

Regulation of the Banking and Related Sectors in Sri Lanka

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1. Rationale for Banking Regulation

Financial system stability is one of the key fundamentals upon which economic growth is built. In Sri Lanka we have a bank-dominated financial system where banks contribute 56% of the assets in the financial system and 77% of GDP. Hence, a sound banking system is a vital pre-requisite to ensure financial system stability and economic growth.

2. Banks are highly leveraged institutions that depend heavily on depositor confidence. The nature of the banking business is such that almost 80% of banking assets are financed primarily through depositors' funds. Equity on the other hand, contributes even less than 5%. Here then lies the *raison d'être* for bank regulation and bank supervision – the protection and safeguarding of depositors' interest being the micro objective and ensuring depositor confidence in the financial system, being the macro objective of financial system stability. This is an obligation that devolves on the Central Bank by virtue of the fact that the authority for market entry through the licensing of banks lies with the Central Bank. It naturally follows therefore, that in approving an entity as a licensed bank to accept public deposits, the obligation lies with the Central Bank to ensure that such institutions function in a safe and sound manner in which the public can repose their confidence. This then is the reason why the Department of Bank Supervision was established by statute with statutory powers over licensed banks in the country. Regulators are mindful that banks, being commercial entities, always seek to maximise shareholder value. What is important is that in doing so they do not compromise the safety of depositors' funds; assuming higher risks to pursue higher returns could threaten the stability of the institution, the industry and ultimately the system.
3. Regulation alone however, cannot provide the absolute assurance that financial failure will not occur. Nor does the occurrence of a failure necessarily point to the existence of a flaw in the regulatory structure of the financial system. Market participants also have an important role to play in order to achieve the desired objectives.
4. A sound banking system contributes to the effectiveness of intermediation, maturity transformation (turning short-term savings deposits into long-term loans), payment facilitation, credit allocation and financial discipline. Banks also play the role of gatherers of savings, allocators of resources and providers of liquidity. As primary providers of payment services and as a fulcrum for the implementation of monetary policy, banks stand apart from other institutions and remain at the centre of economic and financial activity.

Simply stated, the social cost of banking–system failure is too high to be left to a market with imperfections such as inadequate and asymmetric information where consumers are less informed than suppliers of banking services. Depositors are mostly aware of the fact that banks lend out their deposits to longer-term and risky borrowers. They are only prepared to do this however, if they have complete confidence in the ability of a bank to manage its liquidity and credit risk and if the reward for the risks the depositors take is adequate. This confidence is clearly enhanced by the knowledge that banks are regulated and supervised. Unfortunately, regulation and supervision of banks can have perverse effects, such as consumers assuming that banks are safe and that they are free to take all the risks of high interest rates etc. This was amply demonstrated in the aftermath of the failure of Pramuka Bank, Sri Lanka's first post independence bank failure. There was public outrage at what was deemed to be "regulatory failure".

5. The moral hazard of regulation

It was evident from the reaction of the public that there was implicit confidence in the minds of the public that a bank could never fail as long as the Central Bank exercised some sort of oversight over its affairs. The public was, therefore, free to take all the risks they wished and to pursue higher than market interest rates, although this clearly reflected the risk premium of the institutions soliciting such deposits. The fact that the decision to place their deposits with the Pramuka Bank was a conscious decision made by them alone, did not count. Instead the regulator was to blame. This is what is called the moral hazard of regulation: If indeed regulators could guarantee the safety of all financial institutions regulated by them, then Bank management would be reckless and assume higher than normal risks.

6. Regulators only set the broad parameters of general banking prudence within which banks are expected to function. The key risks banks are exposed to are identified, prudential limits and norms are established by law to mitigate such risk and compliance with such prudential norms and directions are carefully monitored. Sanctions are imposed for non-compliance. The adequacy of resources to cushion the risk exposure of banks is also assessed and is a continuous process. It is in this context that the roles of regulatory capital and economic capital assume importance.
7. Whilst a prudently managed bank would always assess and maintain its level of economic capital commensurate with its risk profile and growth strategy, most banks are happy to maintain only the minimum regulatory capital. The risk-asset relationship of regulatory capital ensures that risk asset expansion cannot take place without the required levels of capital to support such expansion.
8. The published information of banks, which is available in the public domain, shows you the capital strong banks where the quality of capital is depicted in the level of core capital or pure capital, commonly known as Tier I capital. It also shows the capital weak banks with high levels of debt capital and other capital hybrids which are components of Tier II capital. The importance of the role of capital in banking business, which is a highly leveraged business, cannot be over-emphasised. A case in point is the collapse of Barings Bank where the losses made by the rogue trader Nick Leeson were far in excess of the capital support that Barings could absorb.
9. In an ever-changing and complex financial environment, it is essential to find the correct level of financial regulation, supervision and enforcement needed to meet the objectives of regulation while minimising unjustifiable costs to the economy and consumers.
10. Central Banks use the provision of lender of last resort (LOLR) to support banks experiencing funding difficulties on a short-term basis. The three main objectives of the LOLR policy are 1. the protection of the integrity of the national payment system, 2. avoiding bank runs spilling over from bank to bank and developing into systemic crises and 3. preventing illiquidity in an individual bank, which may be a temporary phenomenon, from leading unnecessarily to its insolvency.

11. Current Regulations

The Central Bank of Sri Lanka has issued directives that are aimed primarily at the prudential management of licensed banks. These directives which were prepared by the Basel Committee on Banking Supervision are based on the Core Principles for Effective Banking Supervision. The Core Principles comprise of twenty-five basic principles for an

effective supervisory system. The Principles relate to preconditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking. Sri Lanka largely complies with all the Core Principles except for the Principles relating to Cross- border banking, which are at present only partially adopted.

12. The more important of the existing prudential requirements are:

12.1 The Capital Adequacy Ratio applicable to all licensed banks. This is based on the Core Principle that requires the regulator to set minimum capital requirements for banks that reflect the risks they undertake and to define the components of capital, bearing in mind its ability to absorb losses.

At present all banks are required to maintain, throughout, a Total Risk Weighted Capital Adequacy Ratio of 10 percent at minimum, with the Core Capital Ratio constituting a 5 percent minimum.

12.2 Classification of Advances for Provisioning Purposes;

The core banking risk assumed by banks in the industry is credit risk. Because the credit portfolios of banks constitute their major earning assets, credit risk assumes much importance. If this portfolio is not prudently managed, the bank might very well collapse. This was evident in Pramuka Bank where almost 80% of its credit portfolio was non-performing. Depositors' funds are invested in these assets and if they are bad, non-realizable or not repaid according to plan, there is no way the bank will be able to meet its obligations to depositors. The regulations applicable to control and mitigate the credit risk exposure of banks are explicit and meet the international norms of identifying the levels of delinquency in asset portfolios i.e. the capital or interest of advances that are not repaid for a period of 90 days are required to be classified as "non-performing advances" . The NPA ratio thus serves as a key indicator of the financial condition of a bank. Regulations also require that perceived credit risk be mitigated by the allocation of adequate capital in the form of provisions made against NPA.

The information available in the public domain will show how much NPA is provided for by banks in an industry where the credit risk mitigant relied upon is largely collateral and not provision. Provision is a charge on profits and therefore, it is the public sector banks that have the highest and most prudent levels of provision. Reliance on collateral as a credit risk mitigant is discouraged by regulators the world over. The most recent directives introduced in Sri Lanka follow this example and thus the use of collateral to cover credit risk is not endorsed. The credit culture in our banking industry shows that banks predicate their credit decisions not so much on cash flows but on collateral, which, in turn, translates into non-performing advances. It is imperative that the credit culture in the industry improves to a situation where credit decisions are based on a cash flow analysis of the borrower's capacity to repay rather than on the collateral available. This will not just bring vast improvements to the quality of assets held by banks but also reduce the levels of NPA in the industry. This trend can also be reversed through the non-recognition of collateral values against non-performing advances when deciding on levels of provision.

13. The High NPA phenomenon

13.1 The high NPA phenomenon is a uniquely Asian experience. Why this is so and whether this phenomenon signifies a credit culture in decline are questions that need answers. NPA levels across the region are so high that they have become happy hunting grounds

for investment banks which buy up these NPA portfolios and are able to make it into very lucrative businesses. About 40 major investors in this market account for about 90% of global Non Performing Loan (NPL) investments. It is only the aggressive management of NPL problems that would help these countries build and sustain strong economies and financial systems. The global standard for classifying and reporting NPA is a five-tier system of Pass, Special Mention, Substandard, Doubtful and Loss. This system, which is used by the Central Bank of Sri Lanka, also carries provisions ranging from .05% to 100%. However, Asia still faces the challenge of consistent application of the standard, with loans of the same risk characteristics being classified differently from one banking system to the next. Regulators have, therefore, been pushing banks to develop new plans, processes and systems to recognize and identify the problem. Basle II which is the new capital accord presently being phased in, abandons bucket classifications and adopts a more quantitative case-by-case approach to rate credit, thereby aligning the capital of banks to the risks they take. Be that as it may, the high levels of NPA in an industry have not deterred banks from making large profits. The Asian financial crisis is an example of what can ensue when the NPA ratios of banks are not compatible with the banks' levels of profit. The NPA ratios of banks may not be compatible with the bank's level of profits when classification norms are not adhered to across the board and interest is earned but not received as income. As a result profitability and capital are both overstated and provision and NPA are understated. Japan is a case in point for uncertainties and concerns about the true scale of banks' non-performing loans still remain. Banks tend to underestimate the magnitude of their NPA for a multitude of reasons, one of which is having to increase their loan loss reserves.

13.2. The Ernst & Young Global Non-performing Loan Report is very revealing. According to the report, IAS 39, which was first introduced in 2003, focuses on the recognition and measurement of financial instruments while defining and establishing the measurement and evaluation of impaired loans. There is therefore a move toward convergence in the standardisation of loan classifications throughout the world thus making the assessment and comparison of NPA across the globe less of an art and more of a science. It is imperative that bank management recognise the dangers of not recognising, identifying, measuring and mitigating their risk exposures. Unless they clearly understand and acknowledge the problem, they will fall short in their efforts to resolve it. There are banks that also try to postpone problems such as rescheduling debt or making new loans to delinquent borrowers – evergreening. This is what happened in the case of Pramuka Bank – a NPA ratio of 25% shot up, overnight, to 50% and then to 80% - where bank management were only fooling themselves at the expense of the safety of depositors' funds. Thus, the integrity of bank management assumes the greatest importance and cannot be downplayed, especially when they have fiduciary responsibility for other people's money.

13.3. Suspension of Interest on non-performing advances:

This direction has been issued in order to ensure that uniform procedures exist amongst banks with regard to income recognition and that income earned but not received is not recognised as income. All interest earned but uncollected from the date of an advance is classified as non-performing and is required to be credited as the interest of a suspense account and not as income. The 3 months' interest hitherto recognised as income is also required to be reversed out of income as the bank clearly has not received this income while the prospects of receiving it are remote. To recognise as income what it has not received as dividends and to declare out of such income when they are translated into profits is easily one of the most dangerous things a bank can do.

13.4 This problem has certain imperatives – the most important of which, is that in the circumstances, strategies must be implemented to move NPA off bank balance sheets.

Meanwhile governments must have the will to create the appropriate legal mechanisms and provide the necessary financial support. In order to address the problem adequately, banks must provide open, accurate and candid accounting of their NPAs.

13.5 The Single Borrower Limit or the Large Exposure Limit

Large exposures, whether to a single borrower or a group of related borrowers, are a common cause of banking problems that arise from the concentration of credit risk. Credit risk concentration could also arise from large exposures to a particular industry, economic sector or geographical region. Thus, maximum exposure limits are specified in the directions and banks are expected to set internal limits for particular economic sectors.

13.5.1 The directions governing the ownership of banks

These directions are based on the Core Principle, which states that determinations need to be made, that the ownership and organizational structure of a bank will not be a source of weakness and that the bank should not be used as a captive source of finance for its owners. It requires the regulator to have the authority to review and reject any proposal to transfer significant ownership or controlling interests in banks. One thing leads to another however, and the concentration of ownership by an individual or group of companies, can lead to undue influence being exercised in the manner in which the bank conducts its business.

13.7 Lending to Directors and to their interests

The financial landscape the world over is dominated by large conglomerates which are involved in a range of financial activities. The danger of this type of financial landscape can however be seen in the example of the Korean conglomerate Chaebols, which virtually ruined the entire Korean financial system. The Core Principles state that the extension of credit to individuals or firms connected to the bank through ownership or through the ability to exert direct or indirect control, if not properly controlled, could lead to significant problems because the creditworthiness of the borrower is not always made objectively. Regulators should therefore ensure that this type of connected lending does not lead to abuse. Connected lending or related party exposure, translates itself into incestuous banking, where the banking business is conducted largely for the benefit of a few individuals who have a vested interest in the bank. It is common regulatory parlance that bank directors who have borrowing relationships with the banks on which they serve, serve no useful purpose. One of the hallowed principles of banking prudence and good corporate governance is that directors should have borrowing responsibilities and not borrowing privileges. Disclosure of all such related party transactions is required so that there is transparency regarding the extent of reliance and dependence of the directors and their concerns about the bank. A question that does arise however is whether banking prudence and depositors' interests are compromised by this dependence. The prudential directions seek to ensure that such borrowing relationships are strictly within the norms of general banking prudence and are adequately covered by readily realisable security. The directions also try to ensure that credit standards are not compromised by preferential treatment being afforded to related parties i.e. even the accounting standards ensure that such borrowing relationships are at an "arms length" basis.

A story that is often repeated by regulators is one in which a Chairman/Director of a bank seeks to defy regulatory interventions and proudly says "this is my bank I can do whatever I please with it!" In articulating himself in this manner however, he not only exposes his ignorance of his fiduciary responsibility but also clearly highlights the fact that he is not a fit and proper person to reign as director of a bank.

13.8 Disclosure and presentation of accounts

The Central Bank has issued a format for the publication of annual audited accounts and also for the quarterly and annual publication of financial statements to the press. The rationale behind this being that apart from shareholders of banks, the depositing public will also be allowed to discern the general risk profile and risk tolerance of banks. Market participants need access to correct and timely information and therefore, disclosure complements bank supervision. It is the discipline of the market that will determine how attractive the proposition of a bank will be to the depositing or investing public.

The Central Bank also compiles and publishes periodically, the interest rates, fees and other bank charges in order to enable the public to have prior information regarding the cost structure of the financial services available to them.

13.9 The Directions on Statutory Liquid Assets Ratio:

The direction is based on the Core Principle that there needs to be sufficient assurance that an institution is able to meet its obligations when they fall due. This would largely depend on the amount of high quality liquid assets which it has readily available. Compliance with this direction is monitored strictly to ensure confidence in the banking industry and to ensure that banks have sufficient liquid assets to honour its liabilities when they fall due. Banks are required to be aware of the maturity mismatches of assets and liabilities which result in funding gaps, and to arrange for contingency funding to bridge such gaps. A bank can survive if it is capital insolvent but not if it is liquidity insolvent – if it cannot meet the demands of its depositors when they are demanded it will precipitate a run on the bank which might cause contagion and pose a systemic risk.

- 14.** Finance Companies, which are registered, with the Central Bank are regulated on similar lines under the Finance Companies Act by the Non-Bank Financial Institutions Supervision Department of the Central Bank.
- 15.** The Primary Dealers are supervised by the Public Debt Department of the Central Bank. Directions have been issued to Primary Dealers on Capital Adequacy, Forward Rate Agreements and Interest Rate Swaps, Custodial & Trust Holdings of Scrip Securities etc.
- 16.** One ought not to presume that regulation and supervision alone can do the job of preserving financial institution solvency. Regulatory authorities can only impose the minimum prudential requirements on designated banks and supervise them as far as is possible and practicable to ensure that such minimum requirements are complied with. The regulator cannot and does not step into the shoes of the directors or the management of the bank. Nor do regulators involve themselves in the running of the banks' daily operations, a task which rests solely with the directors and management of the bank. Regulators have, perforce, to take decisions that are not popular with Bank management but are in the interests of the depositors. Regulators cannot have cosy relationships with the banks they supervise for it would seriously compromise their independence and their integrity. Strict ethical standards apply to bank regulators vis-à-vis their relationships with banks.
- 17.** Intervention by the regulator is only effective in the context that the bank submits itself to a regulatory regime whose aim is to safeguard the safety of the financial system. Voluntary implementation of the corrective action required by the regulator is the norm. Where a bank seeks to defy or evade regulation and engages in fraud, the regulatory process loses its effectiveness. When the regulator and supervisor impose guidelines, it

expects the bank to comply. No amount of external supervision or regulation can correct an institution if the institution is unresponsive to the regulation and engages in fraudulent activity while misleading the regulator and the public with false information. It has been our experience that the strongest banks in the industry are those that responded positively to regulatory interventions and recommendations with integrity and in a responsible manner. If banks openly defy the regulators, they do so at their own risk. It is important that bank management understands that regulators have only one objective and one goal – the stability of the bank for the depositors and for the financial system.

- 18.** Although regulation may be about changing the conduct of regulated institutions, creating a safe and sound financial system is only one component of a regulatory regime. Regulatory authorities alone cannot achieve the goal of financial system stability. While good corporate governance plays a vital role, the external auditors and the market too must function effectively, in order to achieve this goal. It is only then that the good banks will be rewarded and the bad will be forced to exit. Ratings have now been made mandatory for all licensed banks so that the public will have some knowledge of a bank's standing vis-à-vis its competitors. In a financial environment that is ever changing and more and more complex, regulators and regulations have to keep pace with the changing circumstances. Too much regulation could promote inefficiencies and prevent healthy competition. Therefore, the correct level of regulation has to be maintained and regulatory objectives should be limited to aspects of systemic risk, prudential management and proper conduct of business.
- 19.** The regulator's aim is not zero failure of banks but rather to ensure that failure does not become systemic. Some sort of protection should be afforded, especially after a crisis, to restore depositor confidence. A well thought out Deposit Insurance Scheme without moral hazard should be implemented to provide a safety net-a vital pre-requisite for an efficient and stable financial system.