PAMPHLET SERIES
No. 2

FINANCIAL SYSTEM STABILITY

The maintenance of financial system stability is one of the two core objectives of the Central Bank of Sri Lanka. This pamphlet explains what is meant by financial system stability, the factors that contribute towards achieving it, the causes and consequences of financial system instability and the role of the Central Bank in maintaining financial system stability. The purpose of this pamphlet is to increase public awareness and understanding of the financial system.

Central Bank of Sri Lanka

October 2005

THE FINANCIAL SYSTEM

What constitutes the financial system? Typically, the financial system consists of financial markets, instruments, institutions and infrastructure. The regulatory structure too though not strictly a part of the financial system, plays an important role in regulating and monitoring the system. The financial system carries out the very important financial intermediation function of borrowing from surplus units and lending to deficit units. A dynamic and competitive financial system is characterized by continuous changes in the composition of markets and institutions through entry, exit, mergers and acquisitions supported by evolving infrastructure. An efficient Payment and Settlement System (PSS) which is the mechanism through which transactions in the financial sector are cleared and settled is an important component of the financial system. The PSS facilitates the smooth functioning of the financial system, thereby contributing to financial system stability.

FINANCIAL SYSTEM STABILITY

Financial system stability can be defined as the resilience of the financial system to internal and external shocks, be it economic, financial, political or otherwise. It can also be described as the absence of macroeconomic costs of disturbances in the system of financial exchanges between households, businesses and financial institutions. Financial system stability is evidenced by and reflected through

(i) an effective regulatory infrastructure,

(ii) effective and well developed financial markets and

(iii) effective and sound financial institutions.

Financial instability, on the other hand, is manifested through the failures of significant institutions, intense asset price volatility or the collapse of market liquidity and ultimately in a disruption in the PSS. Such instabilities have potential for greatly affecting the real sector through macroeconomic costs.

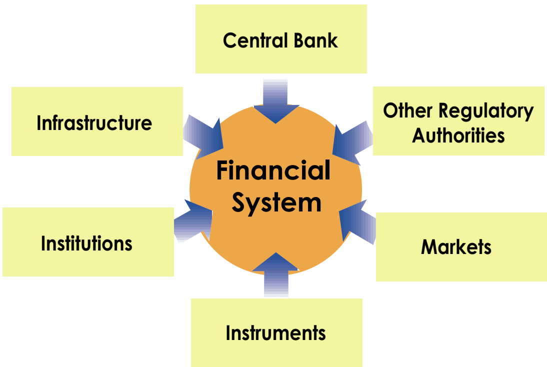
Financial system stability is important for four reasons. Firstly, a stable financial system creates a trusting and enabling environment favourable to savers and investors. Secondly, it helps the transmission of monetary policy, thereby, assisting the attainment of price stability objective. Thirdly, a stable financial system encourages efficient financial intermediation which eventually promotes investment and growth. Fourthly, a stable financial system encourages effective and efficient operation of markets and improves distribution of resources in the economy.

OBJECTIVE OF FINANCIAL SYSTEM STABILITY

The objective of financial stability is much wider than the objective of financial sector supervision. Financial sector supervision follows a micro prudential perspective of examining each financial institution's performance and health to safeguard the interests of depositors and to promote the soundness of financial institutions. Financial system stability follows a macroeconomic perspective of examining the overall functioning and stability of the system including all clearing systems, the PSS as well as exchanges and depositories for securities etc. Although there could be a large number of financial institutions, the health of the financial system could be disturbed by the failure of a few major players, or Systemically Important Financial Institutions (SIFIs). Hence, the financial health of these institutions is important for a stability framework, and it, in turn, depends on the wellbeing of their clients as well as in the internal efficiency of those institutions. The macroeconomic environment, both international and domestic, could affect financial institutions and their clients and the entire financial system.

What are the benefits of the system stability to the general public? Let us try to simplify this statement. Our day-to-day life requires various forms of money transactions. Most of these transactions require various services from the financial system to perform better. Some of us receive our income directly to our bank accounts or in cheques which are payable through banks. We can keep our savings in various deposits and investments offered by banks and financial institutions while receiving interest income. In the event of urgent needs, we can withdraw our savings from the institutions or through automated teller machines maintained by such institutions. We can make payments to various parties through bank accounts or other payment methods such as credit cards operated by the banks. Bank accounts provide a large number of businessmen and firms with a most convenient means of depositing their sales proceeds and to make payments to various parties. Financial institutions provide various types of loans to people who are in need of finance for the businesses and consumption purposes at a charge of interest. Exporters, importers and foreign travelers undertake their foreign exchange transactions through banks. Some of us receive money from friends and relatives abroad through banks. We can pay our utility bills through banks. Likewise, one can give a long list of such services provided by the financial institutions to facilitate our money transactions. When we part with our money, we should be confident that they are safe with the institutions.

Components of the Financial System



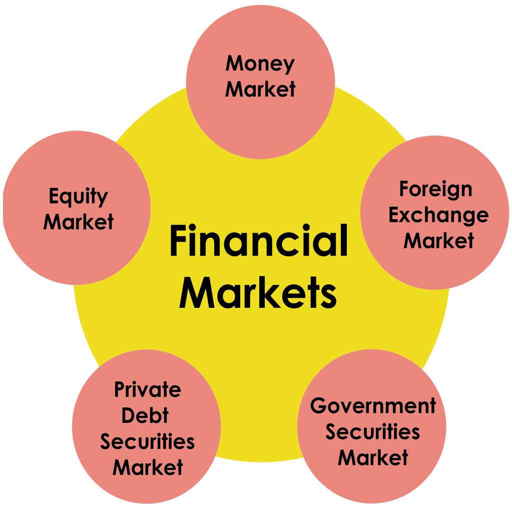
CONSEQUENCES OF FINANCIAL SYSTEM INSTABILITY

Most of us are able to deal with banks and financial institutions in our day-to-day life and complete our transactions safely because of the stability in the financial system. If financial system is not stable, we will not be able to undertake such transactions of money safely because some financial institutions may fail to repay our deposits or disburse loans or remit the payments to due parties locally and abroad. In such event, our day-to-day life will be affected and the economy as a whole will suffer. One can think of a situation where depositors have lost confidence in banks and financial institutions. This is the worst thing that can happen to a financial system. In such situation, the stability of the entire financial system will be threatened and the functioning of the entire economy will be severely affected. Therefore, financial system stability is essential for our day-to-day life and performance of the economy. We all can feel the financial system stability during the course of our transactions although it is difficult to define and measure it.

Financial instability generally implies a situation of wide-spread failures of banks, financial institutions and payments systems. In this situation, the general public and the economy will find it difficult to perform their transactions of money locally and internationally. For example, depositors of failed financial institutions will lose their savings deposited. Firms and business community will suffer from non-availability of loan facilities to finance their businesses. Some parties who are to receive payments which are in the process of settlements through banks will not get their money. International transactions, exports, imports, remittances, etc. will be badly affected. Such difficulties will contract the economic activities which will reduce income and employment.

Such adverse outcome of financial instabilities in many countries has been well documented.

Sub-Markets of the Financial System



For example, financial crises in Mexico in 1994-95, East Asian countries in 1997-98, Russia in 1998, Brazil in 1999, Turkey in 2001 and Argentina in 2001-02 are noteworthy.

CAUSES OF FINANCIAL SYSTEM INSTABILITY

Wide-spread failure of banks and financial institutions is the common feature of financial crises. Although the causes of such financial crises are debatable, weak risk management of banks is cited as one of the causes. Banks like any other business organizations will fail if their business is not managed prudently by taking adequate measures to mitigate the risks faced by banks during the normal course of business. One immediate cause of financial crises in a number of countries was the sudden outflow of foreign capital invested in the country. This capital outflow resulted in shortages of funds in banks leading to bank failures. It is also believed that economic downturns will lead to difficulties in banks and financial institutions because of defaults of loans by their borrowers affected by the economic downturns. Therefore, improving the risk management of banks and financial institutions to enable them to cover themselves against adverse outcome of economic downturns is considered to be crucial to avoid instabilities in the financial system. In this regard, regulation and supervision of banks, financial institutions and payments systems and implementation of financial reforms play a vital role.

The stability of the financial system, therefore, depends on several interdependent and interconnected factors, namely,

(i) a stable macroeconomic environment,

(ii) well governed and sound financial institutions,

(iii) an efficient financial market,

(iv) sound prudential oversight and

(v) a safe and reliable payments and settlement system.

It can be maintained by improving the resilience of the financial institutions and markets against external shocks, good corporate governance, conducive monetary and fiscal policies and a real sector capable of generating high growth. Since central banks have the powers to regulate and supervise the financial institutions, it is incumbent upon the Central Bank to put in place crisis management policies, including a safety net mechanism and contingency plans as well as taking preventive and corrective action against a potential crisis.

TABLE 1

Total Assets of Major Categories of Formal Financial Institutions as at end of 2004

Institution	Rs. Bn.	Share in Total %	% of GDP (a)
I. Central Bank of Sri Lanka	**414.0**	**14.9**	**20.4**
II. Institutions Supervised by the Central Bank	**2,077.9**	**74.6**	**102.4**
(a) Deposit-Taking Institutions	1,602.7	57.5	79.0
(i) Licensed Commercial Banks(LCBs)	1,219.8	43.8	60.1
(ii) Licensed Specialized Banks (LSBs)	316.7	11.4	15.6
(iii) Registered Finance Companies	66.2	2.4	3.5
(b) Other Institutions	475.2	17.0	23.4
(i) Employees Provident Fund	379.4	13.6	18.7
(ii) Primary Dealers	61.4	2.2	3.0
(iii) Leasing Companies	34.4	1.2	1.7
(III) Institutions not Supervised by the Central Bank	**295.2**	**10.6**	**14.5**
(a) Deposit-Taking Institutions	39.7	1.4	2.0
(i) Co-operative Rural Banks	33.5	1.2	1.7
(ii) Thrift and Credit Co-op. Societies	6.2	0.2	0.3
(b) Contractual Savings Institutions	228.8	8.2	11.3
(i) Approved Private Provident Funds	104.8	3.8	5.2
(ii) Employees Trust Fund	51.8	1.9	2.6
(iii) Insurance Institutions	72.2	2.6	3.6
(c) Other Specialised Financial Institutions	26.7	1.0	1.3
(i) Merchant Banks	21.0	0.8	1.0
(ii) Venture Capital Companies	1.5	0.1	0.1
(iii) Unit Trusts	4.2	0.2	0.2
(IV) Total (I + II + III)	**2,787.2**	**100.0**	**137.3**

Source : Central Bank of Sri Lanka

(a) GDP: Gross Domestic Product

Note:

There is a large number of unregistered, unsupervised informal sector micro financial institutions in the country which together could form a sizeable part of the financial activity but taken individually are insignificant. These institutions are not included here due to the paucity of information on them.

THE ROLE OF THE CENTRAL BANK IN FINANCIAL SYSTEM STABILITY

The Central Bank regulates and supervises banks and other financial institutions and payments systems to promote the financial system stability. Legal provisions governing the regulation and supervision are set out in the Monetary Law Act, Banking Act, Finance Companies Act and Payments and Settlement Systems Act. In addition, the Exchange Control Act empowers the Central Bank to regulate foreign exchange transactions as well in order to preventing financial instabilities arising from unfavourable mobility of foreign capital. It is well accepted that failures of banks and financial institutions in the crisis-hit countries could have been less, if effective regulation and supervision had been in place. At present, the Central Bank regulates and supervises the formal financial sector institutions, such as the licensed banks, registered finance companies and leasing establishments, Employees Provident Fund and primary dealers in government securities. These institutions own about 75% of the assets of all financial institutions and include all large and important institutions in the financial system in the country. (Table 1). In addition, the Central Bank initiates policies for financial sector reforms that are necessary from time to time to promote an efficient financial system.

WHY REGULATION AND SUPERVISION?

The adverse repercussions of financial system instability have to be avoided, reduced or mitigated. The ultimate objective of regulation and supervision, therefore, is to promote the financial system stability through a safe and sound system of financial institutions and operations. Unlike non-financial institutions, banks are vulnerable to sudden loss of depositors' confidence in their soundness. Depositors' confidence is the foundation of banking stability. If a bank is unable to pay deposits because of short of funds, the public may lose confidence in other banks as well. Banks by nature of the business are vulnerable to risk of short of funds because banks mobilize funds through short term deposits which are payable on demand or on short notice by the depositors and lend these funds on medium and long term. The failure of one bank may directly affect the other banks that are counterparts of the failing bank. The inter-bank contagion of financial problems and loss of depositors' confidence can quickly turn into panic runs on otherwise healthy banks which will ultimately lead to instability in the entire banking system because banks are not able to meet the wholesale withdrawals of deposits. This may damage operations of financial markets and payments and settlements systems that depend on banking services. Conduct of the monetary policy will also be impaired because a sound banking system is necessary to transmit the policy effects through interest rates and credit operations of banks. Therefore, regulation and supervision should be driven by systemic considerations and not by the interests of individual banks and financial institutions.

METHODS OF REGULATION AND SUPERVISION

The regulation involves laying down prudential requirements that the institutions should comply with relating to their operations. Minimum ratio of capital to total value of estimated risk based assets, minimum ratio of liquid assets to liabilities, limit on volume of lending to a single borrower, provision for bad and doubtful debts and submission of annual audited financial statements within a stipulated period are some of major regulatory requirements. The regulatory requirements are intended to serve as prudential standards that help the institutions to mitigate some of risks inherent in banking or finance business. Such regulations are determined in terms of the provisions of the relevant statutes.

The supervision involves oversight of financial institutions through off-site surveillance and on-site examinations. Off-site surveillance is the examination of information received periodically

Key Institutions in the Financial System

(monthly, quarterly, half-yearly, etc) from the institutions relating to their performances and financial status with a view to revealing early warnings of impending problems which can be resolved by taking early remedial action. Under the on-site examinations, the Central Bank examiners periodically visit the institutions for examination of their books and accounts with a view to making an assessment of the operations of the institutions by (a) verifying the compliance with prudential and regulatory requirements and (b) assessing the various risks, i.e. credit risk, liquidity risk, market risk and operational risk and risk management capacity of the institutions. On the basis of the findings of these examinations, the Central Bank continuously communicates with the management of the institutions and requires them to initiate prompt actions to solve the problems and weaknesses observed.

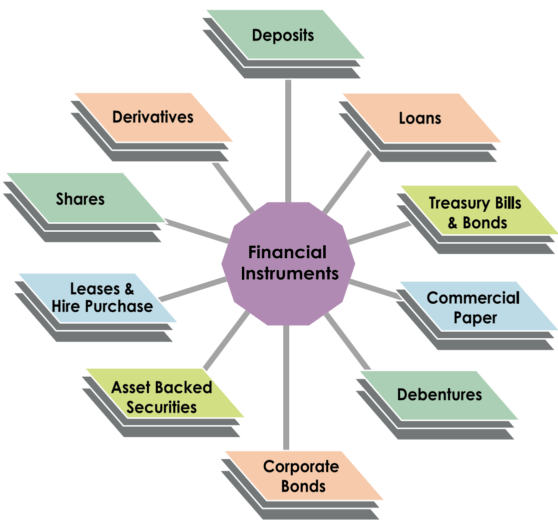
It should be clearly understood that the regulation and supervision do not mean that the Central Bank controls or manages the institutions soliciting deposits and other investments from the public or that the Central Bank stands to protect all such institutions from possible failures irrespective of their mismanagement. All financial institutions, just like any other business organization, seek profits which is the reward for risk-taking on the business. It is the Board of Directors and managers who control and manage the institutions with desired levels of risk-taking. Financial institutions too are bound to fail from time to time given external and internal reasons. Macroeconomic imbalances, external shocks, weak management, lack of controls and commitment, ignorance of fiduciary responsibilities and heavy competitition can be cited as reasons for banks or financial institutions to fail, just like any other business. The Central Bank only regulates and supervises the institutions licensed by it to ensure that they are managed in a sound and prudent manner.

The Central Bank has the responsibility to ensure that the whole financial system remains stable and sound. It is necessary to ensure that the major institutions in the financial system are sound and managed prudently. Institutions with weak risk management pose a threat to the stability of the financial system because a possible failure of one or few such institutions is likely to weaken the public confidence and affect even other well-run institutions unreasonably. In fact, the financial system is sound and stable to the extent that such weak institutions are removed early from the system. Therefore, the Central Bank cannot protect each and every weak or excessively risk-taking institution which will endanger the stability of the financial system.

FINANCIAL SECTOR REFORMS

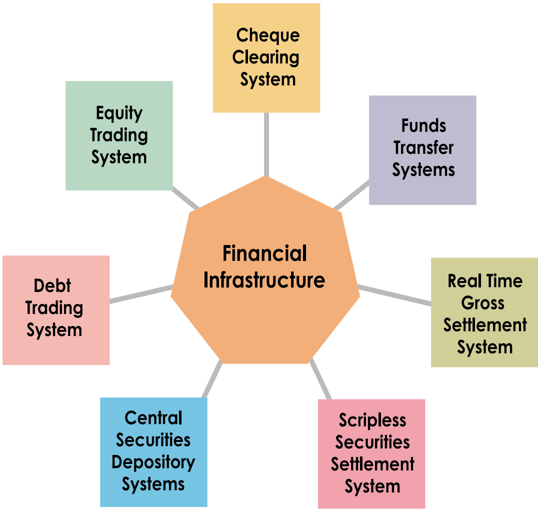
Financial reforms are the new arrangements to improve the efficiency and soundness of the financial system. In this regard, the Central Bank from time to time initiates action to amend the existing financial laws or to introduce new laws after consulting the Government and financial institutions to accommodate new developments under the legal framework. Recent amendments to the Banking Act and Monetary Law Act are two examples. Further, the Central Bank implements systems to upgrade the payments and settlements systems. Setting up the LankaClear Ltd. for retail cheque clearing of commercial banks, establishment of real time gross settlements system for large value payments through banks and scripless securities settlements system for government securities trading are three major systems implemented recently. A new system of cheque clearing through imaging of cheques is now in the process of implementation in late 2005. Further, the Central Bank is in the process of formulation of a deposit insurance scheme mandatory to all licensed banks. The purpose of a deposit insurance scheme is to protect small depositors from the risk of failure of depository institutions. Under the scheme, depository institutions should insure their deposit liabilities with the scheme by paying a premium

Main Financial Instruments



periodically. In the event of failure of an insured depository institution, the deposit insurance will pay deposits subject to a maximum limit.

Major Components of the Financial Infrastructure



PUBLIC AWARENESS AND THE FINANCIAL SYSTEM STABILITY

It is very important that the general public is aware of the developments of the financial system and the risks inherent in their transactions with financial institutions. The Central Bank or the Government does not guarantee the safety of all these transactions or the institutions. The public should exercise utmost care and vigilance on the true affairs of the institutions in which they place deposits and other investments. In order to facilitate this, the Central Bank has required such institutions to disclose to the public up-to-date financial information relating to their operations. Further, banks and registered finance companies have been required to display their annual audited financial statements at their Head Offices and branches for the information of the public. The members of the public are expected to assess the true and fair condition of the institutions from such disclosure of information and other information available to them.

However, the Central Bank as the regulator and supervisor cannot disclose information on individual institutions because of a potential "run" on a weak institution by depositors and other creditors thus precipitating its immediate collapse, perhaps unnecessarily. Instead, the Central Bank makes every endeavour through its regulatory and supervisory process to resolve the problems of institutions in order to protect the public interest. The Central Bank also seeks the assistance of external auditors of banks and financial institutions to cooperate with it, as auditors can signal the problems of institutions to the Central Bank on a confidential basis. If the public is aware of the nature and the soundness of the financial system, and their confidence in the system remains, the financial system stability is protected. For this purpose, the Central Bank also undertakes public awareness programmes through the media and through its own publications in the interest of the general public. In this connection, the Central Bank recently published its first ever Financial Stability Review for 2004.

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