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Management of Bank's Liquidity Risk: Best Practices and Regulation

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1. Introduction

As financial intermediaries, banks play a crucial role in the operation of most economies. The banking system provides an essential store of liquidity by providing deposits valued at par and payable on demand and a mechanism to make payments that are essential for the completion of financial transactions in the economy. These functions make the role of a banking system vital for any given country. The collapse of the US Sub Prime Mortgage market and the assets and liability mismatch (a liquidity problem lead to sudden deposit withdrawals) at Northern Rock Bank in UK have highlighted the importance of bank's liquidity management for the well-functioning of the financial system.

As a result of the financial system crisis, many supervisors and regulators of the financial system woke up, making special note to banks' liquidity and they differentiate it from the bank's capital. Accordingly, an attempt was begun to understand the liquidity risk of the bank and its key characteristics and linkages with the other financial risks. Thus, the liquidity risk is considered as a secondary risk, that rises in liquidity risk usually follows the increase in other financial risks. They differentiated the coverage of liquidity risk from the coverage of other financial risks and identified the usage of capital (as a cushion) was at minimal for the liquidity risk. Their recommendation was to generate more cash inflows in banks by selling liquid and high-quality assets. However, capability of raising additional liquidity by selling assets totally depended on bank's balance sheet position (strength), bank's role in the market and the ability of the market (market liquidity) to absorb additional assets sold by banks.

Meanwhile the publication of Basel Committee on Banking Supervision on *"Liquidity Risk Management in Banks and Supervisory Challenges"* highlighted that many banks had failed to take account of a number of basic principles of liquidity risk management when liquidity was abundant. It has further stressed the most exposed banks did not have an adequate framework that satisfactorily accounted for the liquidity risks posed by individual products and business lines, and therefore incentives at the business level were misaligned with the overall risk tolerance of the bank. In view of these scenarios, in addition to the introduction, this article will provide a brief discussion on practices of liquidity risk management in banks and a note about the regulations and core principles for the liquidity risk management of a bank.

2. Liquidity for a bank

A simple definition on bank's liquidity can be given as a bank's ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the bank. As a player of financial intermediation, the basic business model of a bank is matching short term funds (deposits from the customers) with the long term assets by creating a negative maturity gap of assets and liabilities. This negative maturity gap will create liquidity risk (shortfall of net funding) for the banks, if the banks are unable to raise the funds from the banks themselves or from the market that they are operating in, without incurring additional cost to them. Accordingly, the liquidity risk can identify that the inability of a bank to meet its obligations/commitments as they become due, without adversely affecting the bank's financial condition.

Effective and efficient liquidity risk *management ensures a bank's ability to meet its obligations as they fall due and* reduce an adverse impact (loss) on its profit and ultimately balance sheet of the bank. The post-financial crisis distinguishes liquidity risk faced by banks into two major categories namely funding liquidity risk and market liquidity risk.

The Funding liquidity is a level of liquidity in a bank whereby the bank is able to meet its current and future cash flow and collateral needs, both expected and unexpected, without materially affecting its daily operation or overall financial condition. The funding liquidity position of a given bank is determined pri-marily by its holdings of cash and other readily available marketable assets, as well as by its funding structure and the amount and type of contingent liabilities that may become due over a specified time horizon.

The market liquidity is defined as the ability of the participating banks in the financial market (interbank market) to exchange their financial assets quickly without any material effect on prices/costs. The market liquidity position of a given financial market is determined by the ability to trade any amount of assets at short notice, at low cost and with little impact on its price at any time within trading hours with the minimum loss of value.

Regulators and policy makers are usually not much concerned of a funding liquidity risk in a single bank if it would not make a channel of contagion that exacerbates system-wide instability. However, the problem arises when funding liquidity risk is transmitted from a single bank to more than one bank that exacerbates system-wide instability due to liquidity risk becoming systemic. All financial market players including banks are linked by a common market such as interbank market for liquidity. Therefore, one bank disaster due to shortage of funding liquidity may reduce the common pool of liquidity that links all financial market players including banks together, resulting in the transmission of liquidity shortage to other financial market players and banks. If the situation is the illiquidity in the interbank market, impaired liquidity risk in the interbank market could be transmitted to the asset markets as banks may seek liquidity through fire-sales, thereby impacting asset prices and ultimately market liquidity. Resulting asset price changes in the books of financial institutions would begin to show up in changes in net worth of the financial market players and banks, leading to adjustment on their balance sheet. The process would result in further asset sales and distress pricing in assets which can lead to a downward liquidity spiral in the markets due to the interaction between funding and market liquidity.

3. Liquidity Risk Management for Banks

Managing and generating of assets through financial intermediation is a fundamental function of a bank. This may involve a maturity transformation of short-term deposits into long-term loans that is inherently vulnerable to liquidity risk by the banks. The process of actively managing the assets and liability mismatches on a bank balance sheet is known as liquidity risk management. The liquidity risk management of a bank is of paramount importance because a liquidity shortfall at a single bank can have system-wide repercussions. As a result of recognizing the significance of liquidity risk management of banks, many banks establish a framework of liquidity risk management as an integral part of their overall risk management framework which includes identifying, measuring, monitoring and controlling all material sources of liquidity risks appropriately and spot and manage it well in time.

a) The Governance Structure and Administration of Liquidity:

The Board of Directors is responsible to formulate, approve and establish a liquidity risk management framework of a bank align with its overall risk and business strategy and corporate value together with an effective risk governance structure. Accordingly, the Board is responsible for designing of an organizational set-up for the liquidity risk management considering size and business complexity of banks, legal and regulatory framework of the jurisdiction in which it operates and nature of liquidity risk the bank is exposed to. The Board should also ensure the resources of competent staff for the liquidity risk management function. Commonly, the Asset and Liability Management Committee (ALCO) consisting of the senior management including the Chief Executive Officer is responsible for administering and managing liquidity risk management of a bank subject to the oversight by the Board or Board level Committee.

The ALCO or any other committee assigned to monitor the liquidity risk management of a bank should actively monitor its liquidity risk profile and have adequate broad representation within the bank,

including finance, treasury, credit, marketing, branch operations, investments and risk management. The committee members should ensure that the system set up for liquidity risk management is able to adequately identify and measure the risk exposure and should also ensure that the bank has an information system which is sufficiently flexible and able to prepare and provide timely, accurate and relevant reports to senior management and the board about the bank's liquidity risk exposures.

b) Liquidity Risk Management Policy, Strategy and Procedures:

ALCO or the senior management should develop a policy, strategies and practices to manage liquidity risk in accordance with the risk tolerance level of the bank. Areas relevant to the governance structure, responsibilities and controls for managing liquidity risk and the strategy of risk analysis, evaluation, treatment and reporting should be documented and elaborated in liquidity risk management policy or/ and procedural manual of the bank. The board should approve the policy strategies and practices related to the management of liquidity risk at banks and they should review them at least annually or whenever necessary.

The effective liquidity risk management policy of a bank should include an overall liquidity risk appetite that is appropriate for the bank's business and its role in the financial system, the liquidity risk tolerance, funding strategies, prudential limits, effective information systems to enable active and timely identification, measuring, aggregation, assessing, monitoring and control of liquidity risk exposures and funding needs, framework for stress testing, liquidity planning under alternative scenarios/formal contingent funding plan, nature and frequency of management reporting, periodical review of assumptions used in liquidity projection, etc. The policy should also address adequate oversight by the bank's Board in ensuring that management effectively implements policies and processes for the management of liquidity risk in a manner consistent with the bank's liquidity risk appetite. The Board should ensure to carry a regular review of the bank's liquidity risk management policy appropriately to make adjustments to the bank's strategy, policies and processes for the management of liquidity risk in the light of the bank's changing risk profile and external developments in the markets and macroeconomic conditions in which it operates.

c) Measurement and management of Liquidity Risk by banks:

Two common approaches are adopted by the banks to measure their liquidity risk namely stock approach and flow approach. Under the stock approach the banks may use certain financial ratios such as core deposits to assets, loan and advances to deposits, volatile liabilities to total assets and liquidity assets to total liabilities to measure the liquidity risk of banks. The banks monitor these ratios by putting in place an internally defined limit approved by the Board for these ratios. The banks fix their limits on these ratios, based on their liquidity risk management capabilities, experience and profile.

The flow approach determines liquidity/net funding requirements of banks by analyzing the bank's current and future cash flows based on assumptions of the current and future behavior of assets and liabilities that are classified into specified time buckets and then calculating the cumulative net flows over the time frame for liquidity assessment. Accordingly the cash flows are required to be placed in different time bands based on the residual maturity of the cash flows or the projected current/future behavior of assets, liabilities and off-balance sheet assets and liabilities. The cash flow analysis shows that a bank's projected sources and uses of funds under various time buckets, identifying potential funding shortfalls or gaps thus becomes a starting point for the measure of a bank's liquidity surplus or deficit. The banks should work to limit these funding gaps (cumulative) and should have plans established to address significant potential funding shortfalls (gaps) as liquidity risk management strategy.

d) Liquidity Contingency Funding Plan (CFP):

An analysis of the recent global financial market turmoil has shown that there were substantial unplanned events which influenced the funding decisions of banks. Such events included, but were not limited to, the inability to fund asset growth; difficulty renewing or replacing funding as it matures; the exercise of options by customers to withdraw deposits or to draw down lines of credit;

the demise of a business line; market disruptions and funding and investment strategies of banks that are concentrated in one or few business lines or relationships typically are at greater risk of being disrupted by adverse financial market events. The contingency funding plan sets out the plan of action that the bank would use to fund business activities in such type of crisis situations and periods of market stress.

Hence, the Liquid Contingency Funding Plan (CFP) outlines a list of potential risk factors, key reports and metrics that are reviewed on an on-going basis to assist in assessing the severity of, and managing through, a liquidity crisis and/or market dislocation. The CFP also describes in detail the bank's potential responses if their assessments indicate that the bank has entered a liquidity crisis, which include pre-funding for what they estimate will be their potential cash and collateral needs as well as utilizing secondary sources of liquidity. The CFP identifies key groups of individuals to foster effective coordination, control and distribution of information, all of which are critical in the management of a crisis or period of market stress. The CFP also details the responsibilities of these groups and individuals, which include making and disseminating key decisions, coordinating all contingency activities throughout the duration of the crisis or period of market stress, implementing liquidity maintenance activities and managing internal and external communication.

e) Liquidity Stress Testing:

A well designed and implemented stress testing framework would supplement banks' risk management systems and help in making these systems more robust. The stress testing framework also helps banks to be better equipped to meet the stress situations as and when they arise and also overcome them such that they do not become a serious threat to themselves or to the banking systems in which they operate. The liquidity stress tests allow banks to assess the possible impact of exceptional but plausible stress scenarios on their liquidity position. The Stress test on liquidity examines whether banks have enough net cash inflows or liquid assets to withstand cash outflows in a stress scenario. The banks may encounter a liquidity shortage when they cannot generate sufficient cash in response to a shock. The results of the stress tests can help banks to determine the size of liquidity buffers against potential liquidity shocks to adjust its liquidity risk management strategies, policies and positions and to develop effective contingency funding plans.

4. Regulatory Standard For Bank's Liquidity Risk Management

During the period of the recent global financial crisis, one of the main criticisms on regulatory standards (Basel I and Basel II) was the lack of formulation of formal regulatory standards of bank's liquidity risk management, as the liquidity risk issues caused the collapse of certain banks and heightened systemic risks for certain economic jurisdictions. Further, the European Central Bank recently revealed that the banks' liquidity risk management is an important issue for Central Banks/regulators because liquidity shocks at one bank can have contagion effects and could disrupt the efficiency and stability of the money market via three major channels[1] as indicated below:

> *First, owing to asymmetric information, a liquidity crisis at one bank can lead to increasing uncertainty in the wholesale and retail markets with regard to the liquidity situation of other banks, which – in severe cases – could in turn lead to a drying-up of money market liquidity and/or to a bank run. In less severe cases, it could raise refinancing costs for other banks and increase uncertainty with regard to future cash flows and market conditions, which exacerbates liquidity management.*
>
> *Second, the large and increasing share of interbank exposures and money market instruments in banks' funding can cause contagion, as liquidity problems at one bank directly translate into increasing liquidity pressure (e.g. owing to reductions in cash inflows and unexpected refinancing requirements) on its interbank counterparties.*
>
> *Third, asset fire sales can lead to a market meltdown under certain circumstances, which in turn decreases the counterbalancing capacity of all banks and, consequently, their liquidity risk-bearing capacity.*

Given these regulatory impotencies of liquidity risk management of banks, the Basel Committee on Banking Supervision, which is an apex body of setting the framework of minimum standards for sound regulatory/ supervisory practices, has published *"Principles for Sound*

[1] EU Banks's Liquidity Stress Testing and CFP - November 2008

Liquidity Risk Management and Supervision" in September 2008 as an international framework for sound liquidity risk management for banks including the following 13 core principles[2] covering 4 major areas.

4.1 A fundamental principle for the management and supervision of liquidity risk in banks:

Principle 1: *A bank is responsible for the sound management of liquidity risk. A bank should establish a robust liquidity risk management framework that ensures it maintains sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources.*

4.2 Governance of liquidity risk management in banks

Principle 2: *A bank should clearly articulate a liquidity risk tolerance that is appropriate for its business strategy and its role in the financial system.*

Principle 3: *Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank's liquidity developments and report to the board of directors on a regular basis. A bank's board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manages liquidity risk effectively.*

Principle 4: *A bank should incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole.*

4.3 Measurement and management of liquidity risk in banks.

Principle 5: *A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk. This process should include a robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons.*

Principle 6: *A bank should actively monitor and control liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to the transferability of liquidity.*

Principle 7: *A bank should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an on-going presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. A bank should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.*

Principle 8: *A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.*

Principle 9: *A bank should actively manage its collateral positions, differentiating between encumbered and unencumbered assets. A bank should monitor the legal entity and physical location where collateral is held and how it may be mobilised in a timely manner.*

Principle 10: *A bank should conduct stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance. A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies, and positions and to develop effective contingency plans.*

Principle 11: *A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust.*

Principle 12: *A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios, including those*

[2] Basel Committee on Banking Supervision (BCBS) 2008. "Principles for Sound Liquidity Risk Management and Supervision" available at http://www.bis.org.

that involve the loss or impairment of unsecured and typically available secured funding sources. There should be no legal, regulatory or operational impediment to using these assets to obtain funding.

4.4 Public disclosure

Principle 13: *A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position.*

5. Basel III - Liquidity Standards

Two minimum ratios of liquid assets to be maintained by a bank have been prescribed to complement the above principles by the Basel Committee under the Basel III Liquidity standards. These ratios are Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

a) **Liquidity Coverage Ratio – LCR:** The LCR is intended to promote resilience to potential liquidity disruptions over a thirty day horizon. It will help ensure that banks have sufficient unencumbered, high quality liquid assets to offset the net cash outflows it could encounter under an acute short-term stress scenario. High-quality liquid assets held in the stock should be unencumbered, liquid in markets during a time of stress and, ideally, be central bank eligible.

b) **Net Stable Funding Ratio –NSFR:** The NSFR requires a minimum amount of stable sources of funding at a bank relative to the liquidity profiles of the assets, as well as the potential for contingent liquidity needs arising from off-balance sheet commitments, over a one-year horizon. The NSFR aims to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items.

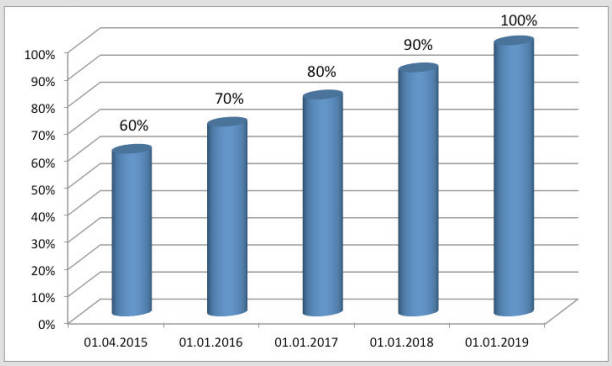
6. Liquidity Regulation and the facility of Lender of Last Resort in Sri Lanka

As the regulator of the banks, the Central Bank of Sri Lanka (CBSL) has imposed a major regulatory measure on banks' liquidity risk management namely, the Statutory Liquidity Asset Ratio (SLAR), Liquidity Coverage Ratio (LCR) establishment of a Liquidity Risk Management Framework (LRMF) as a part of regulation on an integrated risk management framework for the licensed banks, Sri Lanka Deposit Insurance and Liquidity Support Scheme (SDILS) and facility of Lender of Last Resort.

6.1 Statutory Liquidity Asset Ratio - (SLAR): The banks operating in Sri Lanka are required to maintain a minimum 20% of statutory liquidity assets of their liabilities, excluding capital funds. The bank should measure the statutory liquidity assets in accordance with Section 86 of the Banking Act, No.30 of 1988. Accordingly, the CBSL deems some asset items of the bank balance sheet as liquid assets considering their liquidity generating capacity. Failure to maintain the SLAR would result in a cash penalty for the banks.

6.2 Liquidity Coverage Ratio – LCR: CBSL issued the direction No.01 of 2015 dated 31.03.2015 for the implementation of Liquidity Coverage Ratio for Licensed Commercial Banks operating in Sri Lanka in accordance with "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring". At the beginning, LCR computation was applicable to licensed banks on a standalone ("Solo") level including overseas operations through their branches. Currently the licensed banks are required to submit two separate returns on a monthly basis on Rupee Liquidity Minimum Requirement for local currency operations and All Currency Liquidity Minimum Requirement for the overall operations. All banks in Sri Lanka should meet LCR at 100% on 01 January 2019 onwards as a progressive phase –in arrangement given in figure I

Figure – I : Effective minimum LCR for Banks in Sri Lanka



6.3 Liquidity Risk Management Framework (LRMF): As a part of regulation on an integrated risk management framework for the licensed banks issued by CBSL on 05.10.2011 all licensed banks

were required to establish a robust Liquidity Risk Management Framework. The LRMF of a licensed bank should include the clearly articulated liquidity risk management policies, procedures and strategies and a robust governance structure (commensurate with the size and complexity of the bank's operations) that comprise an effective oversight by Board of Directors and senior management (ALCO), periodic assessment, review and monitoring of liquidity profile and frequent reporting mechanism, measurement of liquidity through stock or flow approaches, evaluation of liquidity profile under different stress situations (banks specific crisis and market crisis scenarios) and availability of liquidity contingency plans to measure banks' ability to withstand bank specific or market crisis scenarios.

6.4 Sri Lanka Deposit Insurance and Liquidity Support Scheme (SDILS): The Sri Lanka Deposit Insurance Scheme has been established by the CBSL under the provision of the Monetary Law Act in the interest of the overall financial stability of the country through the protection of small depositors from failure of financial institutions, thereby promoting the stability of financial institutions by maintaining small – depositor – confidence and commenced its operations with effect from 01 October 2010. The Sri Lanka Deposit Insurance Scheme has been renamed as "Sri Lanka Deposit Insurance and Liquidity Support Scheme" with effect from 22 November 2013 to publicize the availability of liquidity support (subject to the collaterals) for needy financial institutions thereby further enhancing the public confidence on the financial system and strengthening the overall financial stability of the country. The Sri Lanka Deposit Insurance and Liquidity Support Fund is operated and managed by the CBSL.

6.5 Facility of Lender of Last Resort

As a bank regulator, CBSL may be liable to provide liquidity facility as lender of last resort to licensed banks by granting extraordinary loans or advances or renewing existing loan facilities secured by the collateralized loans or government securities. The licensed banks can utilize the facility as lender of last resort in periods the CBSL considers that of an emergency or of imminent financial panic which directly threaten the financial system stability. The CBSL charges a penalty rate on this facility and it is higher than other market rates. A Licensed bank by which a lender of last resort facility is enjoyed shall not expand the total volume of its loans and investments except with the prior approval of the CBSL.

7 Conclusion

Recent global banking crisis showed that the liquidity risk management was directly influenced by the soundness of individual banks or banking system of any economy. Therefore, the banks should prioritise to establish a comprehensive liquidity risk management framework which should address the market liquidity and funding liquidity. The sound liquidity risk management system should basically address the liquidity measurement, management and governance structure, contingency funding planning, liquidity stress testing and scenario analysis, minimum disclosures and reporting. Basel committee on Banking Supervision has introduced several principles based requirements for effective liquidity risk management in banks including two minimum standard ratios to measure the liquidity risk in banks based on their time horizons. The two ratios are also useful for the regulators to measure and monitor funding liquidity of the banks under their supervision.

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Current Economic Indicators

Policy Rates - Effective 24 March 2017

Current Policy Rates (Per cent per annum)	
Standing Deposit Facility Rate (SDFR)	7.25
Standing Lending Facility Rate (SDFR)	8.75
Bank Rate	15.00
Statutory Reserve Ratio (SRR)	7.50

Standing Deposit Facility Rate (SDFR): Effective 02 January 2014, SDFR provides the floor rate for the absorption of overnight excess liquidity from the banking system by the Central Bank. This replaced the Repurchase Rate of the Central Bank which was in effect until 02 January 2014. With effect from 01 February 2014, the Standing Deposit Facility of the Central Bank is uncollateralized.

Standing Lending Facility Rate (SLFR): The Interest rate applicable on reverse repurchase transactions of the Central Bank with Commercial banks on an overnight basis under the Standing Facility, providing the ceiling rate for the injection of overnight liquidity to the banking system by the Central Bank. Prior to 02 January 2014, this rate was called the Reverse Repurchase rate of the Central Bank.

Bank Rate: The rate at which the Central Bank grants advances to commercial banks for their temporary liquidity purposes, stipulated under section 87 of the Monetary Law Act.

Statutory Reserve Requirement (SRR): The proportion of rupee deposit liabilities that commercial banks are required to maintain as a deposit with the Central Bank, subject to an allowance for vault cash balances of more than two per cent but not exceeding four per cent of deposit liability, which could be deducted from the requirement.

Source: Central Bank of Sri Lanka
website: www.cbsl.gov.lk

Rationale of Financial Regulation: Facts Vs Myths

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The financial Tsunami that occurred during 2008-2009 washed away gigantic financial institutions mercilessly from the shores of financial systems. In fact the meltdown proved the fact that financial crises have more severe impact on output and employment than business downturn. Consequent to the global financial turmoil there have been dramatic changes to the regulatory frameworks for financial institutions all over the world. These regulatory developments have taken place both at global and domestic levels. Adopting Basel III capital requirements, introducing special resolution regimes for financial institutions, changing regulatory architectures, improving derivative markets, reforming deposit insurance schemes, strengthening accounting standards and developing macro prudential frameworks are examples of such regulatory responses.

Along with tightening financial regulatory regimes, debates on the volume of such regulations as well as their proportionality and effectiveness have also come to the forefront. Overall, the regulatory perspective towards missteps by financial institutions have become less forgiving due to the adverse impact of such violations on financial systems across the globe. The broader regulatory compliance and risk management requirements associated with the responses to the crisis is further reflected in the trend of imposing huge penalties by the law enforcement authorities. Ranging from the mis-selling of subprime mortgages to the manipulation of global foreign exchange markets, regulatory fines have led to enhanced legal risk for financial institutions. It has been reported that the regulatory fees paid by the US and the EU Universal banks during the period 2009-2014 has significantly increased relative to banks' earnings and credit losses.

Considering the trend of mounting regulatory risk for financial institutions, it is topical to shed light on the rationale for financial regulation with the emphasis on separating perceptions from realities. In fact, today's highly competitive and complex financial markets, with blurred boundaries would definitely require comprehensive regulatory framework to rectify the market imperfections. This article will accordingly discuss the key elements of the rationale of financial regulation

along with myths and truths pertaining to modern financial regulation.

Why are financial institutions not set free from regulation?

Despite the financial regulatory landscape having been subject to significant changes after every financial crisis, there are still arguments on the need for such regulation for financial services. Kevin Dowd (1997), a scholar who argued in favor of free banking is of the view that unregulated banking does not cause inflation of the money supply or of prices, and unregulated competition among banks does not destabilize the banking system. Despite free bankers arguing that best governance is self-governance, financial turmoil of recent years proved that self-governance would not always be effective. In fact the global financial crisis seriously undermined the credibility of "efficient market hypothesis". Every financial crisis situation has proved that lack of integrity in financial institutions has been a root cause for such distressed situations. The absence of integrity and a compliance culture in financial systems have attracted more stringent regulatory frameworks. According to the definition developed by Financial Conduct Authority of the UK, compliance requirements are aimed at creating a culture where everyone has ownership and responsibility for doing the right thing. Accordingly, when the alleged first best solution i.e. freely functioning markets fails, the second best alternative of appropriate regulation becomes inevitable.

Need to safeguard the rights and interests of the customers.

Customers of financial institutions are vulnerable to being misled. While financial institutions are focused upon the profit maximization goal there is room for actions detrimental to the rights and interests of the customers. Since they have become the main source of funds for banks and other financial institutions, protecting their rights is of paramount importance. Inserting unfair terms and conditions in the contracts and failure to provide accurate disclosures on transactions are widely discussed misbehaviors. Charles Goodhart (2009), states that protecting the customer against monopolistic exploitation is a key objective of financial regulation. Another opinion states that business activity should be regulated as companies are licensed by the government. Financial innovations that have been designed to circumvent applicable laws also justify the need for financial regulation.

It can be argued that caveat emptor rule i.e. "buyer beware" concept cannot be applied in simple terms to the financial services. The awareness of the customers about the financial products, particularly complex instruments would depend on the amount of information available to customers. Therefore, in the context of today's financial markets there should be regulations in place to address information asymmetry in order to enable the customers to take informed decisions on their investments.

Need to regulate the conduct of business

Subsequent to the global financial crisis greater emphasis has been placed on the conduct of business by financial institutions. Such regulations focus on how and why transactions are undertaken and their impact on customers and wider financial markets. This element of regulation has also been identified as shifting towards monitoring and challenging corporate culture. Corporate governance, organizational systems, fitness and propriety requirements and controlling abusive related party transactions have been given prominence under the modern conduct of business regulation. Confining

such regulation only to technical rules would not be successful in the milieu of todays complex financial markets.

Widespread mis-selling of retail mortgages reported in the USA is an example of triggering instability in the financial system due to non-compliances with conduct of business regulations. Hence, the manner in which the financial transaction are executed needs to be subject to prudent norms and principles, as the outcome may have an impact on resilience of the particular financial firm and its customers. Regulatory intervention into business decisions would nevertheless require a balanced approach.

Along with this focus on the conduct of business, capital regulation of financial firms also assumes importance. If no regulatory capital requirement is available, such entities would run without having capital which is built up during good times to face the gloomier times associated with downturns in the economy. Robert Jenkins (2015), former Bank of England policymaker explains the myth related to capital regulation as follows. *"Capital is there not just for the risks we think we understand – it is there for the ones we don't."* It was evident during the financial crisis that under-capitalized banks could not absorb losses and had to be bailed out with tax payers' money. Hence the argument that regulatory capital requirements compel firms to set aside sufficient capital, appears to be a myth. One of the lessons from the global financial crisis is that such requirements need to be complemented by stress tests to ensure that there is a sufficient capital buffer to support lending in a downturn.

There is no "one size fits all" type regulatory model

In considering the rationale for regulation, the nature of the financial regulatory landscape should also be taken into account. Splitting the single regulator of the UK into two in respect of conduct of the business and prudential regulation was the most recent change of financial regulatory architecture. The Financial Conduct Authority (FCA) has been charged with the responsibility of ensuring the well-functioning of the financial markets, consumer protection, market integrity and competition. It has been revealed that there is no "one size fits all" kind of regulatory architecture. The effectiveness of a particular regulatory landscape cannot be fully assessed until there has been another financial crisis.

The single regulator model has been successful for some jurisdictions whereas the twin peak model has been an efficacious structure for some other countries. Therefore, trying to plant a regulatory model disregarding country specific circumstances would create a dysfunctional outcome. In designing a regulatory architecture for a particular financial system it is imperative to ensure that there are no overlaps between requirements imposed by various regulatory bodies. Regulatory cost for the financial institutions can be reduced by ensuring cohesiveness of regulatory requirements and establishing efficient coordination between entities in a fragmented regulatory framework. Financial institutions also can explore mechanisms to meet requirements of all the regulators, including domestic and international authorities, by devising appropriate reporting methods.

Ensuring financial system resilience

It is considered that financial firms need to be regulated due to their inter connectedness, which results in contagion that causes systemic damage. The global financial crisis provided virtual evidence that turbulence in the financial sector can have rippling effects on the real sector of the economy, with a collapse in output and

employment in advanced economies. Unlike in other industries where failure of one firm creates an opportunity for the competitors, externalities caused by a collapse of a financial firm to the entire system is much more severe. Imposing systemic surcharges and levies under capital regulation are examples of regulatory responses for addressing systemic risk. Free marketers argue that when a crisis hits good banks have a strong incentive to distance themselves from bad banks and therefore the contagion effect does not materialize. Today's multifaceted and interconnected financial sector has, however, proved that exposures of individual institutions to other firms would be a cause to aggravate systemic risk.

Despite most of the regulatory reforms being focused on "too big to fail" institutions, it can be argued that depending on the system specific circumstances, even a tiny financial institution could trigger systemic instability. Financial regulation would, therefore, be a prerequisite to prevent or mitigate such systemic issues through greater scrutiny. Regulated entities can contribute towards the effectiveness of micro prudential regulation by ensuring the compliance. This will contribute to the success of macroprudential regulation which is focused on the systemic picture. Moreover, if there is no specific mechanism to ensure the orderly exit of an ailing institution from the system, it will exacerbate the consequences of the failure.

According to Maserano (2011), financial stability should be considered as a public good. Making financial institutions subject to a stringent regulatory framework can, therefore, be taken as a supply of this public good. According to Anat Admathi (2014) *"better regulation would produce a more stable financial system where banks would be more likely to make the kind of loans and investments that build and expand economic opportunity for society as a whole".*

Need to prevent misappropriation of public funds

There have been domestically and globally reported incidents where financial institutions misuse public funds through fraudulent transactions, financial malpractices, mismanagement and various financial crimes. According to Ricardo (1873), *the distinctive feature of the banker begins when he uses the money of others; as long as he uses his own money he is only a capitalist.* Therefore, the regulatory framework needs to be in place specifically to ensure that handling of public funds by financial firms is subject to proper systems and controls. Gorton (2010), states that "privately created bank money is subject to runs in the absence of government regulation". Restrictions on related party transactions, single borrower limits, business transactions with directors and directions related to investments by financial institutions can be considered as regulatory requirements imposed on the premise of the above mentioned monetary rationale. Therefore in modern financial regulation, attention of the authorities has been paid to preventing wrongful gains from financial misdemeanors and causing undue losses to financial institutions by various parties.

Special role played by financial institutions in the economy

The crucial financial intermediary function carried out by banks and other financial institutions, such as finance companies, emphasize their importance in the system. In fact solvent financial institutions are important for the solvency of the economy. The special role played by the banks is reiterated in the historic speech made by the late president of the USA, Mr. Roosevelt, in 1933 explaining his plans to stop a run on the banks. He went on to state:

"...let me state the simple fact that when you deposit money in a bank the bank does not put

the money into a safe deposit vault. It invests your money in many different forms of credit—in bonds, in commercial paper, in mortgages, and in many other kinds of loans. In other words, the bank puts your money to work to keep the wheels of industry and of agriculture turning round".

The above statement of President Roosevelt endorses another aspect of financial regulation i.e. fractional reserve banking. Since banks and finance companies keep only a fraction of all deposits, they are exposed to liquidity risk. This is an inherent risk of finance business. Apart from their role as the monetary policy transmitter, financial institutions also act as the heart of the payments and settlements system of the financial sector. The very special role of the banks may convert them to risk amplifiers in the event of a crisis. Therefore, the need for a special regulatory framework to address the problems in financial institutions is justifiable.

Free marketers, however, present the critique that financial regulation impedes innovation. But the global financial turmoil demonstrated that "financial innovation" and "financial engineering" led to unhealthy explosive growth of financial markets and amplified the risks. Over the Counter Derivatives, which were at the heart of the damage caused by the global financial crisis, were an example of the repercussions of unregulated financial innovation.

Requirement to ensure social justice

Financial institutions are vital for the purposes of financial inclusion in a country. They can reduce the percentage of the unbanked population and thereby discourage informal financial transactions. Financial inclusion requires careful planning due to the risks associated with rapid deepening. However, instead of attaching priority to the mere expansion of financial outreach, institutions should also focus on enhancing the quality of their services, effectiveness and efficiency. That argument warrants regulating financial institutions to achieve the social objectives, such as alleviation of poverty and enhancing access to finance, while maintaining financial system stability.

According to Thorton (1965) "…in a society in which law and sense of moral duty are weak and property is consequently insecure, there will be little confidence or credit and there will also be little commerce". Therefore, a regulatory framework is required to ensure that the formal financial system delivers affordable financial services to the excluded population with greater efficiency without compromising on safety and soundness.

Availability of public safety nets

This is another justification for the regulation of financial institutions. Lastra (2012), states "if the regulator helps financial institutions on rainy days, it should be possible to monitor them on sunny days". Since the regulators make available assistance to financial institutions by being the lender of last resort and through various other bail out schemes, there should be a regulatory framework to prevent moral hazard. The Deposit Insurance Scheme can be taken as an example of such a safety net. The perception of the general public that regulator should bail out them completely in the event of a collapse of a finance company is a myth related to financial regulation. Financial regulation should be defined as a task which would ensure that financial entities conduct their business subject to prudent norms and regulations. More regulatory assistance during turbulent times warrants more regulatory interventions into the conduct of business and corporate affairs of financial institutions. On the other hand free bankers argue that Deposit Insurance schemes discourage customers from monitoring the activities of financial institutions

and that public safety nets would decrease market discipline. However, the task of safety net undermines the public good concept of regulation, particularly where there has been regulatory forbearance.

Way forward in financial regulation

It is said that financial institutions are global and therefore financial regulation also needs to be global. Hence a carefully devised regulatory framework will be required to address the issues in rapidly evolving globalized financial markets which have digitalized all major areas of financial services. Proportionality of regulation is a vital element as too much risk avoidance may be counterproductive, as it constraints financial intermediation which in turn suppress growth and employment. However disciplined competition through the greater intervention of an effective regulatory framework would support economic activities and enhance consumer welfare. Harmonized regulatory standards through corporation among national and international regulators is necessary in the context of globalized institutions and markets.

Establishing a regulatory system that would accommodate innovations in financial services, while safeguarding customers and ensuring systemic stability would in fact be a challenge, in the absence of collaboration of regulated entities. Instead of mere technical compliance, a holistic approach towards corporate governance structures needs to be ensured by financial institutions to reap benefits of such regulations. All the stakeholders of financial sector need to facilitate to realign the regulatory parameters and principles so as to mitigate the impact of financial crises. Efficiency of law enforcement authorities also need to be coupled with financial regulation in delivering desired outcomes. However no amount of regulation would be effective unless efficient compliance functions of financial institutions prevail in order to prevent corruption and white collar crime.

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Modifications to the Monetary Policy Framework in Sri Lanka

Evolution of the Monetary Policy Framework in Sri Lanka

The conduct of monetary policy by the Central Bank of Sri Lanka to regulate monetary conditions and price developments has evolved gradually over the past sixty six years. Under the fixed exchange rate regime that was in place until 1977 as well as during the period of the managed floating exchange rate regime that existed until the adoption of a floating exchange rate in 2001, the exchange rate played a key role in anchoring inflation expectations. During the early 1980's, the Central Bank adopted monetary targeting (MT) as its monetary policy framework, and monetary aggregates became the key nominal anchor in the conduct of monetary policy in Sri Lanka. Accordingly, the final objective of price stability is to be achieved by influencing an intermediate target defined based on broad money aggregates, which is linked to reserve money through the money multiplier. Reserve money was considered the operating target of monetary policy under this framework. For each year, the MT framework required targets for reserve money and broad money growth to be announced and monitored, based on the annual monetary programme prepared by the Central Bank considering various factors, such as the expected fiscal and balance of payments developments, expected economic growth, desired levels of growth in credit and inflation.

Recent Global Developments in Monetary Policy Framework

Monetary policy conduct under the MT framework assumes that there is a strong and reliable relationship between the goal variable and the nominal anchor. If the relationship is weak, monetary aggregate targeting will not work and hence, may not deliver the expected results of monetary policy. This seems to have been a serious problem in many countries all over the world and given the breakdown of the relationship between monetary aggregates and goal variables such as inflation, as well as the changes in money demand function, many countries have adopted inflation targeting (IT) as their monetary policy framework.

IT framework is characterised by (1) an announced numerical inflation target; (2) an inflation forecast, which facilitates forward looking monetary policy decision making; and (3) a high degree of transparency and accountability. IT framework is generally associated with an institutional framework by the trinity of a mandate for price stability, independence, and accountability for the central bank (Svensson, 2010), which enables anchoring of inflation expectations more effectively. Accordingly, a country needs to fulfill several prerequisites prior or parallel to adopting an IT framework in terms of institutional setup, legal framework and the efficacy of policy transmission mechanism. Since the adoption of IT by New Zealand in 1989, many countries have moved towards IT frameworks as shown in Table B.10.1.

Table B.10.1 Inflation Targeting Countries

Year adopted Inflation Targeting	Countries
1989-1994	New Zealand, Canada, United Kingdom, Sweden, Australia,
1995-1999	Czech Republic, Israel, Poland, South Korea, Brazil, Chile, Colombia
2000-2004	South Africa, Thailand, Mexico, Iceland, Norway, Hungary, Peru, Philippines
2005 onwards	Romania, Guatemala, Indonesia, Armenia, Turkey, Ghana, Serbia

* Three other countries Finland, the Slovak Republic and Spain adopted inflation targeting, but abandoned it when they began to use the euro as their currency.

In practice, IT is flexible rather than strict, and most of the central banks do not only aim at stabilising inflation around an inflation target, but also put efforts in to stabilising other macroeconomic variables in the economy. As such, it appears that all IT central banks conduct flexible inflation targeting (FIT) rather than strict IT. FIT means that monetary policy aims at stabilising both inflation around the inflation target, and the real economy, whereas strict IT aims at stabilising only inflation, with little regard to the stability of the real economy (Svensson, 2009).

In addition to the central banks shown in Table B.10.1, in February 2015, the Reserve Bank of India (RBI) and the Ministry of Finance in India have agreed to put in place a monetary policy to focus on a FIT framework. Under this framework, the Consumer Price Index (CPI) based inflation is targeted to be below 6 per cent by January 2016 and 4 per cent for 2016-2017 with a band of +/- 2 per cent. Further, subject to the establishment and achievement of the nominal anchor in terms of an inflation target, monetary policy conduct is expected to be consistent with a sustainable growth trajectory and financial stability.

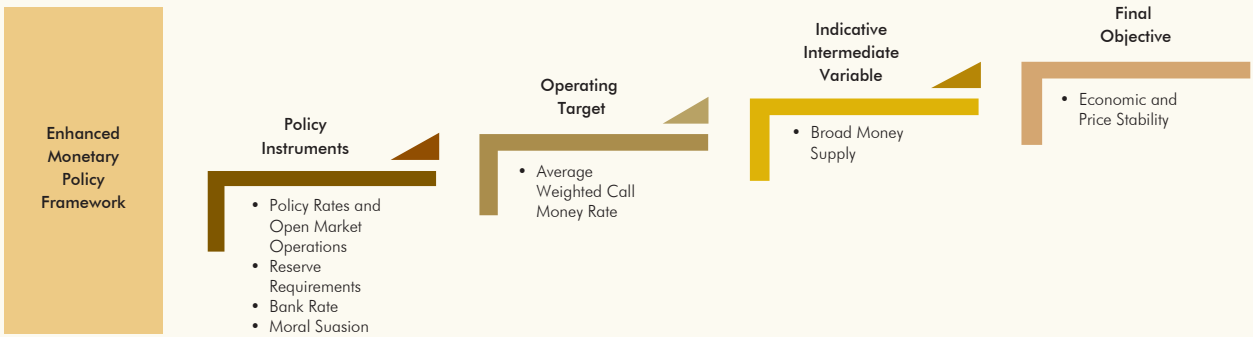
Enhanced Monetary Policy Framework in Sri Lanka

In line with the global tendency for central banks to move away from MT frameworks, the Central Bank of Sri Lanka has also been improving its monetary policy framework and increasingly aligning it with a FIT framework. A

number of prerequisites for the new framework has been fulfilled by the Central Bank of Sri Lanka and the government during the past few years with the view of moving towards FIT in the medium term. This move has also been prompted by several weaknesses that have been observed with regard to the MT framework in Sri Lanka, including the weakening relationship between money supply and inflation. Given the rising volatility in money multiplier and velocity, the role of monetary targets as a nominal anchor has become uncertain and also complicated the Central Bank's communication strategy.

At present, as an interim arrangement, the Central Bank of Sri Lanka conducts its monetary policy within an enhanced monetary policy framework with features of both MT and FIT frameworks. Under this enhanced monetary policy framework, the Central Bank focuses on stabilising inflation in mid-single digits over the medium term, while supporting the growth objectives and flexibility in exchange rate management. Although the Central Bank does not announce any monetary targets explicitly, broad money aggregates would continue to remain as the indicative intermediate variable to guide the conduct of monetary policy. Moreover, instead of reserve money, Central Bank currently uses average weighted call money rate (AWCMR) as its operating target and increasingly relies on its market based policy instruments, namely policy interest rates and open market operations (OMO). Macroeconomic projections of the Central Bank, including inflation projections, are currently being strengthened using short term forecasting tools and medium term dynamic stochastic general equilibrium (DSGE) techniques. Going forward, the Central Bank would continue its efforts to further modify and develop the monetary policy framework in line with the growing needs of the economy as well as the dynamic global environment in order to ensure both price and real sector stability on a sustainable basis. However, the commitment of the government towards fiscal consolidation is essential, if the Central Bank is to formally adopt FIT as its monetary policy framework.

Figure B.10.1 Modifications to Monetary Policy Framework in Sri Lanka



Source: Central Bank of Sri Lanka Annual Report 2015

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Sustainable Development Goals

World leaders unveiled the new global Sustainable Development Goals[1] (SDGs) at the United Nations Headquarters in New York in September 2015, as the successors to the Millennium Development Goals (MDGs) drawn up in 2000. In contrast to the MDGs, SDGs are an outcome of a number of long and complex discussions in different public and private fora, including various UN working groups. The framework of the SDGs is essentially an action plan to end poverty, protect the planet, and ensure prosperity for all. SDGs recognise poverty as the major hindrance for sustainable development and greatly emphasise eradicating poverty in all its forms and dimensions, including extreme poverty. This framework is aimed at bold and transformative initiatives which will lead the world to a sustainable and resilient development path. SDGs are integrated and inter-connected, and balance the three aspects of sustainable development, i.e., the economic, social and environmental aspects and seek to build on the MDGs and complete what they did not achieve. These goals and targets inspire a wide array of initiatives which are crucial for humanity and the planet and are expected to be achieved by 2030 in five broad areas (5Ps) as given in Table B 6.1 below[2] :

Table B 6.1 The Five Broad Focus Areas of SDGs

Board Area	Description
People	To end poverty and hunger, in all their forms and dimensions, and to ensure that all human beings can fulfil their potential in dignity and equality and in a healthy environment.
Planet	To protect the planet from degradation, including through sustainable consumption and production, sustainably managing its natural resources and taking urgent action on climate change, so that it can support the needs of the present and future generations.
Prosperity	To ensure that all human beings can enjoy prosperous and fulfilling lives and that economic, social and technological progress occurs in harmony with nature.
Peace	To foster peaceful, just and inclusive societies which are free from fear and violence. There can be no sustainable development without peace and no peace without sustainable development.
Partnership	To mobilise the means required to implement this agenda through a revitalised Global Partnership for Sustainable Development, based on a spirit of strengthened global solidarity, focused in particular on the needs of the poorest and the most vulnerable and with the participation of all countries, all stakeholders and all people

Source: https://sustainabledevelopment.un.org/post2015/transformingourworld

Accordingly, the SDGs agenda embark on this collaborative journey by announcing 17 SDGs, each of which consists of a collection of several specific targets that add up to a set of 169 targets, covering a broad range of sustainable development issues.

Goal 1 - End poverty in all its forms everywhere

Goal 2 - End hunger, achieve food security and improved nutrition and promote sustainable agriculture

Goal 3 - Ensure healthy lives and promote well being for all at all ages

Goal 4 - Ensure inclusive and equitable quality education and promote lifelong learning opportunities for all

Goal 5 - Achieve gender equality and empower all women and girls

Goal 6 - Ensure availability and sustainable management of water and sanitation for all

Goal 7 - Ensure access to affordable, reliable, sustainable and modern energy for all

Goal 8 - Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all

Goal 9 - Build resilient infrastructure, promote inclusive and sustainable industrialisation and foster innovation

Goal 10 - Reduce inequality within and among countries

Goal 11 - Make cities and human settlements inclusive, safe, resilient and sustainable

Goal 12 - Ensure sustainable consumption and production patterns

Goal 13 - Take urgent action to combat climate change and its impacts

Goal 14 - Conserve and sustainably use the oceans, seas and marine resources for sustainable development

Goal 15 - Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, and halt and reverse land degradation, and halt biodiversity loss

1 There are different ways of defining Sustainable Development, including the following landmark definition: "Development that meets the needs of the present without compromising the ability of future generations to meet their own needs." - The Brundtland Commission (1987).

2 For details see: https://sustainabledevelopment.un.org/post2015/transformingourworld

Source: https://sustainabledevelopment.un.org/sdgs

Goal 16 - Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels

Goal 17 - Strengthen the means of implementation and revitalise the global partnership for sustainable development

The consolidated nature of the SDGs with multiple inter-linkages is of high importance in achieving the multidimensional aspects of sustainable development. Hence, the implementation of SDGs would need integrating them into national/regional planning priorities and documents while encouraging different sectors to work together as the 17 SDGs are highly linked, and cannot be implemented in isolation. It also requires meeting the needs and capacities in implementation, monitoring and reporting as well. Collaboration and participatory actions across different levels of government and stakeholder groups with priorities would also be required. The efforts of all levels will have to be focused across the full extent of the SDGs agenda, if the lives of all to be improved significantly.

Sri Lanka has already achieved some, out of the total number of 169 targets under SDGs, particularly in relation to maternal, child and infant mortality. Further, the new initiatives such as the Blue-Green Development Strategy of the government developed along the lines of the Blue-Green economy concept of the United Nations Environment Programme (UNEP), will address the environmental concerns while fulfilling the relevant SDGs. Despite this progress, a strong collective effort of all stakeholders is required in the country to accomplish SDGs by 2030.

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Source: Central Bank of Sri Lanka
Annual Report 2015

A Message from the Central Bank of Sri Lanka

Why Use Cash or Cheques for Your Payments?

Government & Private Institutions Can Use

LankaClear
TRANSACT THE FUTURE

SLIPS

(Sri Lanka Inter-bank Payment System)

To Make Payments

(Individual or Bulk)

to multiple parties

At a Lower Cost and Greater Convenience

- *How much can you send? Send up to Rs. 5 million per transaction*
- *Value date (payment due date): same day or any day up to 14 days*

- *SLIPS commenced operations in 1994 and was launched online in 2010*
- *44 banks and financial institutions currently connected*
- *126.9 mn transactions amounting to Rs. 5,528 bn up to 2016 (since 2010)*

Maximum fee: Individual Payment: **Rs. 50.00**
Bulk Payment: Special rates can be negotiated with your bank

Contact your commercial bank for more details

Payments and Settlements Department
Central Bank of Sri Lanka
30, Janadhipathi Mawatha
Colombo 01

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இலங்கை மத்திய வங்கி
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