Pathfinder Economic Alert

Towards Resilient and Stable Financial Institutions
Roadmap for Correcting the Past Mistakes

Learning from History and the World.

Sri Lanka's financial sector has experienced significant developments since partial liberalization in the post-77 era. To move from a highly protected environment to a liberalized economy may have required some shock treatment such as the opening of the financial sector. However, unfortunately, the lack of a clear strategy and ad hoc approach to regulation has led to the emergence of a plethora of banking and non-banking financial institutions servicing a limited segment of the population and geographical areas of the island. In realizing that the financial system is the lifeblood of an economy the Central Bank of Sri Lanka (CBSL) has drawn a roadmap for more a efficient and competitive financial system in the country. The efficiency of financial intermediation is a very important determinant of development outcomes. Above all, a stable financial system is a crucial element of a conducive business environment for supporting sustained growth. The recent global financial crisis has highlighted the hugely disruptive effects of instability in the financial system. Robust and stable financial institutions on the one hand and sound regulation on the other are the twin pillars that provide confidence to all stakeholders in the financial system.

One of the lessons of the global financial crisis was the instability associated with "too- large- to-fail banks". The removal of the Glass-Stegall Act in the US and financial deregulation in Europe facilitated the emergence of mega banks where the lines between retail banking and more risky investment banking were blurred. The problems were compounded by the emergence of sophisticated financial instruments (including derivatives) which amplified rather than diversified risks. The upshot was a near meltdown of the global financial system after the fall of Lehman Brothers and a massive tax- payer bailout of the too- large- to- fail banks. Since then, various measures are being introduced to strengthen the global financial system. Capital and liquidity adequacy ratios have been bolstered. Banks have been subjected to stress tests in order to assess their financial viability. In addition, the Volcker Rule in the US and ring-fencing in the UK have sought to separate the risks associated with retail and investment banking to ensure that the tax- payer is protected from the higher risks associated with various aspects of investment banking. The US financial system is further down the road to good health than European banks, where the restoration of stability is more of a work-in-progress.

Against this global landscape of attempts to mitigate the risks associated with too- big- to- fail banks, the CBSL's recent initiatives to press ahead with financial sector consolidation seems to go against the grain. However, such fears are misplaced as Sri Lanka's problem is very different. It is too much fragmentation of the financial sector. As already mentioned above, during the post-77 era, Sri Lanka has not had a clear roadmap for developing the financial sector. The local challenge is to build institutions with sufficient critical mass to withstand shocks and also meet the increasingly complex and sophisticated needs of a rapidly growing economy. A more relevant point of reference is the bank consolidation that has already been undertaken by Malaysia and Singapore to strengthen their respective financial systems.

The ASEAN Experience: From Mushrooming to Consolidation.

Malaysia embarked upon a program to consolidate its financial sector immediately after the Asian crisis (1997). The number of financial institutions was rationalized radically. Within a year (1998), the number of finance companies was reduced from 39 to 8. Since then, all finance companies have been merged with banks. In addition, within three years (2000), 50 out of 54 banking institutions were consolidated into 10 banking groups. Singapore commenced its bank consolidation early this century. The six local banking groups were consolidated into three. The number of participants in Thailand's banking sector is scheduled to come down from 14 to 5. The Indonesian authorities have also highlighted the need for small banks to consolidate to address their weak capital bases.

In Malaysia and Singapore, where more progress has already been made, the authorities have played a very active role in facilitating the consolidation process. Consolidation has generated a number of benefits.

- Increased the critical mass (capital and asset bases) have strengthened the viability and resilience of financial institutions.
- Strengthened banks' capabilities, including their capacity to innovate.
- Built up management teams, with scarce talent becoming less dispersed.
- Enhanced operational effectiveness by reducing overheads, particularly through branch rationalization which served to reduce spreads.
- Greater attention to cost cutting, including IT development, to improve competitiveness

The Sri Lankan Experience: Fragmentation and the Agony of Failures.

The CBSL has pointed out that the last 25 years have been characterized by a number of episodes which have had a destructive impact on the lives of ordinary people. During 1988-90, 13 Registered Finance Companies failed, 11 of which had to be liquidated. In 2002, there was a bank failure and depositors were rescued only in 2007. In 2009, the collapse of a large business group affected eight non-bank financial institutions which faced liquidity problems. They were gradually revived under Central Bank guidance. In recent days, there has been much publicity about the travails of another Registered Finance Company.

The recurrence of these problems raises fundamental questions about the viability of the current highly fragmented structure of the Sri Lankan financial system. There are 16 commercial banks. Only 5 of them (66% of market share) have an asset-base in excess of Rs. 500 billion. (There are 12 foreign banks which account for 10% of market share). There are currently 58 Registered Finance Companies (non-bank financial institutions). Of these, 17 account for 73% of the capital base. Overall, the whole non-bank financial institutions sub-sector accounts for only 7% of the total capital of the financial sector.

A Robust and Dynamic Financial System for Middle-Income Sri Lanka.

The current structure is clearly unsuited for building a robust, stable and dynamic financial sector which is "fit for purpose" to support Sri Lanka's development process as a middle-income country. It is welcome and timely, therefore, that the Central Bank has embarked upon a program of consolidation. This is an essential pre-requisite for building sufficient resilience in the financial sector through mergers and acquisitions which build up the capital and asset bases of financial institutions.

The CBSL envisages a banking sector where at least five local banks will have assets of Rs. 1 trillion each, with such banks also building up their presence in the region. In addition, the DFCC and NDB are to be merged to establish one large development bank. The benefits of this consolidation in the banking sector are expected to include substantially lower net interest margins and investment in new productivity enhancing IT applications.

In the non-bank financial institutional sector, the CBSL envisages a reduction from 58 to about 20 institutions, of which around three would be specialized in microfinance. Increasing the capital and asset bases of finance companies would enable them to mobilize lower cost long-term funds and build greater resilience to shocks. Rationalizing the sector will also generate cost effectiveness which will improve its competitiveness. The conditions will also be created to improve corporate governance through strengthening boards and managing risks better. A smaller and stronger non-bank financial institution sector would also enable the CBSL to discharge its regulatory functions more effectively.

Key Challenges: Keeping to Tight Timeline

The CBSL has set a very tight timeline for the completion of the consolidation program. However, despite the tight timeline, it is crucial that strict due diligence is carried out in all transactions. There will be complex accounting, valuation, tax and human resource issues which would need to be addressed. The CBSL has announced that it will meet consultancy fees associated with these processes. It will also provide long-term advances through the Sri Lanka

Deposit Insurance and Liquidity Support Scheme, on concessional terms, to match any capital infusion by a bank or a category ‘A’ non-bank financial institution taking over a category ‘B’ institution.

It is important to have open communications among the institutions involved in the consolidation process as well as with the CBSL. The CBSL is establishing a special unit to liaise between all stakeholders. It is also undertaking measures to strengthen the overall regulatory framework to align it with international best practices. One should also point out that the Government has introduced tax concessions to incentivise the consolidation process through the Budget Speech 2014.

Licensed commercial banks, for their part, will be required to increase their core capital to Rs. 10 billion by 1 Jan 2016 (Rs. 5 billion for Licensed Specialized Banks). They will also be expected to adopt Basle 3 Capital Standards.

The guidelines associated with the consolidation process stipulate that mergers/acquisitions must not lead to the “forcible retrenchment” of any staff member. It is to be hoped that this would be implemented in a manner that enables Voluntary Redundancy Schemes (VRS), supported by re-training programs. A major advantage of consolidation is the generation of cost efficiencies at various operational levels, including staffing. Some shake-out of employees is necessary to capture the benefits of a consolidation program. Bank staff are likely to be “relatively-highly employable” (with training where necessary) in a context where there are acute skilled personnel shortages in other key sectors of the economy. This process requires careful handling. People are key to making bank consolidation work. Minimizing the importance of human resource issues and processes are often the reason for the failure of mergers and acquisitions. It is important, therefore, that HR professionals are an integral part of the whole financial sector consolidation process.

Whither the State Sector?

The ultimate objective is to create a financial services sector which is not only stable and resilient but also competitive. In this respect, it is positive not only that the balance sheets of the two state banks have been strengthened through the reduction in the losses of SOE’s, particularly the CEB and CPC following the electricity and fuel price adjustments but also that their share in total banking assets has been declining. Despite this the two state banks account for over 50% of the banking sector and their inefficiencies are a contributory factor to the high spread that characterize this sector.

In addition, the operations of the National Savings Bank (NSB) continue to be anti-competitive due to the concessions provided to it. The NSB has historically been a captive source of funding for the government budget. It has been argued that it serves as a substitute for the social security contributions which fund welfare programs in other countries. However, with the current increased commitment to fiscal discipline, consideration should now be given to creating a more level playing field. This would incentivize the development of other savings institutions, such as mutual and private pension funds which would mobilize much-needed long term financing in the economy.

As Sri Lanka moves forward to middle-income country status, ideological positions of yesteryears may need to be replaced with more pragmatic approaches to the challenging globalized environment. In this regard, the Pathfinder Foundation wishes to repeat a statement by former Chinese premier Deng Xiaoping "If a party, a country or a nation does everything by sticking to dogmas, follows an ossified way of thinking, and is prevailed over by superstition, then it can never move forward, its hope of life will die, and either the party or the country will be doomed". This statement applies to the emerging financial sector reforms as well.

Developing the Financial Architecture

The proposed bank consolidation process will increase the stability and resilience of the sector. However, this is only part of the story in terms of evolving a financial architecture that will sustain the development of the country in the medium to long-term. In this connection, it is important that the SEC and CSE continue their efforts to improve the workings of the stock market. This needs to be complemented by other measures to incentivise the continued development of the long-term debt market to complement the above mentioned efforts to promote mutual and pension funds. It is also important to encourage angel investors, venture capitalists and private equity.

This is the Fifty-Fifth Economic Alert published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org