Stabilizing the Financial System in South Asia

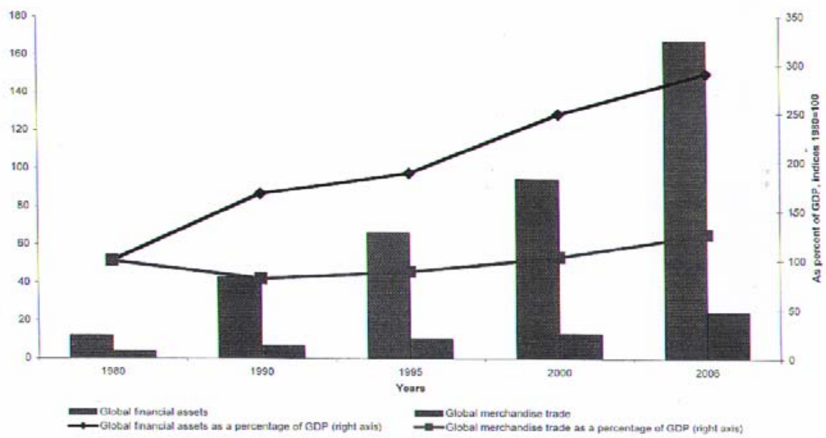
Saman Kelegama
Institute of Policy Studies of Sri Lanka
(www.ips.lk)

Outline

- Global Scenario
- South Asian Scenario
- Sri Lankan Case
  - Background
  - Home-grown problems and policy action
- Challenges for South Asia
  - Corporate Governance
  - Speed of financial deregulation
  - Avoiding over-regulation
  - Exploring regional instruments

Globalization: finance → trade

Figure 1
Finance driven globalization



Global Scenario

- Financial instability is a result of booms and busts of the globalized world where regulatory systems are not in place
- Further deregulation was the norm in developed countries: (a) financial markets are self correcting, and (b) financial innovation is required to minimize risks
- Rapid expansion of debt was facilitated by the shift from traditional ‘buy and hold’ financial model to ‘securitization’ model
- Much faith on the Information Revolution by IT that risks can be overcome and prevent bubbles from causing disruptions in the financial market
- International Financial Architecture yet to arrive and global financial instability will prevail from time to time

South Asian (SA) Scenario

- Not exposed to 'toxic assets' due to limited financial liberalization. Capital account of the balance of payments (BoP) hardly liberalized in most SA countries
- Mainly impacted by the global financial cisis through the trade channel than the financial channel
- Response to the crisis mainly through monetary policy and structural adjustment by most SA countries, some had room to pursue a fiscal stimulus to overcome the crisis

Sri Lankan Scenario

- Not exposed to 'toxic assets' but due to partial opening of the capital account of the BoP (10% foreign investment allowed in Treasury Bills and Bonds), there was capital outflows amounting to US $ 430 mn during September-December 2008, contributing to the foreign exchange reserve erosion
- Domestic financial sector is not sophisticated, it is at early stages of development and due to regulatory failures, SL faced a home-grown financial problem

Current Status of the Financial System

- Banking system dominates the financial system – 13% of financial assets controlled by the Central Bank, 58% by other commercial banks
- Venture capital, unit trusts, etc. are negligible in terms of controlling financial assets
- The bond market is dominated by debt securities of the government; the corporate bond market is relatively underdeveloped, with the corporate sector relying on bank credit
- Securitization remains at the early stages of development
- Contractual savings (including insurance and provident and trust funds) account for 21% of total financial assets
- There are some 2000 unauthorized Finance Companies (FCs) in operation in the country

Recent Instability

- SL financial structure is governed by several pieces of legislation: Banking Act, Securities and Exchange Commission Act, Insurance Act, etc. They are sound in paper, but there are challenges when it comes to enforcement and there are legal loopholes
- Home-grown problems of the financial sector (Pramuka Bank, Sakvithi FC, Golden Key FC, Danduwan FC, Seylan Bank, etc.)were due to a regulatory failure

Response

- Central Bank of SL put into operation a number of prudential measures to face the situation (e.g., rapid appointment of Bank of Ceylon as the managing agent of Seylan Bank (Dec. 2008), special support package to assist FCs (Feb. 2009), issuing notices to the public on unregulated FCs, etc)
- There were voluntary codes of corporate governance put into effect by the Securities and Exchange Commission and Institute of Chartered Accountants of Sri Lanka in 2002 and the Colombo Stock Exchange for listed companies in 2007. Few companies adopted the standards due to the voluntary nature

Outcome

- GKCC -- many depositors lost their savings, workers lost their jobs. FCs related to the Ceylinco conglomerate (Shriram, F&G, etc.) also showing signs of collapse and the outcome will be somewhat similar
- Commercial Bank lending to FCs reduced, deposits in better performing FCs reduced, withdrawals from other FCs increased, etc.
- Property market was affected, construction sector suffered, etc.
- All this contributed to the financial instability

Meeting the Challenge: South Asia

- **Corporate Governance**
- SL experience with FC failure emphasize the need for workable code of corporate governance
- Risk identification, management and mitigation at corporate governance level may be weak in other SA countries too
- The regulation and supervision of financial conglomerates are becoming increasingly complex due to systemic risks that arises from the inter-related nature of their activities. Large number of cross-shareholdings, common directors, and inter-company transactions are areas that need attention because conflict of interest and abuse of power are not conducive for financial stability
- Non-disclosure of related party lending. The culture of SA has not been one of disclosure
- Transparent, timely and reliable financial statements essential (unexpected and bad news creates investor panic and causes instability)
- Whistle blowing policy has to be introduced

Meeting the Challenge

- **Speed of Financial Deregulation**
- Reversals are greater in the financial market due to information asymmetry, thus all deregulation measures need to be implemented by doing adequate checks
- For instance, SA countries have to ensure that macroeconomic stability and sound regulatory frameworks are in place before further liberalization of the capital account of the BoP

Meeting the Challenge

- **Avoid Over-Regulation**
- There are financial market failures and they have to be rectified, but heavy handed regulation should be avoided for that discourages risky lending that is essential for the financial sector growth and overall real sector growth
- SA needs to follow the middle path taking into account the principles of regulation and competition. The regulator needs to weigh the costs and benefits of regulation
- The regulatory body should be independent, centralized not fractured

Meeting the Challenge

- **South Asian Regional Cooperation**
- SAARCFINANCE: looking at ways and means of cooperating in financial issues to minimize risks and learn from each other
- Collective regional defence mechanisms against systemic instability and contagion: the experience of EU with monetary and financial cooperation and the Exchange Rate Mechanism introduced in response to the breakdown of the Bretton Woods system holds useful lessons
- Macroeconomic policy coordination, regional surveillance, common rules and regulations over capital flows, etc., may prove useful in the absence of a global architecture for finances
- Once a SA Common Market is formed serious work needs to be done to move towards common currency and a common Central Bank

- Thank you