		1990	189,795	
		1991	120,471	
		1992	91,915	461,881
4.	Percentages-			
	4.1	No. of Deposits paid as a % of Total Deposits		
		1989	15.4	
		1990	41.7	
		1991	22.4	
		1992	9.4	88.9
	4.2	Value of Deposits paid as a % of Total Deposits		
		1989	5.7	
		1990	18.0	
		1991	11.4	
		1992	8.7	43.8

* Data relate to 08 finance companies, the administration and management of which have been taken over by the Monetary Board of the Central Bank of Sri Lanka.

4. AN EVALUATION OF THE 1989 REFORMS

As we noted earlier, the finance companies that were engaged in finance business, the day prior to the enactment of the 1988 Act, ie. 17. 12. 1988, were granted a two year transitional period to satisfy the conditions stipulated in the 1988 Act. During the two year transitional period the Central Bank pursued a multifaceted moral suasion approach to achieve the objectives of restructuring the finance company sub-sector in the financial system. Finance companies were classified into four categories after examination. The Category 'A' companies have had the adequate capital and managerial capacity. However, some marginal improvements were needed. The Category 'B' companies were only a few and they had to improve the capital base as well as the management of their organisations. The Category 'C' companies were also small in number, but they were required to make major improvements in their organisations by way of injecting fresh capital and recruiting new staff or through mergers and/or amalgamations if they wished to continue in the finance business. The companies in Category 'D' which had formed the majority were advised to wind up/divest their finance business. The market forces were also forcing them out of the finance business as shown by the withdrawal of deposits. During the transitional period 1988/90, the number of operational finance companies against the registered ones declined. In December 1988 there were 56 operational companies. This number declined to about 45 by June 1989 and by the end of 1989, the number of operational finance companies declined to less than 30.

In the consultations which followed on-site examinations, the weaknesses of individual finance companies were discussed and time-tables were proposed for implementing corrective measures. The Dept. of SNBFI also organised several workshops and seminars to discuss the general weaknesses of finance companies and the corrective measures.* The managements of majority of finance companies responded positively to the suggestions and hence, at the end of the transitional period, the number of finance companies which were found satisfactory exceeded the original expectations.** However, as it was noted in Section 3, as at 31. 12. 1992, only 27 finance companies were registered with the Monetary Board of the Central Bank of Sri Lanka. The reduced number has helped to prevent excessive competition among FCs.

The capital inadequacy which was a general problem of finance company sector, has been, by and large, overcome because of the requirement to have a minimum capital of Rs. 5.0 million as a condition of entry. The Central Bank encouraged managements to infuse fresh capital as much as possible. Only half of

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* The proceedings of seminars are published. Please see Sri Lanka Economic Journal, April 1989 and September 1990 issue.

** However there were a few companies which had already satisfied the minimum requirements specified in the 1988 Act which felt that they should be given registration under the new Act, in spite of the weaknesses in their companies.

the revaluation values were allowed to be accounted as capital. All borrowings by companies, including those from directors, were not considered as part of capital. As shown in Table 5, the capital funds of finance companies increased considerably during 1989-92. Issued share capital which was 1.5% in 1989 increased to 2.2% by 1991.

The concentration of the loan-portfolio on hire purchase lending to the transport sector which was about 51.5% of all assets in 1989 has considerably declined to reach 26.4% in 1992. Although no regulation was issued on this, the consultations with managements as well as discussion forums were used to high-light the risks involved with the concentration of loans in a narrow range of economic activities. The market forces also pursuaded the managements to diversify their lending activities. The trends in various lending activities can be seen from Table 5.

As it was noted earlier in Section 2 of this Study, hire purchase loans which appear to have high earning capacity, also carry high credit risks. Therefore, the reduction of lending on hire purchase contracts, has somewhat reduced the credit risk associated with finance company lending. The expansion of lease financing is a notable development. The lending rates on leasing are much lower, however, credit risks are also significantly lower than in hire purchase lending. The growth of other types of lending, particularly, trade financing is a welcome development.

There have been considerable improvements in the investment portfolio. Investment in approved securities, mainly the Govt. Treasury Bills has increased from 1.7% in 1988 to 4.5% is 1990. This is important

Table 5

Summaries of Consolidated Balance Sheet of Finance Companies (Percentages) as at end financial years

ASSETS	1989	1990	1991	1992
1. Liquid Assets				
Cash & Due from Banks	6.5	7.2	8.0	6.1
Govt. Treasury Bills	5.8	4.6	2.6	5.6
Total Liquid Assets	**12.3**	**11.8**	**10.6**	**11.7**
2. Investments				
Shares in Sub. & Ass.	1.3	1.1	1.7	1.4
Shares in Other Cos.	2.4	2.4	3.1	6.2
Total Investments	**3.7**	**3.5**	**4.8**	**7.6**
3. Advances				
Loans	7.5	13.3	15.2	14.8
Hire Purchase	51.5	40.4	38.2	26.4
Leasing	10.0	12.0	12.2	17.2
Total Advances	**69.0**	**65.7**	**65.6**	**58.4**
4. Due from Sub. & Ass.	**0.9**	—	—	—
5. Fixed Assets				
Freehold Land & Bldgs	5.1	6.8	7.1	7.0
Furniture, Fittings, Fixtures & Other Equipments	1.0	1.3	1.0	1.3
Motor Vehicles	0.7	0.6	0.7	1.2
Others	3.2	0.3	3.3	4.2
Total Fixed Assets	**10.0**	**9.0**	**12.1**	**13.7**
6. Other Assets	**4.1**	**10.0**	**6.9**	**8.6**
GRAND TOTAL	**100.0**	**100.0**	**100.0**	**100.0**

Table 5 Continued

LIABILITIES	1989	1990	1991	1992
7. Capital Funds				
Issued Share Capital	1.5	1.9	2.2	2.5
Capital Reserve	3.9	3.1	4.7	4.3
General Reserve	3.3	3.7	2.7	2.7
Reserve Fund	1.3	1.4	1.3	2.0
Other Reserves	0.1	1.0	1.4	2.6
Profit & Loss A/c	-0.3	-0.3	-0.9	-0.7
Total Capital Funds	**9.8**	**9.9**	**11.4**	**13.4**
8. Prov. for B&D Debts	**4.0**	**3.4**	**3.4**	**1.7**
9. Deposits	**63.7**	**64.4**	**58.5**	**59.3**
10. Borrowings				
Banks	7.9	9.9	15.7	15.8
Others	6.0	1.9	0.4	0.8
Total Borrowings	**13.9**	**11.8**	**16.1**	**16.6**
11. Other Liabilities	**8.6**	**10.7**	**10.8**	**9.1**
GRAND TOTAL	**100.0**	**100.0**	**100.0**	**100.0**

Note: For details see Appendix Table II.

from the point of liquidity management also, as Treasury Bills can be discounted readily. Investment in shares of quoted companies too has increased considerably in 1991 and 1992. These investments in shares are being monitored closely to prevent excessive allocation of funds for speculative investments. The investments in subsidiaries and associate companies are within the limits stipulated by the regulations.

As it was noted in Section 2 of this Study, through very liberal revenue recognition practices, the profits had been over-stated in the past. However, due to the revenue recognition regulations which became effective from 01. 04. 1990, the profit and loss accounts have reflected a more realistic financial position.

The provision for bad and doubtful debts, which was grossly inadequate during the pre-reform period has considerably increased, from 1.3% in 1988 to 3.4% in 1991. However, the provision provided has been far below what is required under the directions issued by the Monetary Board of the Central Bank of Sri Lanka. Before the introduction of the current reforms, credit risk management in the finance company sector in general, was very unsatisfactory. In an over competitive market, advances were given largely on the consideration of the value of the collateral. This has been the practice, particularly, in case of hire purchase lending which targetted the newly emerging private transport sector. A large proportion of the hire purchase loans had fallen into arrears, after a few instalments had been paid, primarily due to the poor management of the asset by the borrower. Although macro-economic factors, such as Govt. guidelines on fares too had made a contribution to the problems of the transport sector, the lack of managerial capability in evaluating the repayment capacity of investments in public transport also contributed to the problems of borrowers. Further, the high lending rates and other charges imposed on these loans, further discouraged the borrowers from repaying the loans. The result of all these inter-related factors was the large volume of non-performing loans in the advances portfolio of finance companies. In the context of virtual absence of the practice of classifying advances by the finance company managements, loans which had been non-performing for long periods, such as 24 months or 36 months, too appear as performing assets in the balance sheets. Although these loans would have been classified as losses, after taking into account the realisable collateral values, such provisionings had not been made.

A classification of loans as doubtful or loss does not mean there is no potential for eventual recovery. If managements pursue a pragmatic loan recovery programme, some collections would be possible and such collections would form part of income on a cash basis. Nonetheless, as some losses appear inevitable, either due to waiving of interests or due to the delays and costs of litigation, provisioning is required as part of risk management. Further, often judgements are given for sums less than the amount claimed. The repayment schedules decided by the Courts are also often lengthy. The advances which have become problem loans, are still shown as performing assets of finance companies; and the proportions of these advances are still considered significant. Therefore, the risks which could arise from hard-core problem loans are still substantial in the finance company sector. The objective of the regulations issued on provisioning requirements was to encourage the finance company managements to manage the risks of problem loans, by making allocations from their current profits.

A considerable improvement in the finance company managements has been achieved. The position shown in Table 3 significantly changed. Finance companies started to recruit professionals, to man key posts, such as Accountants, Internal Auditors, Credit Officers and Legal Officers. Finance companies have also compiled manuals of operations and issued them for compliance by the staff. Further, finance companies have started developing comprehensive management information systems for the benefit of the Board of Directors. The Central Bank conducts regular courses to train middle level managements of finance companies in credit management. The finance companies themselves have organised a training institute for employees of finance companies. Therefore, on the whole, the professionalism of the finance company managements has improved considerably. The continuous supervision and the regular examinations of finance companies and the regulations which prohibit self-lending of various nature have minimised the opportunities for mismanagement to a large extent. However, it is necessary to recognise that directors of FCs are entirely responsible for the management of their companies, and managements which are bent on mismanagement for their benefits would always and find ways of doing so, in spite of regulations and supervision.

The regulations issued on revenue recognition and suspension of interest on non-performing loans and advances have helped in improving the accounting practices of most of the finance companies. However, there has been a few instances where these regulations have been circumvented. The explanations given by the companies were, that the staff is not clear as to the ways of adopting these accounting requirements. In response to this, the Institute of Chartered Accountants* has recently developed accounting standards on Revenue Recognition and Disclosure Requirements in Financial Statements of Non-Bank Financial Institutions based on the Monetary Board Directions 1989. Once these accounting standards are adopted by finance companies, there will be a substantial improvement in the financial statements of finance companies.

As it was noted in Section 2, the auditing standards in finance companies had been unsatisfactory, largely because the accounting practices were inappropriate. It has also been said that auditors often overlook weaknesses in finance companies, as they are also performing the duties of Consultants to the same companies through their consultancy firms.** In October, 1991, the Monetary Board issued a direction stipulating the nature of auditing required in finance companies. With the enforcement of revenue recognition and accounting standards, the auditing standard in finance companies are likely to improve.

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* Draft Sri Lanka Accounting Standard on Revenue Recognition and Disclosures in the Financial Statements of NBFIs, Institute of Chartered Accountants of Sri Lankra-February 1993.

** Sumanasekera, Harischandra;
Can Auditors be Independent-
The Island 21st September, 1991.

5. SUMMRY AND CONCLUSIONS

As it was noted in Section 3, the reforms introduced after the enactment of the Finance Companies Act No. 78 of 1988, were comprehensive. These reforms aimed at addressing the main weaknesses of the finance company sector which included mismanagement and fraud, excessive competition, inappropriate accounting practices, portfolio concentration and capital inadequacy. In all these areas, substantial improvements have been achieved. However, a longer time is required to consolidate the achievements of the reforms, particularly in the area of prudent practices.

Section 25 of the Finance Companies Act, which was strengthened later by amendments, along with the establishment of a legal division of the Dept. of Supervision of Non-Bank Financial Institutions, and the frequent on-site examinations by supervisors, have minimised the opportunities for misappropriation of finance company funds. The excessive competition within the finance company sector, both for deposits as well as for lending, had disappeared, due to the regulations issued by the Monetary Board. A significant beginning has been made in adopting appropriate accounting practices with the enactment of directions on revenue recognition and provisioning for bad and doubtful debts. The auditing profession has recently complimented the efforts of the regulatory authority to improve accounting practices by presenting accounting standards for non-bank financial institutions. As the need for diversification of the advances portfolio is being recognised by finance company managements, a considerable reduction in the concentration of advances had been achieved. Disclosures in advertisements by finance companies have improved, providing data, enabling depositors to make an assessment of the financial standing of the individual companies.

Problems of recovering debts directly affects the solvency of the financial institutions. As the experience of failed finance companies show, one of the crucial factors which had contributed to the failure of finance companies in Sri Lanka was the problem of recovering debts. An examination of problem loans in finance companies shows that the lending rates have significantly contributed to the debt recovery problems. Data given in Table 2 shows that the higher lending rates of failed FCs were very high.

The prevailing lending rates of finance companies are also higher than those of commercial banks as could be seen from Appendix Table 3. The lending rates of commercial banks are in the region of 20 per cent per annum. Further, in commercial banks the interest component is computed on the reducing balance basis on the loan outstanding. The lending rates of leasing companies are around 13 to 14 per cent per annum. However, as the reducing balance basis is not followed in calculating interest, the effective lending rates work out to about 28 to 30 per cent per annum. The finance companies charge lending rates of around 26 to 27 per cent per annum on the initial sum loaned which work out to effective annual lending rates of 42 to 45 per cent per annum. The penal interest rate which is charged on overdue loans is about 6 per cent per annum in the banking sector. The leasing companies charge an additional interest of about 2 per cent per month on overdue lease instalments. On the other hand most finance companies charge an additional 4 per cent per month on overdue loan instalments.

The debt recovery levels of financial institutions are determined by a number of factors. In addition to the effectiveness of the credit evaluation and recovery processes, the lending rates along with default charges have a critical bearing on debt recove levels. As the experience of failed FCs show, higher lending rates and default charges have contributed to lower loan recovery levels. The higher lending rates of FCs reflect the higher risks they take in providing credit. This aspect need to be taken into consideration in evaluating the credit risks of FCs. Further, it also needs stressing that the deposit rates offered by FCs are the highest as shown by the Appendix Table 3.

The monetary Board of the Central Bank of Sri Lanka, has issued a comprehensive set of directions and rules to promote soundness and solvency of finance companies. These regulations aim at protecting depositors, adoption of appropriate accounting practices, particularly in the area of revenue recognition and provisioning for bad and doubtful debts and prudent management of funds in granting advances. When one considers the finance company sector as a whole, only a beginning has been made in adopting appropriate accounting practices. Some finance companies have already adopted very satisfactory practices. However, there are a few companies which have to improve their revenue recognition and provisioning for bad and doubtful debts considerably. Therefore, continuous monitoring of the adoption of appropriate accounting practices by finance companies has to continue. In short, a significant part of the reform programme is yet to be implemented. Hence, the enforcement of regulations that have already been issued, appears to be the most critical component of the unfinished part of reforms.

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APPENDIX TABLE I

Summaries of Consolidated Balance Sheets of Finance Companies

(Rs.'000)

ASSETS	As at 31.03.83	%	As at 31.03.84	%	As at 31.03.85	%	As at 31.03.86	%	As at 31.03.87	%
1. Liquid Assets										
Cash & Due from Banks	143,236	7.2	187,418	6.74	382,343	8.64	702,258	11.40	910,208	11.85
Govt Treasury Bills	—	—	10,981	0.39	48,434	1.09	108,729	1.[illegible]	126,605	1.65
Total Liquid Assets	**143,236**	**7.2**	**198,399**	**7.1**	**430,777**	**9.7**	**810, 987**	**13.2**	**1,036,813**	**13.5**
2. Investments										
Shares in Sub. & Ass.	80,445	4.03	95,456	3.43	101,780	2.30	98,930	1.61	94,925	1.24
Shares in other Cos.	32,532	1.63	17,694	0.64	81,626	1.84	115,172	1.87	173,645	2.26
Total Investments	**112,977**	**5.7**	**113,150**	**4 1**	**183,406**	**4.1**	**214,108**	**3.5**	**268,570**	**3.5**
3. Advances										
Loans	177,105	8.87	240,645	8.65	483,686	10.92	1,072,949	17.42	1,222,588	15.91
Hire Purchase	864,962	43 33	1,148,467	41.29	1,789,323	40.41	2,328,878	37.81	2,873,013	37.39
Leasing	40,646	2.04	155,765	5 60	236,864	5.35	319,863	5.19	567,975	7.39
Total Advances	**1.082.713**	**54.2**	**1.544.877**	**55.5**	**2.509.873**	**56.7**	**3,721,690**	**60.4**	**4 663 576**	**60.7**
4. Due from Sub. & Ass.	**197.742**	**9.9**	**235.518**	**8.8**	**399.653**	**9 1**	**321,193**	**5 2**	**280 837**	**3.6**
5. Fixed Assets										
Freehold Land & Bldgs	146,364	7 33	152,573	5.50	255,731	5 78	394,885	6.41	458,202	5.96
Furniture, Fittings, Fixtures & Office Equipments	29,317	1.47	35,234	1.27	42,834	1 00	87,324	1.42	85,478	1 11
Motor Vehicles	21,407	1.07	20,887	0.75	25,522	0 58	34,890	0.57	44,528	0 58
Others	17,629	0.88	29,260	1 05	65,095	1.47	70,109	1.14	95,529	1.24
Total Fixed Assets	**214,717**	**10.7**	**238 254**	**8.6**	**389,182**	**8 8**	**587,208**	**9 5**	**683,737**	**8.9**
6. Other Assets	**244,666**	**12.3**	**441,254**	**15 9**	**514,559**	**11.6**	**503,766**	**8 2**	**750 323**	**9.8**
GRAND TOTAL	**1.996,051**	**100.0**	**2.781.452**	**100.0**	**4.427.451**	**100.0**	**6.158.952**	**100.0**	**7,683 856**	**100.0**

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Table I (Cont'd.)

LIABILITIES	As at 31.03.83	%	As at 31.03.84	%	As at 31.03.85	%	As at 31.03.86	%	As at 31.03.87	%
7. Capital Funds										
Issued Share Capital	49,401	2.47	58,193	2.10	81,859	1.85	95,164	1.55	109,281	1.42
Capital Reserve	93,084	4.66	102,474	3.68	186,564	4.21	291,839	4.74	347,328	4.52
General Reserve	86,861	4.35	101,342	3.64	110,781	2.50	174,469	2.83	212,785	2.77
Reserve Fund	-	-	16,169	0.58	33,879	0.76	36,467	0.59	58,623	0.76
Profit and Loss A/c	6,698	0.34	5,865	0.21	32,467	0.73	25,509	0.41	23,196	0.30
Total Capital Funds	**236,044**	**11.8**	**284,343**	**10.2**	**445,550**	**10.1**	**623,448**	**10.1**	**751,213**	**9.8**
8. Prov. for B & D Debts	13,519	0.7	18,092	0.7	72,135	1.6	160,056	2.6	176,055	2.3
9. Deposits	1,329,219	66.6	1,891,189	68.0	3,012,073	68.0	4,245,101	68.9	5,131,339	66.8
10. Borrowings										
Banks	175,382	8.8	269,774	9.70	303,477	6.85	384,820	6.25	548,951	7.14
Others	-		11,314	0.41	50,728	1.15	177,361	2.88	330,185	4.30
Total Borrowings	**175,382**	**8.8**	**281,088**	**10.1**	**354,205**	**8.0**	**562,181**	**9.1**	**879,136**	**11.4**
11. Other Liabilities										
Taxation	9,531	0.48	8,561	0.31	16,353	0.37	15,721	0.26	10,635	0.14
Dividends	5,270	0.26	6,758	0.24	9,482	0.21	8,415	0.14	11,816	0.15
Others	227,987	11.42	291,130	10.47	517,653	11.69	544,030	8.83	722,662	9.40
Total Other Liabilities	**242,788**	**12.1**	**306,449**	**11.0**	**543,488**	**12.3**	**568,166**	**9.3**	**745,073**	**9.7**
GRAND TOTAL	**1,996,051**	**100.0**	**2,781,452**	**100.0**	**4,427,451**	**100.0**	**6,158,952**	**100.0**	**7,683,856**	**100.0**
Number of Companies Registered	61		63		66		71		71	
Audited Accounts Received	61		59		62		65		62	

Source: Central Bank of Sri Lanka

APPENDIX TABLE 2

Summaries of Consolidated Balance Sheets of Finance Companies

(Rs' 100)

ASSETS	As at 31.03.88	%	As at 31.03.89	%	As at 31.03.90	%	As at 31.03.91	%	As at 31.03.92*	%
1. Liquid Assets										
Cash & Due from Banks	737,414	10.8	490,970	6.5	591,337	7.2	758,885	8.0	441,076	6.1
Govt Treasury Bills	122,779	1.8	434,561	5.8	379,427	4.6	254,960	2.6	405,915	5.6
Total Liquid Assets	**860,193**	**12.6**	**925,531**	**12.3**	**970,764**	**11.8**	**1,013,845**	**10.6**	**846,991**	**11.7**
2 Investments										
Shares in Sub. & Ass.	52,202	0.8	96,100	1.3	92,420	1.1	162,207	1.7	102,696	1.4
Shares in Other Cos.	241,118	3.5	181,156	2.4	195,476	2.4	295,791	3.1	444,814	6.2
Total Investments	**293,320**	**4.3**	**277,256**	**3.7**	**287,896**	**3.5**	**457,998**	**4.8**	**547,508**	**7.6**
3. Advances										
Loans	894,816	13.1	561,780	7.5	1,101,896	13.3	1,459,087	15.2	1,071,482	14.8
Hire Purchase	3,102,673	45.2	3,864,658	51.5	3,336,659	40.4	3,660,904	38.2	1,911,866	26.4
Leasing	787,063	11.5	746,767	10.0	987,367	12.0	1,167,505	12.2	1,246,388	17.2
Total Advances	**4,784,552**	**69.8**	**5,173,205**	**69.0**	**5,425,832**	**65.7**	**6,285,496**	**65.6**	**4,229,736**	**58.4**
4. Due from Sub & Ass.	**62,490**	**0.9**	**69,001**	**0.9**	-				—	
5. Fixed Deposits										
Freehold Land & Buildings	377,483	5.5	383,109	5.1	569,285	6.8	683,340	7.1	507,495	7.0
Furniture, Fittings, Fixtures & Office Equipments	61,472	0.9	72,372	1.0	104,093	1.3	98,331	1.0	96,434	1.3
Motor Vehicles	37,176	0.5	52,708	0.7	50,601	0.6	61,619	0.7	83,178	1.2
Others	67,336	1.0	245,355	3.2	22,469	0.3	318,988	3.3	303,336	4.2
Total Fixed Assets	**543,467**	**7.9**	**753,544**	**10.0**	**746,441**	**9.0**	**1,162,281**	**12.1**	**990,443**	**13.7**
6. Other Assets	**310,564**	**4.5**	**310,701**	**4.1**	**833,685**	**10.0**	**668,676**	**6.9**	**622,718**	**8.6**
GRAND TOTAL	**6,854,586**	**100.0**	**7,509,241**	**100.0**	**8,264,618**	**100.0**	**9,588,296**	**100.0**	**7,237,388**	**100.0**

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Table 2 (Cont'd.)

LIABILITIES	As at 31.03.88	%	As at 31.03.89	%	As at 31.03.90	%	As at 31.03.91	%	As at 31.03.92*	%
1. Capital Funds										
Issued Share Capital	117,792	1.7	111,963	1.5	162,084	1.9	209,310	2.2	185,533	2.5
Capital Reserve	281,861	4.1	292,977	3.9	254,335	3.1	449,577	4.7	315,629	4.3
General Reserve	241,561	3.5	248,431	3.3	302,495	3.7	256,246	2.7	196,087	2.7
Reserve Fund	55,194	0.8	99,376	1.3	116,265	1.4	126,871	1.3	147,457	2.0
Other Reserves	2,589	0.1	784	0.1	843	0.1	134,174	1.4	191,737	2.6
Profit & Loss A/c	6,386	0.1	(19,193)	-0.3	(21,847)	-0.3	(83,936)	-0.9	(56,578)	-0.7
Gross Capital Funds	**705,383**	**10.3**	**734,338**	9.8	814,175	9.9	1,092,242	11.4	**979,865**	**13.4**
Less: Deferred Expenditure	—		523		11,166		15,006		13,868	-0.1
Net Capital Funds	**705,383**	**10.3**	**733,815**	9.8	**803,009**	9.7	**1,077,236**	11.2	**965,997**	**13.3**
2. Prov. for B & D Debts	**89,606**	**1.3**	**300,044**	**4.0**	**283,980**	**3.4**	**322,665**	**3.4**	**125,866**	**1.7**
3. Public Deposits	**4,630,085**	**67.5**	**4,783,472**	**63.7**	**5,318,995**	**64.4**	**5,613,224**	**58.5**	**4,288,943**	**59.3**
4. Borrowings										
Banks	443,840	6.5	591,141	7.9	819,030	9.9	1,5[illegible]7,784	15.7	1,147,746	15.8
Others	376,526	5.5	446,979	6.0	153,294	1.9	35,652	0.4	49,159	0.8
Total Borrowings	**820,366**	**12.0**	**1,044,120**	**13.9**	**972,324**	**11.8**	**1,542,836**	**16.1**	**1,196,935**	**16.6**
5. Other Liabilities	**609,[illegible]46**	**8.9**	**647,790**	**8.6**	**886,310**	**10.7**	**1,032,315**	**10.8**	**659,677**	**9.1**
GRAND TOTAL	**6,851,586**	**100.0**	**7,509,241**	**100.0**	**8,264,618**	**100.0**	**9,388,290**	**100.0**	**7,237,388**	**100.0**
Number of Companies Registered	—		—		—		26		27	
Audited Accounts Received	58		47		46		28		25	

* Excluding MCL, the administration and management of which was taken over by the Monetary Board of the Central Bank of Sri Lanka.

APPENDIX TABLE 3

Comparative Deposit and Lending Rates of Financial Institutions

Deposit Rates (12 Months)				Lending Rates	
Year	Com. Bank	NSB	FCs	Com. Bank	FCs
1979	14	12	—	-	-
1980	20	15	—	-	-
1981	20	15	—	-	-
1982	15	15	—	-	-
1983	16	14	—	-	-
1984	14	14	—	-	-
1985	12	13	20	14.8 - 30	-
1986	8.5	12	20	14.8 - 27	-
1987	8.5	12	20	14.2 - 28	-
1988	9.0	12	20	14.8 - 28	-
1989	11.0	14	20	16.8 - 30	-
1990	11.0	17	20	17.5 - 30	-
1991	12.0	17	20	19.3 - 30	25 - 42
1992	10.0	17	20	19.5 - 30	28 - 42

Source: Central Bank of Sri Lanka.

Notes: Com. Bank = Commercial Banks
NSB = National Savings Bank
FCs = Finance Companies

APPENDIX TABLE 4

Common Lending Rates* (Annual Interest) of Finance Companies 1990 - 1992

Nature of Advance	1990	1991	1992
Hire Purchase	25—27	25—28	25—30
Lease Purchase	15—20	15—20	15—22
Leasing	13—18	13—20	14—22
Other Loans	18—36	24—42	24—60
Range	13—36	13—42	14—60

* Default charge of 4 per cent per month is generally imposed on advances in arrears. The effective lending rates are much higher than those stated in the Table.

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