16th October 2019

All Stakeholders
Licensed Finance Companies (LFCs)

Dear Sir/Madam,

Introduction of Ownership Limits on the Licensed Finance Companies

The Department of Supervision of Non-Bank Financial Institutions (DSNBFI) is in the process of introducing ownership limits for LFCs to strengthen the corporate governance practices, proper delegation of duties, collective decision-making process and internal controls.

Accordingly, DSNFBI has re-drafted the master plan on introducing ownership limits of the LFCs, based on the observations/views from all stakeholders on the initial consultation paper issued on 15.05.2019. The master plan is intended to bring down the ownership limits to 15 per cent by end 2032.

You are required to submit observations or views on the consultation paper on 'Introducing Ownership Limits on the LFCs' to the undersigned on or before 15.11.2019.

You may contact Mrs. N Mathusoothanan, Senior Assistant Director (Tel: 011-2398529, email - nalinis@cbsl.lk) or Mrs. A S M S Nazny, Assistant Director of this Department for any clarification in this regard (Tel: 011-2398734, email - nazny@cbsl.lk).

Yours faithfully

W Ranaweera
Director

Encl:

Consultation Paper

on

Introducing Ownership Limits on the Licensed Finance Companies (LFCs)

1. Background

1.1. Over the past few years there has been an increase in the prominence of LFC sector in terms of its market penetration and its contribution towards financial inclusion of the country. However, due to various reasons there have been instances where several LFCs have either failed or become almost bankrupt during the last few decades.

1.2. There are many international examples where limitations have been imposed on bank ownerships. In Sri Lanka, there have been several occasions where LFCs have failed due to financial distress resulted in bringing stress to many depositors. Most of the small financial institutions that had internal issues and led to crisis situation mainly due to the mismanagement of the company with the involvement of the main shareholder.

1.3. In view of the above, a consultation paper was issued intending to bring down the ownership limits to 25% within a timeframe of 5 years (i.e. by 2025), on 15.05.2019. This revised consultation paper is issued, based on the observations/views from all stakeholders on the initial consultation paper.

2. Observations

2.1. Historically, the LFC sector has been operated as family owned companies. At present, the majority of LFC ownership is controlled by either a single owner, family, holding company or ultimate beneficiary. The business model, operational procedures and other administration functions are designed to suit the operating environment of the respective company. The decision-making process is centralized with the major shareholder and no proper delegation of duties and collective decision-making process are in place.

2.2. During the last several years, Central Bank of Sri Lanka (CBSL) has taken measures to enhance the regulatory framework in the areas of capital, liquidity, corporate governance, operational and business conduct. However, despite the prudential directions, many LFCs are non-compliant with several directions, reflecting weak financial positions and corporate governance practices. Examining the history, the primary reasons for such situation has been identified as lack of ownership diversification in LFCs and lack of interest in taking a holistic view on different stakeholders in adapting good practices and in complying with regulations.

2.3. In theory, good governance of a company mainly depends on the ownership levels of the company. Highly concentrated ownership level would reduce the chances for an independent view at the board and would create more space for directors that would act in the interest of the main shareholder. The role of the non-executive directors is important especially in a financial institution as they can express their views in the interest of the stakeholders other than shareholders such as depositors and creditors.

2.4. Introducing ownership limits on LFCs is significantly important as a part of the process of strengthening good corporate governance practices in this sector, while addressing the common concerns in imposing such limits on LFCs.

2.5. Further, several LFCs are still not listed with the Colombo Stock Exchange as per the requirement and even few already listed LFCs are looking forward to delisting. Introducing ownership limits on LFCs would be supportive to this requirement as it gives the necessity for the LFCs to get listed in order to broad base their shareholding.

3. Proposed Plan on ownership diversification

3.1. Defer the proposed direction on ownership diversification to a period later than LFCs meeting the minimum core capital level of Rs.2.5 billion by 01.01.2021, in compliance with the Finance Business Act Direction No.02 of 2017 on Minimum Core Capital, to allow LFCs upsurge their capital levels without impediments through the existing shareholders or new strategic partners.

3.2. Thereafter, allow the major shareholders a reasonable time period of 10 years to diversify their shareholding in LFCs in an appropriate manner in a staggered basis, to allow smooth ownership diversification without major losses in shareholder value.

3.3. Considering the above two factors, it is decided to bring down shareholding limits in 2 phases. In the first phase, ownership limits will be introduced, thereby bringing down the maximum limit to 15 per cent by end 2032. Thereafter, in the second phase the ownership limits should be brought down to 5 per cent by end 2037.

3.4. Based on the characteristics of ownership and the nature of the business model, LFCs could be clustered in to 4 categories and the proposed actions for each category are given in Table 1 below:

Table 1: Categories of LFCs and recommended actions

Business Model	Recommended Actions
1. Subsidiaries of banks	Completely merge with the respective shareholding banks or divest, at least by end 2032. • LFCs need to submit a consolidation/divesting plan by end 2020. • LFCs and respective shareholding banks are given a 5-year timeline, commencing from 2023, to complete the merger, if applicable by end 2027. • The merged entities are given a further 5-year timeline, commencing from 2028, to diversify the shareholding and comply with ownership limit of 15 per cent by end 2032.
2. Subsidiaries of another LFC	Completely merge with the respective shareholding LFC, at least by end 2032 to ensure only one LFC remains for a particular group. Cross-holdings by LFCs in other LFCs will not be permitted. • LFCs need to submit a consolidation plan by end 2020. • LFCs and respective shareholding LFCs are given a 5-year timeline, commencing from 2023, to complete the merger by end 2027. • The merged entities are given a further 5-year timeline, commencing from 2028, to diversify the shareholding and comply with ownership limit of 15 per cent by end 2032.
3. Subsidiaries of a group or conglomerate	If one or more LFCs and banks belong to the same group or conglomerate, such LFCs and banks are required to completely merge as one entity, at least by end 2032. • LFCs need to submit a consolidation plan by end 2020. • LFCs and banks belonging to the same group or conglomerate are given a 5-year timeline, commencing from 2023, to complete the merger by end 2027. • The merged entities are given a further 5-year timeline, commencing from 2028, to diversify the shareholding and comply with ownership limit of 15 per cent by end 2032.
4. Owned by a single shareholder and related parties	(i) Companies with regulatory concerns on capital, i.e. minimum capital, capital adequacy ratio, minimum liquidity requirements and/or issues relating to corporate governance • LFCs are required to submit a capital augmentation plan to rectify the capital shortfall and/or a proposal to rectify regulatory concerns on liquidity and corporate governance by March 2020, and comply with all prudential regulations by end 2020. • If the above plan is approved to be viable by D/SNBFI and LFCs comply with all prudential regulations by the stipulated timeline, such LFCs are required to submit a plan to diversify the ownership limit to 15 per cent by end 2032.

Business Model	Recommended Actions
	• If the capital augmentation plan and/or proposal to rectify regulatory concerns on corporate governance is not approved to be viable by D/SNBFI or if LFCs of whose proposals were initially approved but have not complied with all prudential regulations by the stipulated timeline will be required to exit the industry. (ii) Companies with no regulatory concerns • LFCs are required to diversify the ownership limit to 15 per cent by end 2032.
5. Distress and restructured companies (as of the issuance of the consultation paper)	Separate restructuring plans will be implemented; therefore, this category is exempted from the proposed direction.

3.5. Under special circumstances as specified below, LFCs may be given a special Monetary Board approval to hold limits in excess of specified limits and require such LFCs to bring down the shareholding to the required limits on a staggered basis over a longer time period (i.e. within another 5 years), subject to submission of a viable plan.

(a) Restructuring of a problematic/weak LFC

(b) LFCs that are undergoing a consolidation process, at the moment

(c) In view of stability of the financial institution or the sector as a whole

3.6. **Sanctions for non-compliance:**

(a) Freeze distribution of dividends or repatriation of profits of such LFCs, as and when necessary

(b) Restrict voting rights on shares held in excess of specified limits, with effect from 01.01.2033

(c) Prohibit the issue of further shares or pursue any offer made to shareholders who hold shares held in excess of specified limits

(d) Restrict expansion of business operations of such LFCs

(e) Impose disclosure requirements

(f) Cease/ suspend business activities

(g) Cancellation of license

3.7. Except for the special circumstances referred in 3.5 above, the following timeframe is proposed on ownership diversification for LFCs.

Matrix of Shareholding Limits (%)

by end	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
1. Subsidiaries of banks LFCs to be merged with the bank or another LFC						80	65	50	35	15
2. Subsidiaries of another LFC						80	65	50	35	15
3. Subsidiaries of a group or conglomerate						80	65	50	35	15
4. Owned by a single shareholder and related parties:										
(i) Companies with regulatory concerns			80			60		30		15
(ii) Companies with no regulatory concerns	80	75	70	65	60	55	45	35	25	15

3.8. In order to implement the above proposed ownership structure the DSNBFI is of the view that, the sale of LFCs by holding company or banks is not permitted.