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The Role of the Watchdog – Strengthening Financial Regulation in Sri Lanka

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Introduction

Economic prosperity of any country is dependent on a safe, vibrant and active financial system, and its financial institutions. A stable financial system will lead to sustainable development of the economy due to efficient channelling of financial resources for investment purposes, mainly through improved confidence. Hence, to promote investments as well as to harness the potential of the economy, a sound, efficient and trustworthy financial system is of paramount importance.

The financial system of a country plays the very important intermediation role of transmitting money between savers and borrowers and it consists of a set of closely interconnected financial markets, instruments, services, institutions and infrastructure. An efficient payment and settlement system, which enables the transactions in the financial sector to be cleared and settled on time, is another important component of a financial system. The regulator, which plays the important role of regulating and monitoring the system to ensure the stability, is considered an integral part of a financial system.

Financial system stability can be defined as the system's ability or resilience to withstand pressures from within and outside and continue to function smoothly. Why is the stability of the financial system important? Firstly, a stable financial system would create a trusted environment to savers and investors. Secondly, it would help to attain the price stability objective through the transmission of monetary policy. Thirdly, a stable condition in the financial system would support investment and growth through efficient financial intermediation. Fourthly, a stable financial system would improve the distribution of resources in the economy efficiently and effectively.

Financial system stability does not happen automatically. It has to be established and maintained. The stability of the financial system depends on a combination of several prerequisites viz. (i) a stable macroeconomic environment, (ii) a well governed liquid and solvent group of financial institutions, (iii) an efficient financial market, and (iv) a safe and reliable payment and settlement system. These prerequisites are highly interconnected and an incident that affects only one area initially can subsequently have adverse implications for a range of other factors, eventually destabilising the overall financial system.

Financial institutions, which represent a major part of the system, are exposed to various risks in the processes of financial intermediation. The major categories of risk are – credit, liquidity, interest rate, foreign exchange rate, operational, legal, regulatory, reputational etc. As the financial markets grow in sophistication in terms of the instruments and the way in which these transactions are processed, the above mentioned risks tend to increase. Therefore, an independent institution to perform the watchdog's role to monitor and regulate these risks at micro and macro levels is needed for the development and the stability of the financial system. Hence, the Central Bank of Sri Lanka has been chosen to perform the abovementioned independent role.

A sound and a well governed group of financial institutions and a safe and reliable payment and settlement system can be achieved only through comprehensive laws and prudential regulations. Past experiences have proved that voluntary observation of prudential regulations does not work. Therefore, an effective supervisory framework is needed for mandating to ensure uniformity. Effective supervision would help to closely monitor all aspects of potential instability and to ensure enforcement.

Evolution of the Regulatory Regime of the Central Bank

"Banking is an economic activity which affects the public welfare to an unusual degree: it touches in one way or another, almost every phase of a country's economic life. Sound banking is essential to healthy and vigorous economic development. Supervision of banks helps to protect the public against mismanagement, bank failures, and loss of confidence in the banking system. It helps to protect depositors and stock-holders against loss and frequently enables bank directors and officers to manage the affaires of their banks more wisely and intelligently."[1]

The 'Monetary Law Act No. 58 of 1949' made it mandatory for the Central Bank to administer, supervise and regulate the monetary, financial and payment system of Sri Lanka. However, the financial regulations introduced by the Central Bank during the period from 1960 to

1 John Exter's Report on the Monetary Law Act

1978 were mainly focused on commercial banks' rate of interest on advances, supply of credit to various sectors within the economy and adoption of monetary measures to conserve the foreign exchange resources available to the country for essential purposes. In addition, the Central Bank had played a key role in developing the financial markets during the period from 1977 to about 1985 by introducing foreign currency banking schemes, encouraging new foreign banks to open branches in Sri Lanka and establishing regional rural development banks.

Year 1988 has been a remarkable year for the regulatory regime as the Central Bank had been able to put in place and operate a procedure for the licensing of persons carrying on banking business for the regulation and control of matters relating to the business of banking through the implementation of the Banking Act No. 30 of 1988. In the same year, the Finance Companies Act No.78 of 1988 was also enacted to provide for the control and supervision of finance companies. Implementation of the Credit Information Bureau (CRIB) in 1990 and requiring all licensed banks and non-bank financial institutions to provide credit information and sharing same with the stakeholders of CRIB has been another regulatory measure that has helped in uplifting the regulatory regime of the country.

The Banking Act gave authority to the Central Bank to issue prudential regulations/ directions to licensed banks for reasons to be stated in writing to any one or more of them regarding the manner in which any aspect of the business such bank or banks is to be conducted. In exercising the above mentioned powers, the Central Bank has been able to upgrade its regulatory regime in par with the international regulatory regimes and best practices by implementing several important prudential regulations to ensure that the conduct of an individual bank will not have implications on the stability of the overall financial system. Selected key financial regulations adopted by the Central Bank during the three decades from 1980s are summarised below.

(a) **Maintenance of risk weighted minimum capital adequacy ratio (March 1989)** – Credit risk is the biggest risk exposure of a bank, which will have direct implication on the profitability, liquidity and solvency. Accordingly, the Central Bank, in line with the requirements laid down by the Banking Regulation and Supervisory Practices Committee, also known as the Basel Committee, has formulated these regulations directing towards assessing capital in relation to credit risk (the risk of counterparty failure) to assess overall capital adequacy of a licensed bank.

(b) **Maintenance of liquid assets (April 1989) – Liquidity-** the ability to fund increases in assets and meet obligations as they become due - transcends the individual bank since a liquidity shortfall at a single bank can have systemic repercussions. Therefore, the Central Bank through these regulations made it mandatory for licensed banks to maintain liquid assets ratio, on an ongoing basis, over the prescribed liabilities.

(c) **Suspension of interest on non-performing advances and classification of bad and doubtful debt for provisioning purposes (August 1997) –** Since there was no uniform practice observed by licensed banks with regard to the suspension of interest accrued but uncollected on non-performing advances and classification of advances for provisioning purposes, these mandatory prudential norms were introduced to establish a common standard for income recognition and loan loss provisioning, which would be in line with the accepted international best practices.

(d) **List of qualified auditors (April 1998)** – The Central Bank having regard to the need to ensure that experienced and qualified auditors are engaged in auditing accounts of licensed banks, has transmitted a list of selected qualified auditors to audit the accounts of licensed banks.

(e) **Publication of audited annual accounts (June 1998)** – Since there was no uniform format observed by licensed banks with regard to the publication of their audited financial statements and minimum disclosure, the Central Bank has prescribed the form of the Balance Sheet and Profit & Loss Account together with minimum disclosure requirements in line with the Sri Lankan Accounting Standards for licensed banks to comply with.

(f) **Limitation on ownership in share capital in banks (October 1988)** – In order to avoid licensed banks from being owned and controlled by a selected group of people and undue influence by such investors on the manner in which banking businesses are conducted, the Central Bank imposed limitations on maximum ownership in shares of licensed banks by individuals/companies and their close relatives/related companies individually or in aggregates to ensure soundness of the banking system.

(g) **Single borrower limit (October 1999)** – The objective of these regulations was to limit accommodation granted to a single borrower to a predetermined level of capital funds of the lending bank with a view to avoid credit risk concentration of the bank and also by all banks to a single borrower.

(h) **Customer due diligence** – Know Your Customer procedures (December 2001) – In order to prevent unchecked use of the financial system for money laundering and transactions related to terrorism and subversive activities, the Central Bank had issued these guidelines on customer identification at the time of opening an account for a prospective customer or before establishing a business relationship with a prospective customer or thereafter when there is a material change in an account operated. These guidelines are also expected to provide protection against possible frauds, and enable timely recognition of suspicious transactions and protect the bank from reputational, legal and financial risks.

(i) **Code of corporate governance for banks and other financial institutions (June 2002)** - In view of the growing concerns on financial instability resulting from inadequate corporate governance, the Central Bank felt that it was necessary to formulate a national consensus for corporate governance as one of the critical pillars of the national financial architecture for economic development through improved performance of banks and financial institutions. With the financial assistance of the working group on corporate governance of the Commonwealth Secretariat funded by Commonwealth Fund for Technical Co-operation, the National Task Force on Corporate Governance in the Banking and Financial Sector constituted with eminent and influential professionals, was setup by the Central Bank in May 2001 as an initial step towards promoting corporate governance at national level.

The National Task Force on Corporate Governance in the financial sector had been able to put in place the above code of corporate governance. Even though the principles and guidelines set out in the Code of corporate governance were not intended to be treated as regulations, they were expected to be treated as standards of conduct by the financial institutions to maintain the integrity and stability of the financial system.

The publication issued by the Commonwealth Secretariat on "Review of Corporate Governance in the Banking and Financial Sector in Sri Lanka" (December 2000) suggested that the Central Bank of Sri Lanka leas the inauguration of a comprehensive national strategy in applying and promoting corporate Governance in a systematic manner.

(j) **Inter-Regulatory Institutions Council (2007)** – In order to strengthen existing regulatory framework, monitor systemic risks of financial conglomerates and to facilitate consolidated supervision the Inter-Regulatory Institutions Council (IRIC) was setup. Current membership of IRIC includes representatives of the Central Bank, Insurance Board of Sri Lanka, Securities & Exchange Commission, Colombo Stock Exchange, Office of the Registrar of Companies, Institute of Chartered Accountants of Sri Lanka and Office of the Commissioner of Co-operative Development.

(k) **Directions on mandatory corporate governance for banks (2007)** – In view of the importance of proper governance in banks for the overall banking sector stability, which is fundamental to the financial system stability, the Central Bank has issued directions on mandatory corporate governance to improve and sustain the corporate governance processes and practices of banks. The corporate governance processes and practices referred to in the above mentioned directions are deemed to be the management framework that facilitates the conduct of the banking business in a responsible and accountable manner. These mandatory corporate directions have been formulated based on eight core principles as follows:

(i) The board of directors should assume the overall responsibility and accountability for the management of affaires of the bank, i.e. conduct of business and maintenance of prudential risk management mechanisms, and safety and soundness of the bank.

(ii) The composition of the board shall be in such manner that the element of independence and required skills levels are reflected in the overall strategic decision making process.

(iii) Only the persons deemed fit and proper to hold office as directors of a bank shall be appointed to the board.

(iv) There should be clear demarcation between corporate governance and corporate management so that the board members do not involve in day to day management of affairs of a bank.

(v) Overall strategic policy direction and governance should be the area coming under the chairman and the board whereas day to day management of business and risk rest with the chief executive officer.

(vi) In order to ensure strict oversight while maintaining impartiality, board is expected to appoint its subcommittees with specific terms of reference.

(vii) Transactions with related parties shall not grant such parties more favourable treatments than that accord to other constituents.

(viii) Information relating to the business and risk management of banks should be disclosed in a transparent manner so that the market discipline would be promoted.

(l) **Asset bubbles and requirement for additional provisions (2006)** - With a view to bring about an extra capital cushion during the financial and economic stress and mitigating any possible threat to the banking industry and thereby the financial system, the Central Bank required licensed banks to maintain a general loan loss provision of 1% against performing loans and loans in the special mentioned category. This proactive measure of the Central Bank had proven to be a well though prudential measure and had the desired effect on licensed banks during the global financial turmoil.

(m) **Dealing with failed banks and finance companies (2008)** - Weak banks and non-bank financial institutions pose a continuous challenge for bank regulators worldwide. Bank failures cause huge indirect and direct costs to the economy. Such failures not only shrink economic values of assets and businesses but also jeopardise stability and public confidence in the financial system. Thus, the objective of these guidelines was, at best, to prevent the occurrence of weak banks or, at least, to reduce its harmful effects to the economy. On the basis of the experience gained in handling weak financial institutions in 2007 and 2008 the Central Bank has put in place a mechanism consists of the techniques for identifying weak banks and financial institutions, corrective measures to turn around those institutions and resolution and exit strategies for such failed financial institutions on solo basis, based on "Supervisory guidance on Dealing with weak Banks" evolved by the Basel Committee on Banking Supervision.

(n) **Risk management relating to foreign exchange business (2009)** - These directions have been issued to standardise and strengthen foreign exchange risk management guidelines in licensed commercial banks and increase their soundness, thereby strengthening financial system stability.

(o) **Mandatory Deposit Insurance (2010)** - The Sri Lanka Deposit Insurance Scheme (SLDIS) was implemented to protect small depositors from failure of financial institutions, to promote small-depositor-confidence and in the interest of the overall financial system stability of the country. Under the provisions of the Monetary Law Act, SLDIS came into effect from 1 October 2010 with an initial capital of Rs.1.1 billion provided by the Central Bank. The members of SLDIS, i.e. licensed banks and registered finance companies, are require to pay annual premium ranging from 0.10% to 0.15% p.a. on a monthly/quarterly basis. SLDIS is distinctly separate from the Central Bank.

(p) **Cap on interest rates (2010)** - In view of the slow progress shown by banks in reducing risk premia added to lending rates in response to the improved macro economic performance and stability since early 2009, the Central Bank required all banks to take urgent measures to reduce interest rates on housing loans and credit card advances to at least 14 per cent per annum and 24 per cent per annum, respectively, by end of October 2010. The Central Bank further required banks to reduce lending rates on other loans and advances by around 1-2 per cent per annum.

(q) **Minimum capital requirement and cap on liabilities and profits for non-compliant finance companies (2011)** - The Central Bank has observed several issues in common relating to few non-bank financial institutions within two business groups during the period from 2007-2010. These common features had resulted in negative capital and accumulated losses in those companies. Having acted on time, the Central Bank made it mandatory for registered finance companies at all times maintain an unimpaired minimum capital. Further, regulatory sanctions, including cap on total amount of deposits and debt and prohibition of payment of dividend, until the minimum capital requirement is complied with, have been enforced against registered finance companies that have failed to ensure the compliance with the above requirement.

Note: (a) Most of the early dated regulations have been revised or amended subsequently in line with domestic or international developments

(b) Financial regulations were initially aimed at the activities of banking institutions. However, with the failure of non-bank financial institutions in late 1980s, most these banking sector regulations were customised to develop a regulatory regime covering the activities of non-bank financial institutions.

Present Regulatory Framework

The Central Bank has been a continuous promoter of the development of the financial system of the country. Thus, the regulatory framework of the Central Bank, which has evolved over the past six decades, provides a comprehensive institutional setup for the three pillars of stability i.e. governance, risk management and compliance, in regulated banks and non-bank financial institutions and payment and settlement systems.

Governance is self-discipline. It is the process that facilitates the conduct of businesses of regulated entities, i.e. licensed banks and non-bank financial institutions, in a responsible and accountable manner so as to promote the safety and soundness of individual financial institutions, thereby leading to the stability of the overall financial system.

Corporate governance and corporate management are of critical importance for the smooth functioning of regulated financial institutions. The two are constantly depending on each other. Well-structured channels of communication, accommodation of valuable inputs from each are essential for efficient and effective functioning and growth of licensed financial institutions. While appreciating the significance of the aforesaid cohesive character of the governance and management, the regulatory experience of the Central Bank highlighted the urgent need for demarcating the areas of responsibility, authority and accountability of the governance distinct from that of the management. Further, it has been observed that governance and management stepping into each other's area has been a root cause of many malpractices developing, persisting and proving detrimental to the interest of depositors, creditors and other stakeholders. In view of the foregoing, the Central Bank has introduced the Mandatory Corporate Governance for licensed financial institutions in December 2007.

The Central Bank recognises the need for having in place a set of prudential norms covering major risks to ensure that individual financial institutions are not vulnerable to any of these risks. Therefore, a comprehensive set of prudential norms, covering all major risks, has been developed to be strictly adhered to by all regulated financial institutions. In order to ensure compliance with the above mentioned prudential norms on an ongoing basis by licensed financial institutions, the Central Bank has put in place a robust ongoing monitoring system (Continuous Supervision) based upon periodic regulatory returns submitted by regulated institutions. Additionally, a risk based statutory examination process has been in place to identify risks, manage these risks and assess the adequacy of resources to mitigate these risks and the compliance of licensed financial institutions with statutory requirements, applicable laws and regulations, internal controls and the standards of corporate governance. Matters relating to non-compliance with prudential requirements of weaknesses and deficiencies in the financial condition, controls and systems of financial institutions are brought to the notice of its Board of Directors, by the Central Bank to ensure that timely corrective action is taken.

Compliance relates to the need for regulated financial institutions to independently ensure compliance with applicable laws and prudential regulations of the Central Bank. The Central Bank requires compliance to emerge from an ongoing board-level engagement for execution of business processes designed to manage risks and to continuously benchmark against expected parameters/tolerance levels applicable for the entire industry, laws, regulations, international best practices, internal policies and procedures. Recently, the Central Bank extended its regulations relating to compliance to cover specific areas such as operations of money laundering and terrorist financing.

The financial regulations of the Central Bank only provide minimum parameters based on international best practices. Thus, financial institutions have the operational flexibility in evolving own more stringent parameters, compatible with the Central Bank's regulatory regime, their balance sheet profile and complexity of operations and expertise, to mitigate any potential adverse impact of the risk category under consideration.