NOTICE TO THE PUBLIC

In the past few weeks, in the aftermath of the difficulties faced by the CIFL, a finance institution registered under the Finance Business Act (FBA), many allegations have been leveled and claims have been made by various persons. The reality of the situation is however quite different. Therefore, the Central Bank has decided to publish this notice in order to apprise the general public about the reality surrounding these various allegations and claims.

Allegations & Claims *vs* Reality

Allegation/Claim 1: There have been several rounds of finance company failures. The Central Bank has been ineffective in dealing with this situation.

Reality

Over the past 7 years, not a single finance company has collapsed, and consequently had to be liquidated. Although there have been some finance companies that have encountered stresses, whenever that has happened, those companies have been restructured in a gradual manner to regain financial strength.

In contrast, in the most advanced markets, banks and Non-Bank Financial Institutions (NBFIs) have faced immense difficulties, and sometimes collapsed in the hundreds in recent times! Even in Sri Lanka, in the late 80s and early 90s, 13 financial companies collapsed, and some are yet under liquidation.

During the last few years, the Central Bank has taken a series of measures to strengthen the regulatory mechanism to ensure soundness of the Non-Bank Financial Institutions (NBFIs) and safeguard the funds of the depositors. These include the enactment of the Finance Business Act, increasing minimum core capital, introduction of corporate governance and assessment of fitness and propriety of executives, and listing in the Colombo Stock Exchange. **As a result of all these measures, Sri Lanka today enjoys a substantially strong financial sector. Further, during the past 7 years, the assets in Bank and the NBFI sectors have grown almost 200%, from Rs. 1,908 billion as at 31 December 2005 to Rs. 5,698 billion by 31 December 2012.**

Nevertheless, unfair allegations that the Central Bank has not been acting are being levelled every time some weakness is displayed, in any NBFI. That reasoning indicates an absolute ignorance of the financial sector, or a deliberate misunderstanding of the situation. Instead of such an attitude, if an unbiased view is taken, it would be possible to see that an enormous improvement has taken place in the Sri Lankan Banks and NBFI sectors and the credit for such improvement should go to a large extent, to the Central Bank, which has introduced timely action, proper norms, sound supervisory measures, good governance procedures, necessary directives in times of buildup of weaknesses, and the required legal framework to deal with errant officials and companies.

Allegation/Claims 2: If the Central Bank had regulated properly, no finance company should have ever faced any difficulty.

Reality

Regulating an institution means that such institutions would be issued directions and guidelines to ensure that the boards of directors and officials would operate according to certain codes and practices. To secure compliance, supervision is also exercised by the regulatory authority. Nevertheless, there is always a risk element in business, and there could also be instances of risk crystallization and business downturn that could make an institution vulnerable. In such situations, the regulatory authority is given certain powers under the law to take specified action. Notwithstanding these safeguards, there could still be certain instances of fraud, waste or losses. In those circumstances the regulatory authority is usually given powers to issue further directions to the management of the regulated institutions or take other appropriate action, and such powers also are usually provided for, in the law. Those powers and actions also has a deterrent effect on officials and other stakeholders as well.

It must also be appreciated that the Central Bank regulates finance companies in accordance with the Finance Business Act. No. 42 of 2011 (FBA). Under such law, specific legal powers are granted to the Central Bank under this law, and the Central Bank has to act accordingly. On that basis, regulating finance companies does not mean that the Central Bank gives a blanket guarantee that every institution in the NBFI sector would meet its obligations, in every circumstance. Nowhere in the world is such a guarantee given. When framing the laws, the Sri Lankan Parliament too, has never contemplated a blanket guarantee to be given by the Central Bank.

The position that the Central Bank does not guarantee deposits of Finance Companies has been clearly laid down and given wide publicity. In fact, in the Central Bank's media campaigns, unambiguous notice has been given to all would-be depositors that: "The Central Bank is authorized to regulate and supervise the named institutions in order to promote prudence in their business operations and thereby safeguard the deposits of the public. However, the Central Bank does not have legal authority to guarantee deposits or assure that any such institution will never fail……When depositing money in any of the named institutions, please exercise due care for the safety of your deposits."

Through the provisions of the FBA too, depositors have been notified as to what to expect, and what not to expect, when dealing with finance companies that are registered with, and regulated by, the Central Bank. No one can go beyond the law, and expect to receive assurances, over and above what has been provided in the law. The Central Bank has also clearly conveyed as to what its' responsibilities are, and in fact, has mentioned in all its' advertisements, that the Central Bank is not able to guarantee deposits, as per the law.

However, through its actions, the Central Bank has been successful in bringing order and discipline into the NBFI sector, based upon which actions, the sector has enjoyed a high degree of stability over the past several years, even while massive collapses in the finance sectors were taking place in many parts of the world. In this regard, as already stated in the Central Bank notices to the public, depositors also need to be vigilant about the activities of the companies in which they invest their money. Unfortunately, in some instances, depositors have contributed to liquidity constraints and distress situations faced by some NBFIs, by accepting higher interest rates for deposits, than the ceiling that has been imposed by the Central Bank to the NBFIs. As consistently maintained by the Central Bank, prior to investing, depositors should evaluate the risks of the investment by considering the financial statements of the relevant company, ratings assigned to it by reputed rating agencies, etc. If the depositors and other stake holders of the licensed finance companies expect that the regulator will prevent the NBFIs from losses and collapse under any circumstances, it is an obvious misconception that will also create an unacceptable moral hazard for society, as well.

In that background, people who blame the regulatory authority whenever there is a loss, obviously do not understand that regulation does not mean a blanket guarantee. At the same time, it must also be stated that there are many NBFI's that are managed well in conformity to the laws and directions of the Central Bank, and these continue to perform well giving satisfactory returns to all its stakeholders, including depositors.

Allegation/Claim 3: The Central Bank has not encouraged mergers in the finance industry.

Reality

The Central Bank has continuously encouraged the NBFIs to merge and consolidate. This has been communicated at various forums of stakeholders in the sector. During 2013, two NBFIs namely, People's Finance PLC and Ceylease Ltd. merged with People's Leasing and Finance PLC and MCSL Financial Services Ltd respectively. Over the past several months, policies have also been discussed to consolidate the NBFI sector by way of the merging and amalgamating small and medium sized NBFIs. The outcome of this strategy would be to have large, systematically important NBFI to further improve the financial stability and create synergies. Further, this will enable to broad base the business model of the NBFI sector to be in line with the economic growth and to facilitate absorption of any future risk. In addition, it is expected to substantially increase the minimum core capital requirement for NBFIs from the current level, to strengthen the balance sheets of NBFIs.

As mentioned on many occasions, the Central Bank also expects more acquisitions to take place within the industry. Accordingly, if any of the banks come forward and take over some of the NBFIs and bring them under their control, it would be welcomed by the Central Bank. In fact, as a case in point, the Union Bank took over the F&G Finance Co., which was a finance company that faced distress at one time. As of now, some new opportunities have arisen for the stronger and bigger financial institutions in the private and public sectors to take over some of the NBFIs, and in that context, it is hoped that these stronger institutions would now come forward and engage in some acquisition activities in time to come.

Allegation/Claim 4: Sri Lanka has too many finance companies and although the Central Bank said it would not issue any licenses in 2013, it had given one to Indra Finance.

Reality

The Central Bank is authorized to issue finance companies' licenses at any time, but the Bank had taken a policy decision in late 2012 that it would not issue new licenses during the years 2013 and 2014. At the same time, the Central Bank also encourages Specialized Leasing Companies (SLCs) to upgrade to Licensed Finance Companies, (LFCs) which undergo a more stringent regulation. Such moves have been designed to encourage mergers and acquisitions between companies. That policy decision is yet in force.

Indra Finance Ltd. was already registered SLC which was already registered under the Finance Leasing Act, No. 56 of 2000. Accordingly, Indra Finance Ltd was elevated to the LFC status in May 2013. Similarly, Sampath Leasing and Factoring Ltd which is a SLC will also be upgraded to a LFC in due course. Nevertheless, the total number of NBFIs will remain unchanged even after their upgrading.

The Sri Lankan economy is a growing economy and a dynamic one. At the same time, NBFIs are not institutions that can suddenly be set up overnight to meet the evolving needs of the country. The Central Bank has to plan ahead for the future and ensure that the NBFIs that are required for the country, particularly in order to deliver financial inclusion, are sufficient to meet the needs of the country. NBFIs play a very important role in the economy of the nation, and the Central Bank believes it is its' responsibility and duty to ensure that the required infrastructure and framework is available to meet the needs of the people and the country. Towards that end, the current numbers of NBFIs and its collective level of operations is basically adequate, but in time to come there will be a need to make the industry even more professional and broad based in order to ensure a wider reach, right across the nation.

In that background, what is important to recognize, is not just the number of NBFIs, but the services that need to be delivered by the sector, at present and in the future. When Sri Lanka moves towards a US100 billion economy over the next few years, the NBFI sector will play an even more critical role, in that a greater degree of financial inclusion will have to be promoted, while also ensuring that entrepreneurs from all parts of the country will have access to finance, in a convenient and timely manner. The fulfillment of such a goal would need strong NBFIs which have wider reach and access to finance themselves, so that those companies, in turn, could provide the necessary funds to the sectors that need such funds. These sectors would include the SMEs , the agricultural sector and individuals. In time to come, it is also expected the NBFI sector would mature further, and in that journey there would be NBFIs that would merge and build up greater strength to play a more useful role.

In that background, if the existing NBFIs, with or without a few mergers, could play that role, it would be ideal. However, if a gap builds up in the future because the existing NBFIs are unable to deliver the necessary financial framework to meet the needs of the country, new NBFIs may also need to be enlisted from 2015 onwards. In such an event, it is likely that the Central Bank would require the new NBFIs to have a much larger capital base, so that those could commence operations as strong entities, and be able to meet the needs of the growing economy.

Allegation/Claim 5: The Central Bank's NBFI department is not sufficiently equipped to monitor/regulate the stated number of companies.

Reality

It must be understood that the size of institutions in the NBFI sector varies across a wide range, and the type and scale of monitoring and regulating of such institutions may also differ, one to another. Obviously, a, NBFI that is very well managed and has few supervisory concerns would be subjected to a different type of regulatory oversight, than that of a NBFI which has more supervisory concerns.

The Central Bank supervision is done in a professional basis, in keeping with international norms, by highly qualified persons who have been trained in this field and who have the necessary knowledge, expertise and understanding. The Central Bank also deploys adequate resources to monitor and regulate the companies that are presently under the supervision of the NBFIs and the prevalence of a large number of companies that are in good health and performing well, confirms the fact that the supervision has been adequate and up to the standard.

Allegation/Claim 6: The Central Bank had cautioned the public to invest only in companies registered with the Central Bank. Since CIFL is a registered company and is now in distress, the Central Bank must take responsibility for the deposits.

Reality

The Central Bank had advised the public to invest in companies registered with the Central Bank, because registered finance companies are expected to conform to certain norms and practices in their operations, and therefore those companies have a much greater chance of surviving and prospering, when compared with those that don't. Further, the companies that are regulated have also got to submit certain data and information in a timely manner, which brings about a certain discipline in their operations as well. Nevertheless, as enunciated by the Central Bank consistently, simply being registered as a finance company, does not mean that a blanket guarantee has been given by the Central Bank that the Central Bank would stand as guarantor, if the company faces a crisis or difficulty.

It was to particularly deal with such eventuality, that the Deposit Insurance Fund (DIF) was established in October 2010. The DIF has been in operation since January 2012, and based upon which, a single depositor would be entitled to receive up to Rs.200,000 in their deposits in the event of a failure of a bank or an NBFI, supervised by the Central Bank. The terms of the DIF also allows the Central Bank to provide liquidity support to companies that encounter liquidity difficulties. On that basis, the Central Bank has already formulated the necessary regulations to enable any Bank or NBFI which faces a liquidity crisis to apply and receive funding support under certain conditions. However, as it would be appreciated, the DIF funds cannot be invested without proper safeguards. Accordingly, in order to receive funds, certain conditions would need to be met by the troubled NBFI.

In the case of the CIFL, they would be eligible to receive DIF funds, and in fact, the process to restructure the CIFL has already been set in motion, with a managing agent being appointed. Based on the managing agent's recommendations, the Central Bank would be able to issue necessary directions to deal with the crisis, and perhaps also facilitate the entry of a new investor, as well. But it must be understood that such operations are usually complicated and complex, and are likely to take a reasonable period of time.

It is also pertinent to point out that CIFL has now entered a process of restructuring in a similar manner that a few other registered finance companies underwent restructuring, in the aftermath of the Golden Key crisis. It must also be remembered that such a restructuring can only be done because CIFL is a registered NBFI, which provides the legal authority to the Central Bank to intervene in times of distress.

Allegation/Claim 7: The available laws are not sufficient to rein in errant finance companies and directors.

Reality

The present laws provide teeth to prosecute wrong doers, and the Central Bank is determined to take the necessary measures to recover whatever funds that have been siphoned off, from the errant directors and officials, as well as take the necessary action under the law to deal with the persons responsible.

In fact, the FBA stipulates certain offences which prescribe jail sentences and fines to officials of NBFIs who have been errant or have misappropriated funds. In the past 7 years, not a single NBFI has actually failed, but, some have experienced stresses and had to be nursed back to good health. However, at present, there are certain directors and others who are suspected of wrong doing, against whom evidence is being accumulated and investigations are being conducted. If the evidence suggests their complicity in offences that would warrant jail sentences, the law would prevail and the necessary legal action would be taken, so that the penalties imposed by the law could be meted out for those who are found guilty.

Allegation/Claim 8: The stress that has developed in CIFL, which is not only registered with the Central Bank, but also listed on the Colombo Stock Exchange, and regulated by the Securities and Exchange Commission will lead to the de-stabilization of the entire financial system.

Reality

There are many listed banks and NBFI that are operating in Sri Lanka, and are regulated by the Central Bank and the SEC that are performing very well, and are providing good returns and steady cash flows to their depositors and shareholders. But unfortunately, few people speak of the many companies that are doing well with high profits and stable growth. However, out of nearly 50 companies in the NBFI sector, when one company faces trouble for whatever reason, people tend to speak about that company only, and point fingers and blame anyone and everyone, especially the Central Bank.

The total financial sector of Sri Lanka is approximately Rs.9,035 billion, as at 31st December 2012. While the banking sector accounts for 56% of that sector, the NBFI sector accounts for 6.6%. Within the NBFI sector, certain companies are large institutions with assets of over Rs. 20 billion, while others have assets which are in the range of Rs. 0.5 billion to Rs.20 billion. When considering the entire NBFI sector in Sri Lanka which is about 6.6% of the total financial sector, CIFL's share is less than 1%. Accordingly, CIFL represents less than 0.06% of the total financial sector. Further, CIFL has faced these problems mainly due to its own mismanagement, and therefore, the liquidity problem of CIFL will not affect the NBFI sector as a whole. In the case of CIFL, most of members of the Board of Directors and members in senior management were very experienced, while also being academically and professionally qualified. Unfortunately however, the Board of Directors and Senior Management who are responsible to safeguard depositors' money did not discharge their responsibilities properly, and consequently the Central Bank was compelled to appoint a managing agent. Such managing agent has already engaged the services of an Audit firm to conduct a forensic audit to find out the reasons for the distress. It is likely that once those investigations are completed, a clear picture will emerge as to the reason of the current debacle in the company. In that background, it is clear that there is no liquidity issue in the entire financial system due to the current CIFL situation and the financial system and industry is continuously growing in terms of assets, deposits and profitability.

At the same time, the general public is also mature enough to understand that a difficulty in a single company does not mean that the entire sector is suffering from the same situation. They are also aware of the action taken by the Central Bank in the past to deal with such situations.

Further, it must be reiterated that CIFL has not collapsed as claimed by some, and it is being restructured. It is also likely that if the CIFL diligently follows the path that would be prescribed by the Central Bank upon the advice of the managing agent, it could be nursed back to health. The Central Bank also wishes to emphasize that all NBFIs should continue to follow sound and prudent financial and managerial practices and adhere to the provisions of the FBA and the prudential directions and rules issued thereunder. They should also continue to be transparent with proper disclosures being made to the stakeholders.

Allegation/Claim 9: The difficulties faced by Finance companies make it impossible for the Central Bank to regulate these finance companies properly or effectively. Further, some directors of Finance Companies had siphoned off funds, but the Central Bank has not been able to detect this, due to the difficulties faced by them.

Reality

Unlike banks which serve the more credit worthy type of customers in the country, most NBFIs deal with the next level of customers, where the risks are greater than the top level customers. In that context, the interest levels of NBFIs are higher, both for deposits as well as in lending. As may be appreciated, this is because the risk level is higher than that of the banks, and the defaults by the customers of NBFIs could possibly be more likely, than in the case of the banks. **Notwithstanding such a general situation, there are many NBFIs that have developed effective business models to deal with the higher risks, while of course benefitting by the higher returns. Those NBFIs have therefore continued to perform well, and provide good returns, to their depositors, customers, staff and shareholders.**

It must be appreciated that there are a large number of depositors, customers and shareholders who are today enjoying satisfactory returns in NBFIs, and that fact must not be ignored. Nevertheless, whenever there is an instance where a NBFI faces some difficulty, the Central Bank has to sometimes allocate a large quantum of professional time and resources at all levels of the Central Bank to deal with such situations. In some instances, the professional time and energy spent by supervisors may be quite disproportionate to the size of the NBFI, and that is one of the major difficulties that the Central Bank faces in this complex exercise.

At the same time, the Central Bank supervises on an overall basis and does not, and cannot examine the values of each and every asset of each and every finance company. It cannot also get involved in management decisions of borrowing, lending, paying salaries, obtaining collateral, filing action for recovery, buying fixed assets, raising capital etc. It is the directors of the respective NBFIs who are expected to act according to their business models, internal guidelines and controls, as well as adhere to the laws and overall directions given by the Central Bank.

As any sensible person would realize, the Central Bank's NBFI Supervision department cannot physically inspect the assets of individual companies or determine their values. No Central Bank or any other regulatory body anywhere in the world, could ever do that, and even the company's auditors have to mainly rely upon the internal controls of organizations as well as the judgment of directors in relation to business practices and valuation decisions. Therefore, every time a dishonest cashier walks off with some money, or a negligent accountant overpays a supplier, or a reckless purchasing officer buys an asset at an inflated price, the Central Bank cannot be expected to detect such practices. The directors of the Company have to set out their internal controls to deal with such situations, but sometimes where there is collusion, fraudulent activities may take place. Fraud is often discovered after the event, and in some instances, it is not discovered at all! In many instances it is when the company encounters liquidity problems and a forensic initial study made, that suspicions are confirmed that some siphoning off of funds may have taken place. That is why a forensic audit is usually carried out to ascertain who is responsible and how much funds have been siphoned off in such situations.

Allegation/Claim 10: The short-term assessment for the NBFI sector is very bleak.

Reality

The NBFI sector is playing a key role in the economy of the country, and all indications are that they would continue to do so. The country is experiencing a strong growth, and there are more and more opportunities that are developing in this growing economic scenario. The NBFI sector will continue to play a significant role in the short, medium and long term economic growth of the country and this sector will continue to remain stable, whilst performing in a satisfactory manner by providing returns to its depositors and shareholders, whilst also being of benefit to the hundreds of thousands of customers who benefit by their services and the thousands of employees who work in this sector.

In the meantime, it is clear that certain political elements are attempting to use the CIFL issue to try and frighten the public about all finance companies. Even in the past, a few politicians made similar attempts and, particularly in the aftermath of the Golden Key crisis, some politically motivated economic hit-men tried their utmost to bring about de-stability by predicting horror scenarios. Some of them even warned about an imminent collapse of a large number of finance companies, and some went to the extent of prophesizing the collapse of the entire economy! As is of course now known, none of those dooms-day scenarios materialized, much to the disappointment of these economic hit-men! Nevertheless, these elements continue to resort to these unsavory practices, but fortunately, the public is now getting used to these efforts and are wary of these economic hit-men. In that background, it must be reiterated that public confidence in the financial sector is strong, and NBFIs in particular, are taking steps to convey their individual and collective strengths to the public, in order to confirm their own strength and stability.

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