Chapter 8

Supervision of Banks and Financial Institutions

During 1950-1976 the financial system of Sri Lanka expanded considerably as the banking system dispersed with the opening of bank branches by the two state owned banks - the Bank of Ceylon and the People's Bank - in the rural areas. The assets/liabilities of the banking system, the number of bank accounts, the branch network, etc., expanded considerably during this period. However, modernization was slow and consequently, the level of efficiency and sophistication in the financial system remained, by and large, static in the absence of serious competition.

After the economic reforms of 1977, the financial system expanded both in volume as well as complexity and sophistication. Before that, there were only four indigenous commercial banks in Sri Lanka, viz., the Bank of Ceylon and the People's Bank forming the state sector banks, and the two private banking institutions of the Commercial Bank of Ceylon Ltd and the Hatton National Bank Ltd. Since then, two new Sri Lankan banking institutions, the Sampath Bank Ltd and Seylan Bank Ltd, have been established in 1987 and 1988, respectively.

In 1977, there were only seven foreign banks operating in the country as against 18 foreign banks operating in 1990. Another innovation in commercial banking during the post-reform period has been the launching of Foreign Currency Banking Units (FCBUs) as units of commercial banks designed specifically for engaging in off-shore banking operations of accepting deposits and granting loans in foreign currencies. A new development in domestic banking was the establishment of Regional Rural Development Banks (RRDBs) since 1985 to meet the credit needs of the rural sector. As of June 1990, eleven RRDBs were operational in the country with a branch network of 93. In short, since 1977 there has been a very rapid development of the banking system in Sri Lanka, accompanied by a broadening of the financial system. In mid-1990, the financial system consisted of 24 commercial banks, 11 Regional Rural Development Banks, 3 development banks, 3 merchant banks, 1 savings bank and about 45 operational finance companies.

However, it needs stressing that during the period 1977 to 1988, numerous problems arose in the financial system due to a deterioration in the conditions of some banks and finance companies. The most prominent of these was the failure of a number of finance companies during 1986-1988. In addition to this well publicised crisis, there had been substantial problems in some financial institutions, particularly due to poor quality of management, excessive risk taking in loan disbursement and debt recovery difficulties arising from socio economic factors and legal delays.

Meanwhile, the Bank Supervision Department of the Central Bank, which was responsible for supervision of banks and other financial institutions, was not sufficiently equipped to deal with the problems in the financial institutions. However, the institutional and policy innovations implemented by the Bank since the end of 1988 marked the beginning of a new era in the regulation and supervision of financial institutions in the country. More specifically, the legal framework for regulation and supervision of financial institutions was strengthened considerably. The Banking Act No.30 was passed in 1988, providing wider powers to the Central Bank to regulate banking institutions in the country. The Finance CompaniesAct No.78 was also passed inDecember 1988 enabling the Central Bank to restructure the non-bank financial

sector. The regulation and supervision of non-bank financial institutions was separated from bank supervision and a separate department was created for this purpose with effect from 23rd December, 1988. From the beginning of 1989, significant changes have been introduced to the supervision of financial institutions. As indicated by the relative stability in the financial system and the dynamism in the operations of financial institutions since the beginning of 1989, the new initiatives have been effective in improving the system. This paper will largely concentrate on the new initiatives taken by the Central Bank in the regulation and supervision of financial institutions.

Table 8.1

Structure of the Financial System

Institution	Asset/Liabilities (Rs.Mn.)			Growth Rate %		As a % of Total Assets/Liabilities		
	1950	1977	1989	1950-1977	1977-1989	1950	1977	1989
1. Commercial Banks	858.5	10,251.5	106,351.9	1,094	937	82.30	61.59	61.14
2. Foreign Currency Banking Units[(1)]	-	-	29,244.0	-	-	-	-	16.81
3. National Savings Bank (POSB)	160.9	3,090.4	19,901.8	1,821	544	15.42	18.56	11.44
4. Finance Companies	-	2,498.8	8,213.3	-	229	-	15.01	4.72
5. Development Finance Corpn. of Ceylon	13.9*	149.1	2,254.0	1,201	1,412	1.33	0.90	1.30
6. National Development Bank[(2)]	-	-	-	1,984.8	-	-	-	1.14
7. Regional Rural Development Banks[(3)]	-	-	-	326.9	-	-	-	0.19
8. Cooperative Rural Banks	-	491.2	3,162.3	-	544	-	2.95	1.82
9. State Mortgage & Investment Bank	9.9	164.9	2,502.4	1,566	1,417	0.95	0.99	1.44
10. Number of Merchant Banks[(4)]	-	-	-	3	-	-	-	-
11. Number of Brokers Houses[(5)]	-	-	-	7	-	-	-	-
Total	1,043.2	16,645.9	173,941.4	1,496	945	100.00	100.00	100.00

(1) FCBUs were started on 2nd May, 1979
(2) NDB was started on 1st October, 1979
(3) RRDBs were started on 13th July, 1985
(4) The People's Merchant Bank was started in 1983, the Merchant Bank of Sri Lanka was started in 1982 and the Mercantile Merchant Bank was started in 1989
(5) Bartleet Brokers Association was started in 1979
* Agricultural and Industrial Credit Corporation

Regulation and Supervision of Banks

The Monetary Law Act No.58 of 1949 which contained the legal framework for the establishment of the Central Bank of Sri Lanka provided the authority for bank regulation and supervision to the Monetary Board of the Central Bank. The regulatory powers were enforced largely through the Departments of Banking and Exchange Control while the supervisory function was carried out by the Department of Bank Supervision which was established "for the purpose of continuous supervision and periodic examination of all banking institutions in Sri Lanka (Ceylon)".

However, the need for intensive supervision of banks was not felt so urgently as the commercial banks in Sri Lanka were well organized and managed financial institutions from the very inception. Some had been established as branches of international banks, while the local banks too had been established after acquiring considerable experience and expertise. Moreover, during the period 1950-1977, although banking activities expanded in volume, the degree of complexity and sophistication remained modest. Therefore, the need for regulation of banks arose largely from the monetary and balance of payment regulatory requirements. The directions needed for monetary policy purposes were issued to the banks by the Banking Department while the directions relating to exchange control regulations were issued by the Department of Exchange Control. However, in recent years, largely due to new developments and the increasing complexity and sophistication of the financial system, it has become necessary to regulate the banks more closely. The Banking Act No. 30 of 1988 provides powers to the Central Bank to regulate banks in a wide range of areas including licensing of banking institutions, regulation of the use of banking names and banking businesses, capital requirements, reserve funds and maintenance of liquid assets, payment of dividends, offshore banking operations, accounts, audits and inspection disqualifications for appointment of directors and senior officials, procedure for closure of branches of foreign banks and liquidation of local banks.

Under the provisions of the 1988 Banking Act, the Monetary Board has already issued five directions to regulate commercial banks.

(i) Direction No.1 on Single Borrower Limits

On 20th April, 1989 directions were issued to commercial banks specifying limits to a single borrower in respect of local lending. According to this direction, commercial banks incorporated in Sri Lanka are not permitted to grant loans which exceeded 30 per cent of the capital funds of the respective banks. Further, in respect of loans which exceed 15 per cent of capital funds, a further limit of 50 per cent of total advances including total commitments to undertake contingent liabilities is imposed. In respect of banks which have been incorporated outside Sri Lanka, a single borrower limit of 10 per cent of advances including total commitments to undertake contingent liabilities is imposed. However, offshore lending is not subject to the above limits.

(ii) Direction No.2 on Limits on Ownership of Shares

The purpose of the direction is to broadbase the ownership of local banking institutions. Therefore, an ownership limit of 15 per cent is placed on an individual or a company. The foreign ownership of a local bank is limited to a maximum of 49 per cent of the total share capital.

(iii) Direction No.3 on Unimpaired Capital,Capital Funds and Reserve Funds

The Banking Act of 1988 requires commercial banks which are incorporated in Sri Lanka to maintain an unimpaired minimum capital of Rs. 25 million. The banks which did not have this amount of capital in 1989 were given time to acquire the necessary capital. In addition to the above stipulation in the Banking Act, Direction No.3 requires every licensed commercial bank to have capital funds of not less than 4 per cent of the average of its month-end liabilities including contingent liabilities during the preceding twelve months.

Section 20 of the Banking Act also requires licensed commercial banks to maintain reserve funds. The objective of this requirement is to improve the capital base of banking institutions on a continuous basis.

(iv) Direction No.4 on Liquid Assets.

With effect from April 1, 1989 the commercial banks were required to maintain liquid assets of not less than 20 per cent of their total liabilities excluding the liabilities to the Central Bank and their shareholders.

(v) Direction No.5 on Lending to Directors' Interest

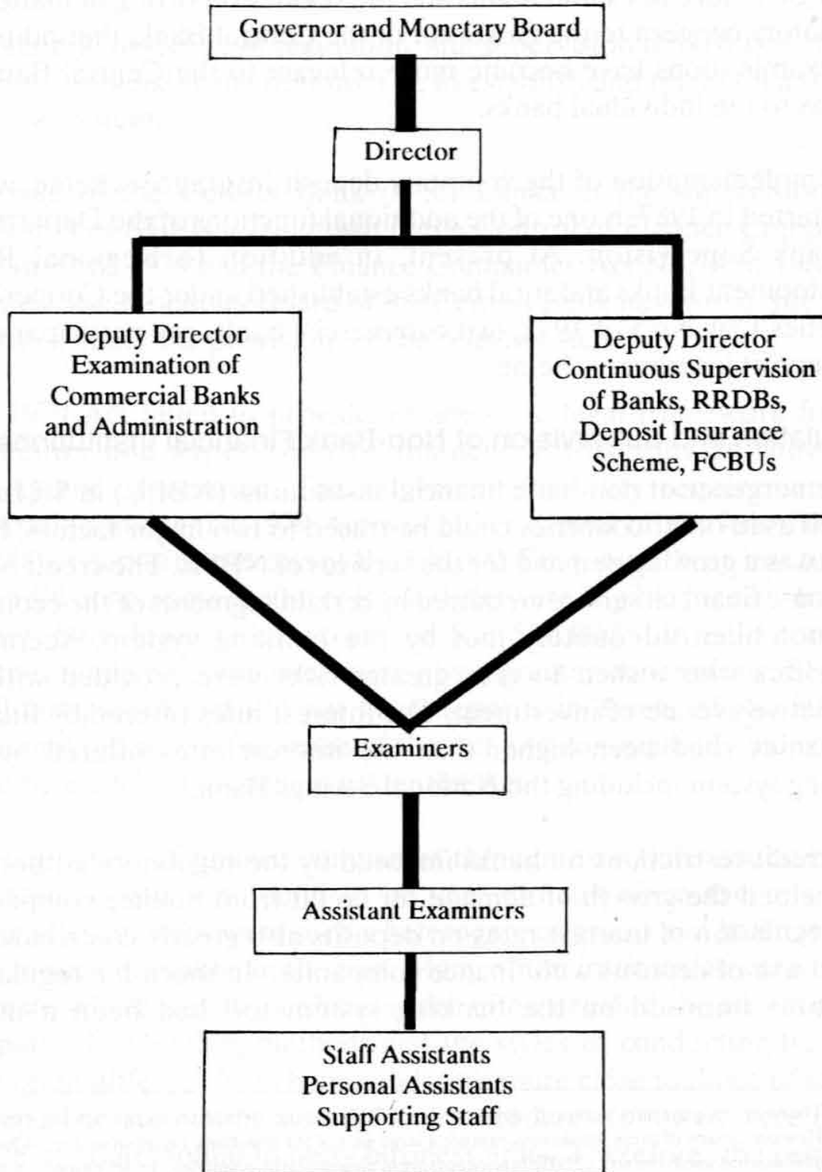
In granting loans to directors and companies where they have a substantial interest, commercial banks are required to obtain securities approved by the Monetary Board. The objective of this directive is to prevent banks from granting unsecured loans to directors.

Organisation of the Bank Supervision Department

The organisational structure of the Bank Supervision Department is given in Chart 8.1. As at 30th June, 1990, the Department consisted of a Director, two Deputy Directors, 15 Examiners and 20 Assistant Examiners, in addition to supporting staff. The present organisation is significantly different from the organisational structure that existed before 1990. Earlier, off-site surveillance through analysis of data received from the banks was insignificant. However, this aspect is now being given considerable significance and at present it is being supervised by a Deputy Director. Analysis of profit and loss accounts, particularly the earnings and expenses, are undertaken in addition to analysis of quarterly returns on over-due advances. Conducting of on-site examinations which was the main function of the Department earlier, is being restructured to make the examinations more relevant to the new developments in banking business.

A detailed check of the whole credit portfolio to decide the provisions, which had been the main objective of examinations earlier, has now been modified to concentrate on areas of importance such as the verification of assets and liabilities, liquidity and capital adequacy, off-balance sheet risks and the quality of management. Detailed examinations are also being conducted where it is found necessary.

CHART 8.1
Organisational Structure of the Department of Bank Supervision
June 30, 1990



The adaptations made to the on-site examination of banks since 1990 have reduced the time required for examinations. Earlier, banks were examined once in two years. However, in future the Department expects to conduct examinations annually. At the same time, in view of the strategic nature of examinations and the regular reporting of matters of regulatory concern to the Governor of the Central Bank, thefindings of the examinations have become more relevant to the Central Bank, as well as to the individual banks.

The implementation of the voluntary deposit insurance scheme, which was started in 1987, is one of the additional functions of the Department of Bank Supervision. At present, in addition to Regional Rural Development Banks and rural banks established under the Cooperative Societies Law No.5 of 1972, two commercial banks are participating in the deposit insurance scheme.

Regulation and Supervision of Non-Bank Financial Institutions[1]

The emergence of non-bank financial institutions (NBFIs) in Sri Lanka as well as in other countries could be traced to two major factors. First, there was a growing demand for the services of NBFIs. The credit needs and some financial services required by certain segments of the economy had not been adequately met by the banking system. Secondly, depositors who wished to take greater risks were provided with an alternative avenue of investment. The interest rates offered by finance companies had been higher than the interest rates offered by the banking system including the National Savings Bank.

The credit restrictions on banks imposed by the regulatory authorities also helped the growth of demand for credit from finance companies. The regulation of interest rates on deposits also greatly contributed to the growth of deposits with finance companies. In short, the regulatory measures imposed on the banking system too had been a major

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1 There is no generally accepted definition of NBFIs as the definition varies among countries. However, many of these definitions capture a large part of the non-bank financial sector. Whichever definition is used, the size of NBFIs is increasing in almost all the countries. In developed economies such as USA and UK, the NBF sector is as large as the banking sector, and the differences between banking and non-banking sectors are breaking down. In short, with the growing maturity of the financial system, the non-bank financial sector is expanding. In Sri Lanka, the Central Bank at present regulates and supervises only finance companies in the non-bank group.

contributor to the growth of the non-banking financial sector in Sri Lanka as well as in other countries.

The Scope of Regulation and Supervision

The general objective of regulation and supervision of NBFIs is the same as for banking institutions, i.e., to establish and maintain a sound financial system.

The role of the Central Bank of Sri Lanka in the supervision and regulation of NBFIs is laid down in the Control of Finance Companies Act No.27 of 1979 and the Finance Companies Act No.78 of 1988. In addition, the Monetary Board of the Central Bank has issued directives and rules under the provisions of the relevant Acts.

The 1979 Act failed to provide an adequate legal framework for the inspection and supervision of financial institutions as shown by subsequent experience. The minimum eligibility requirement for registration under the 1979 Act was either capital of not less than Rs. 100,000 or deposits in excess of Rs. 500,000. First, even those institutions which did not possess capital of Rs. 100,000 were eligible for registration, if they had deposits in excess of Rs. 500,000. In other words, under-capitalized companies were given greater concessions. Second, small companies that did not have deposits in excess of Rs. 500,000 would not fall within the scope of the Act and consequently, no control could be exercised over them under the Act.

The regulation of finance companies through directions issued by the Monetary Board was found to be very difficult since the non-bank financial institutions were such a heterogenous group and had not been used to such discipline in the past. Many of the institutions were family concerns where the major shareholder often decided the affairs of the company. The lending methods and the styles of conducting business were often different from banks and were more close to those of money lenders. The accounting systems and procedures followed were of the nature of affairs found in petty business units. Therefore, the response to directions issued by the Central Bank was very poor. Only a few finance companies agreed on the desirability of Central Bank regulations. The majority of finance companies ignored the guidelines

issued by the Bank. The process of dealing with non-compliance of directions involved long delays since all legal action had to be through complaints made to the Police Department. In short, the regulation of non-bank financial institutions under the 1979 Act was of limited effectiveness.

The Finance Companies Act No.78 of 1988 is applicable to all institutions that are engaged in finance business. The Act prohibits any person or body of persons from carrying on a finance business unless -

(a) it is registered under the Companies Act No.17 of 1982, and
(b) it has a minimum issued and paid-up capital of not less than Rs. 5 million.

Moreover, according to the 1988 Act, in addition to a finance company satisfying capital and company status requirements, the Monetary Board should also be satisfied by the information made available to it that the registration of a particular finance company would not be detrimental to the interests of its depositors and creditors (Section 5(ii)). The third requirement expects an applicant company to have a satisfactory accounting system, internal controls and a management record which shows that the company is sound and solvent. The requirements stated in the 1988 Act are applicable not only to new finance companies which seek registration under the Act, but also to the companies that have already been registered under the 1979 Act. In other words, the new Act provides an opportunity to the Central Bank to restructure the non-bank financial sector in an appropriate manner.

Regulation through Directions and Rules

Section 11 of the 1979 Act gave authority to the Monetary Board to issue directions to all non-bank financial institutions. Section 9 of the 1988 Act has further widened these powers.

Some of the directions issued by the Monetary Board are as follows :

(i) Monitoring of Liquidity Position

According to Direction 8, finance companies are required to maintain a minimum holding of liquid assets not less than 15 per cent of the deposit liabilities. The liquid assets may be in the form of cash and balances in current accounts of banks, fixed or time deposits with banks and investments in approved securities. This is also meant to further strengthen the monitoring of the liquidity position of finance companies. Some investigations carried out by the Central Bank revealed that certain finance companies, although investing in approved securities, had also secretly taken loans from banks pledging these as security. According to the directions issued on 10th March, 1989, every finance company should have 6 per cent of its deposit liabilities invested in Government securities, Central Bank of Sri Lanka securities or Government Treasury bills, and documents relating to those investments should be lodged with the Chief Accountant of the Central Bank of Sri Lanka.

(ii) Ensuring Solvency of Institution

In financial institutions the largest component of assets is the advances granted. Accordingly, the largest proportion of earnings too should be realized through loan operations. Therefore, prudential loan portfolio management is the basis of solvency of a financial institution. Hence, most of the directions issued relate to the terms and conditions of granting advances. The direction on grant of financial accommodation states that no financial institution shall -

(a) grant loans or advances against security of its own shares or security of shares of any of its subsidiaries;
(b) grant unsecured loans exceeding 10 per cent of capital funds; and
(c) grant loans to any one borrower exceeding 10 per cent of total loans.

(iii) Prevention of Excessive Competition

One of the reasons for the failure of finance companies during 1986/88 was the excessive price competition that prevailed through the offer of

high interest rates. Some finance companies promised interest rates as high as 36 per cent per annum and persuaded the public to deposit their savings with them. In order to prevent excessive competition between finance companies, the cost of funds as reflected in deposit interest rates are controlled by Direction 2 on Rates of Interest and Other Charges. According to the currently prevailing direction, the maximum annual rate of interest payable on 12 months deposits is 20 per cent per annum and the maximum interest payable on longer term time deposits is 24 per cent.

(iv) Improve the Capital Adequacy

The directions on capital funds and reserve funds are also primarily aimed at providing an adequate capital base which is essential for solvency. According to Direction 10 on Capital Funds, every financial institution shall maintain capital funds which are not less than 10 per cent of total deposit liabilities. Direction 11 on Reserve Funds states that every financial institution should maintain an adequate reserve fund as specified in the Direction.

(v) Single Borrower Limit

The single borrower limit requires that no single borrower should be given an advance which is more than 10 per cent of the capital fund.

(vi) Limits on Acquisition of Fixed Assets

Acquisition of fixed assets utilizing public deposits could lead to solvency problems. On the one hand, it may not be possible to convert fixed assets into liquid assets as and when required by the finance company. On the other hand, income generation by fixed assets can be easily manipulated to the disadvantage of depositors, creditors and shareholders. This is the rationale of Direction 6 which places restrictions on the acquisition of fixed assets. According to this direction, finance companies should not purchase or acquire any immovable property or any right to title or interest therein exceeding 50 per cent of the capital funds. However, finance companies that are engaged in real estate business are permitted to acquire or purchase immovable property as part of the stock in trade.

(vii) Prevention of Mismanagement and Fraud

In the finance business, the possibility of mismanagement and opportunities for fraud are considerable. Mismanagement can take place due to inadequate professional expertise, poor internal controls and accounting systems. It can also happen due to lapses and negligence on the part of the management. Fraud is a deliberate act of mismanagement for enrichment at the cost of the company. To prevent these acts of mismanagement and fraud, a number of directions are issued to finance companies. The requirements that the profit and loss account and balance sheet need to be audited and such financial information be transmitted to the Central Bank are stated under separate sections of the 1988 Act. Here, we shall deal only with some of the directions issued by the Monetary Board to prevent mismanagement and fraud. Direction 15 places restrictions on transactions with directors and connected concerns as follows -

"15(1) No institution shall as from 1st March, 1985 grant any loan or advance or financial accommodation of whatever nature including hire purchase financing and inter company transaction to its directors, subsidiary companies, associate companies or to partnerships in which any of its directors own shares amounting to ten (10) per cent or more of such company's paid-up capital".

Direction 12(3) also states -

"12(3) Every institution shall obtain the approval of the Monetary Board before writing-off any loan or advance granted by it to -

(a) any of its directors;

(b) any undertaking in which any of its directors has an interest as a director, partner, manager, agent, investor or guarantor;

(c) any of its subsidiary companies;

(d) any person who is a director, manager or officer of an institution registered under the Control of Finance Companies Act No.27 of 1979. For the purpose of sub-paragraph (3) in Direction 12 the word

"director" includes the wife, husband, mother, father, son or daughter of a "director".

Direction 14(1) and 14(2) further states -

"14(1) No institution shall as from 1st March, 1985 invest in the shares of any company, an amount of which in the aggregate at any time exceeds five (5) per cent of the capital funds of the institution as at the last balance sheet date. Provided that such investments shall not exceed forty (40) per cent of the issued share capital of such company.

14(2) Where any investment of the nature described at sub- paragraph (1) has been made in excess of the limits imposed before the date these directions come into operation, steps shall be taken to conform to the above directions before 1st January, 1989".

(viii) Directions on Accrued Interest

Sometimes, the information given in the profit and loss account is not reflective of the true financial position of a financial institution. Incomes are overstated when accrued interests are treated as income, which also means the profits are over-estimated. In the event of dividend declarations on over-estimated profits, there could be some mismanagement of funds. Hence, to prevent such mismanagement of funds, in July 1989, the Monetary Board issued a direction to the effect that financial institutions shall not, as from 1st April, 1990 take into account as income, any accrued interest on advances on which interest and/or capital repayments are in arrears for six months or more.

The direction issued by the Monetary Board received greater recognition after the enactment of the 1988 Act as officials of the Department of Supervision of Non-Bank Financial Institutions (DSNBFI) are given authority to prosecute finance companies which violate the directives. During 1989-90, a considerable number of finance companies was prosecuted by the DSNBFI officials for violating directives issued by the Monetary Board.

Another feature in the 1988 Act that deserves emphasis is the enlargement of the powers of the Director of the DSNBFI to examine

finance companies through independent auditors appointed by him. The relevant subsection 12(3)(d) reads as follows :

"In any case where there is evidence of mismanagement by a finance company, to require any director, manager or secretary of such finance company to submit the accounts of the finance company for audit by an auditor authorised by the Director and to require the finance company to furnish such information, or produce such books, records or documents and to pay such fees as may be specified or authorised by the Director, to such auditor".

The powers given to the Central Bank to appoint independent auditors are of particular significance in preventing mismanagement and fraud. The absence of such authority under the 1979 Act was a major obstacle to the Central Bank when it became necessary to obtain the views of independent auditors.

Before the establishment of the DSNBFI, the supervision of finance companies depended largely on off-site monitoring which was done through an analysis of financial statements and returns supplied by the finance companies. On-site examinations of finance companies were undertaken randomly. This approach to supervision was found unsatisfactory, as shown by the experience of failed finance companies. The DSNBFI has reversed the order of priorities in supervision, on the one hand, while introducing new innovations in both on-site examinations and off-site monitoring, on the other. The new methodology of conducting on-site examinations has the following features :

(a) About 75 per cent of data are collected according to a structured questionnaire, while the remaining 25 per cent of data are collected outside the questionnaire depending on the nature of the financial institution. The new methodology places greater attention on loan portfolio management, particularly on the loan recovery record, internal controls and accounting system, quality of management and capital adequacy, with the objective of evaluating the overall viability of the institution. The integrity of the management is particularly evaluated in view of the experience that the failure of finance companies in Sri Lanka was primarily due to fraud and embezzlement of funds by the directors.

(b) The examinations are designed in such a manner that they can be completed within a period of one month. About eight working days are allocated for data collection and two weeks for data processing and preparation of reports. The findings of these examinations, along with the Department's recommendations, are communicated to the respective finance companies within a month of commencing a particular examination. It is the view of the Department that the timely communication of findings and recommendations of an examination to the relevant company would increase the effectiveness as well as the usefulness of such an examination.

(c) In addition to these on-site examinations conducted by the officials of the DSNBFI, some finance companies have been examined through independent auditors appointed by the DSNBFI where there has been evidence of mismanagement or mismanagement and fraud.

Since February 1989, the DSNBFI has expanded the scope of the finance company monitoring through statistical returns by the introduction of an Early Warning System (EWS). The data collected under the EWS include the weekly position of deposits, new deposits and deposit renewals, deposit withdrawals on maturity and prematurely, loans granted by type of accommodation and the liquid assets. The objectives of the EWS are two fold. On the one hand, it helps the DSNBFI to collect data to compile a set of key indicators which would help the Department to identify the finance companies which are likely to fall into difficulties and hence, to advise the respective finance companies about the remedial actions that should be taken. On the other hand, the data requested under the EWS could also serve as part of the management information system of the respective finance companies. The DSNBFI also plans to modify the EWS, which was introduced as a crisis management instrument, to form part of a comprehensive off-site monitoring system which would encompass the collection of data on monthly financial statements, including the profit and loss account and the balance sheet.

In addition to the data which are collected through the EWS, the DSNBFI also undertakes periodic evaluation of finance companies through postal survey questionnaires. In 1989, two postal surveys were conducted, one to evaluate the finance companies in respect of their

staff, and the other to collect data on deposit interest rates and lending rates. In 1990, a postal- questionnaire survey was conducted on advances for the purpose of collecting detailed information on performing and non-performing accounts. The annual evaluation of finance company profit and loss accounts and balance sheets are also being undertaken by the Department.

Organisation of the Department of Supervision of Non-Bank Financial Institutions

The organisational chart of the DSNBFI is given in Chart 8.2. For convenience of discussion, the organisation in the DSNBFI can be divided into three main branches or sections viz.,

(a) Regulatory and Supervisory Section
(b) Crisis Management Section and
(c) Research and Evaluation Section

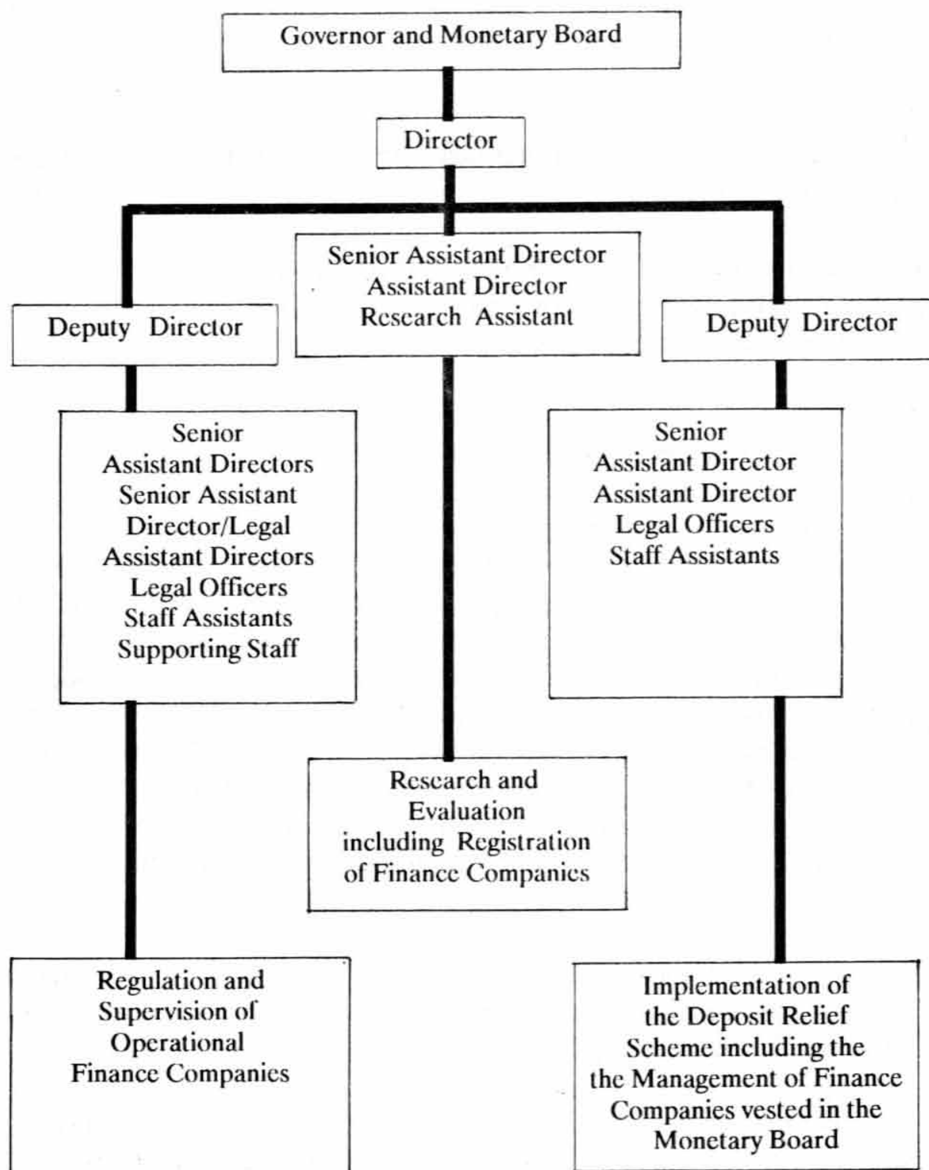
The Regulatory and Supervisory Section is headed by a Deputy Director who is assisted by four Senior Assistant Directors and about nine Assistant Directors. The operational finance companies, which were about 45 in number in 1989, have been classified into four groups and are being supervised through on-site examinations, quarterly returns on over-due advances and the Early Warning System (EWS) which collects data on a weekly basis. The combination of on-site examinations which are being done annually and off-site monitoring based on returns has provided a very effective continuous supervision technique on the operations of finance companies.

The Crisis Management Section is being handled by two Deputy Directors, assisted by three Senior Assistant Directors and nine Assistant Directors. The main functions of this section are :

(i) implementation of the Deposit Relief Scheme in the distressed finance companies which are vested in the Monetary Board;

(ii) management of these distressed finance companies either directly or through management agencies;

Chart 8.2
Organisational Structure of the Department of Supervision of Non-Bank Financial Institutions
June 30, 1990



(iii) taking of legal action against directors of finance companies in consultation with the Attorney-General's Department; and

(iv) organising of external and internal audits in the finance companies vested in the Monetary Board which are managed by the DSNBFI.

The Research and Evaluation Section, which is the smallest of the three sections, functions directly under the Director of Supervision of Non-Bank Financial Institutions. The Research and Evaluation Section is headed by a Senior Assistant Director who is assisted by an Assistant Director who is in charge of data processing. In addition, there is a Research Assistant who helps in data collection. The Research and Evaluation Section, which is also in charge of the registration of finance companies, provides the co-ordination between the two branches - Regulatory and Supervisory, and Crisis Management.

The work of the Crisis Management Section deserves some discussion, since such work does not fall within the normal regulatory or supervisory functions of central banks. Under the existing laws, the Central Bank of Sri Lanka has no obligation to pay relief to depositors of failed financial institutions, since at present there is no deposit insurance scheme in respect of finance companies. However, in view of the fact that about 44,000 depositors could lose their savings amounting to about Rs. 1,000 million, the Central Bank introduced the Deposit Relief Scheme on welfare grounds.

In addition to implementing the Relief Scheme, the management teams in the distressed finance companies are also engaged in the collection of debts and management of assets in an attempt to rehabilitate these institutions. As at 30th June, 1990, six distressed finance companies are vested in the Monetary Board and five of them are directly managed by the DSNBFI. The total staff employed in these five finance companies amounted to about 150, which includes one management consultant, 6 project officers and ten Central Bank officers on secondment. The Central Bank of Sri Lanka has allocated Rs. 410 million for the Deposit Relief Scheme, and of these funds, about a third had been paid to depositors as at 30th June, 1990.

Concluding Remarks

The regulation and supervision of banks and other financial institutions in Sri Lanka underwent very little change during the period 1951 to 1988. In fact, inadequate development in the approach to regulation and supervision of financial institutions permitted some deterioration in financial institutions and this was most visible in respect of finance companies. The large proportion of non-performing advances in the loan portfolio of financial institutions is partly a result of the poor credit policies followed by these institutions. The liberal policy adopted in the registration of finance companies and the disproportionate dependence on off-site surveillance for supervision of finance companies also gave room for finance companies to mislead the regulatory authorities as well as the general public.

The Banking Act No.30 and the Finance Companies Act No.78, both passed by Parliament in 1988, provided the legislative framework to implement reforms in the banking and non-banking sectors. The Central Bank quickly responded to the growing crisis in financial institutions by implementing a number of initiatives which included the creation of a new department to deal with non-bank financial institutions. In addition, through a series of directions issued by the Monetary Board, the regulatory framework has been made comprehensive and relevant.

The priority issues that have received the attention of the Central Bank can be summarised as follows :

(a) Improvement of the Quality of Management

Both the Bank Supervision Department as well as the Department of Supervision of Non-Bank Financial Institutions have given priority in their on-site examinations to evaluation of management. After the examinations, at a conference with management, specific suggestions are made to the directors of financial institutions regarding the manner in which the quality of management should be improved. Some of the general suggestions made are :

(i) at various management levels, i.e., Board of Directors, senior, middle and lower management levels, there should be professionally qualified, experienced personnel;

(ii) to achieve qualitative improvements in management, staff should be trained, and steps should be taken to provide the necessary training.

(b) Improvement of Capital Base of Financial Institutions

The Banking Act of 1988 stipulates a minimum capital of Rs. 25 million for a new commercial bank, while the Finance Companies Act of 1988 stipulates a minimum capital of Rs. 5 million for every finance company. In addition to the minimum capital requirement, capital adequacy is determined using a number of criteria such as risk of assets, deposit liabilities and total assets/liabilities, including contingent liabilities.

(c) Closer Monitoring of Loan Portfolio Management

Financial institutions in Sri Lanka, both banks as well as non-banks, have to submit returns every three months, giving details of overdue advances. Financial institutions which have a large proportion of non-performing advances in their portfolios are closely monitored by the Central Bank.

(d) Close Monitoring of Liquidity Requirements

In the past, finance companies used to window-dress their liquidity positions frequently. However, due to the direction on approved securities which was issued in 1989, finance companies have to lodge the certificates of approved securities with the Central Bank. This has considerably improved the monitoring of the liquidity position of finance companies.

(e) Improvement to Internal Controls and Accounting Systems

Finance companies were not particularly interested in employing qualified accountants and internal auditors, since there was no compulsion for them to have systematic accounts and financial statements. Moreover, the external auditors appointed by some companies were of a poor standard. The present position is that where

the accounts and financial statements are unsatisfactory, the Director of the DSNBFI has the power to appoint independent external auditors to examine a company and to recover the cost of such an audit exercise from the relevant company.

To upgrade the supervisory capability of the staff, the Central Bank also gave priority to training. During April-May 1989, an in-house training programme of six weeks' duration was conducted in the Department of Supervision of Non-Bank Financial Institutions with the guidance of a foreign consultant made available by the United States Agency for International Development (USAID). During January-March 1990, the 15th SEACEN Training Course on Inspection and Supervision of Financial Institutions was held in Colombo, hosted by the Central Bank of Sri Lanka. This training programme, which was attended by 32 participants from SEACEN member countries and conducted by an international faculty of experts, provided an opportunity to train a large number of staff involved in the supervision of banks and other financial institutions. In addition, the Central Bank continues to send participants to training programmes and seminars to upgrade the supervisory capability of the Central Bank staff.

Continuous supervision done through the amalgamation of on-site examinations with off-site monitoring has made supervisory efforts more effective. The results of this approach are already visible as shown by the stability in the financial system of the country. Once the present financial sector reforms are completed, Sri Lanka could expect to have a stable, dynamic and efficient financial system. The Central Bank of Sri Lanka has taken measures to implement a flexible and more appropriate approach to regulation and supervision of financial institutions in the country.