Financial System

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It is the system that includes the decision of markets, financial institutions, financial instruments and financial infrastructures by economic agents of domestic and foreign households, business firms and the government

It consists of following components,

1. Financial institutions

   - Banking system

     - Central bank
     - Licensed commercial banks
     - Licensed specialized banks
     - Deposit taking institutions
     - Licensed finance companies
     - Thrift and cooperative societies

   - Specialized financial institutions

     - Primary dealers
     - Specialized leasing companies
     - Share brokers
     - Unit trust management companies
     - Market intermediaries
     - Investment trust companies

   - Contractual savings institutions

     - Insurance companies
     - Employees provident fund
     - Employees trust fund
     - Approved private provident fund
     - Public service provident fund

2. Financial markets

   - Money market
   - Capital market

3. Financial instruments

   - Debt securities Issued by government

     - Treasury bills
     - Treasury bonds
     - Government debt securities

   - Debt securities Issued by companies

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- Commercial papers
- Debentures

➢ Debt securities Issued by commercial banks

- Certificate of deposits
- Assets backed securities
- Hire purchase
- Interbank call money market
- Shares

4. Financial infrastructures
5. The regulatory bodies which supervise the financial institutions

Central Bank

The CBSL is established under the monetary law act in 1949. It is established to govern the monetary policy of Srilanka.

The main function of central bank of Srilanka is managing the financial instruments in order to lead interest rate and money supply of the country.

The objectives of Central Bank of Srilanka

1. Maintain economic and price stability

   - It mainly focuses on establishing the stability of domestic price level
   - It means keeping the inflation level in the minimum level.
   - It expects that price stability enhances strong long term economics growth and full employment level.

2. Maintaining Financial system stability

   - It is the maintenance of stability in economics, financial, political & other sectors from the internal & external shocks.

The Reasons for financial stability

1) Effective performance of financial institutions & financial markets.
2) Removal of problems in Balance of payment.
3) Ensuring asset prices
4) Maintenance of market liquidity

Core Functions of CBSL

- Conduct of monetary policy
- Conduct of exchange rate policy
- Management of official foreign reserve
- Currency Issue

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- Licensing, regulating, supervising banks and selected non-bank financial institutions
- Banker and financial advisor of the government
- Banker to commercial banks
- Employees' Provident Fund Management
- Foreign Exchange Management
- Public Debt Management
- Micro finance and Regional development

The central Bank has many different types of relationship with commercial banks. The key relationships are as follows.

- The regulator and supervisor of the commercial banks
- The banker to the commercial banks.
- The lender of the last resort
- Provider of facilities to manage liquidity of commercial banks
- The advisor to commercial banks.

Commercial Banks

The financial institutions which specially accept demand deposits from the public which permit their customers to convert their deposits into the cash by writing the cheque is known as commercial banks.

The Main Functions of Commercial Bank

1) Primary functions

- Attract deposits from public.
- Lending money in the form of loans or overdraft.

2) Secondary functions

- Collections of cheques and bills

3) Agency functions

- Issuing letter of credit
- Issuing letter of references
- Issuing travelling cheques
- Safety locker facility
- Electronic fund transfer
- Automated teller machines
- Issuing debit cards and credit cards

The objectives of the Commercial Banks

01. Maintenance of High Liquidity
02. Maintenance of High profitability

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1. Maintenance of High Liquidity

   It is the capability of the commercial banks to return the money at any time with any amount to the customers when they require from their deposits.

   They must to maintain liquidity to maintain the trust worthiness the customers keep on the bank.

2. Maintenance of High Profitability

   The aim of the commercial banks are earning the profit. Therefore they earnli main income by interest through providing loans and investments therefore they must to organize their business Functions in the effective way in order to earn the maximum profit.

Note

These 02 objectives are opposed to each other, therefore if they maintain high liquidity there will be the problem in the profitability & vice versa.

Monetary Policy

It is the management of financial instruments in order to guide and influence on interest rate and money supply to achieve the macro economic objectives of maintaining economic price stability and maintaining stability of financial system.

Central Bank influences on expenditures on load and liquidity with the support of monetary policy.

Instruments of Monetary Policy

01. Quantitative Instruments

- Bank Rate

CBSL provides loan to the commercial bank as the lender of the last resort

- Statutory reserve ratio

Central bank stipulates that the commercial banks should keep a certain proportion of their deposit liabilities as reserves with the central banks.

- Open market operation

It refers to the purchase and sale of treasury bills by the central bank in the open market

02. Qualitative Instruments (Selective tools)

- Moral Suasion

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Tactics used to influence and pressure by closed door meetings with bank directors, severity of inspections etc.

- Fixing maturity period for commercial bank credit
- Portfolio ceiling
- Provision of refinance facilities
- Fixing selective interest rates

Role of banks in financial inclusion and business expansion

Bank accept deposits and make loans and generate a profit from the difference in the interest raid paid and charge to depositors and borrowers respectively. The process performed by banks of taking in funds from a depositors and then lending them out to a borrower is known as financial intermediation.

Through the process of financial intermediation, certain assets are transformed into different assets or liabilities. Accordingly, financial intermediaries channel funds from people who have extra money or surplus savings (savers) to those who do not have enough money to carry out a desire activity (borrowers)

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