

# DIFFERENT BANKING LICENCES IN SRILANKA AND THEIR IMPACT ON THE BANKING INDUSTRY

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Sri Lankan banks are regulated by the Central Bank of Sri Lanka (CBSL). The CBSL is responsible for regulating and supervising banks, finance companies and primary dealers to promote the safety and soundness of the banking and financial system and to safeguard the interests of depositors and investors.

There are two legal acts by which this function is governed, viz Banking Act and the Monetary Law Act. The CBSL is the licensing authority for banks in Sri Lanka and issues banking licences for two categories of banks as follows;

- Licensed Commercial Banks (“LCBs”)
- Licensed Specialized Banks (“LSBs”)

**This article seeks to achieve the following objectives;**

- Distinguish between the prevailing differences between LCBS and LSBS based on the permitted regulatory framework within Sri Lanka
- The anomalies created in the industry as a result of the different licensing requirements
- Regional experience in the same sphere
- A possible unitary framework within which different levels of activities are permitted

**Functions and salient regulatory obligations of LCBs**

1. Accepting demand, savings and fixed deposits in Sri Lankan rupees and permitted foreign currencies
2. Purchase and issuance of foreign currency remittances such as telegraphic transfers, rafts and traveller’s cheques
3. Granting mainly short term loans including overdrafts, leasing and term loans for housing
4. Opening, advising and confirmations of Letters of Credit and Bills Discounting
5. Operate and manage a number of nostro accounts and correspondent banking relationships.
6. Custodial and trustee business
7. Act as an authorised dealer of foreign exchange appointed by CBSL
8. Act as primary dealers for government debt (Not mandatory)
9. Investments in equity, debt and foreign exchange products
10. Maintain statutory capital, reserve and liquidity ratios
11. Maintain the business of the bank conforming to minimum capital requirements nationally and Basle II requirements internationally.
12. Provide payment services through the national and international payment systems such as RTGS, SSSS and SWIFT.



## **Functions and salient regulatory obligations of LSBs**

1. Accepting savings and fixed deposits in Sri Lankan rupees
2. Granting mainly medium to long term loans including leasing and housing
3. Opening, advising and confirmations of Letters of Credit and Bills Discounting where permitted by CBSL
4. Operate and manage a number of nostro accounts and correspondent banking relationships based on permission given by CBSL as in 3 above.
5. Act as primary dealers for government debt (not mandatory)
6. Investments in equity, debt and foreign exchange products where permission has been obtained from CBSL
7. Maintain statutory capital and liquidity ratios
8. Maintain the business of the bank conforming to minimum capital requirements nationally and Basle II requirements internationally.

The LCBs' functions are broader than those of LSBs which are mainly savings and development banks.




As could be observed by the above, the main distinction between commercial banks and specialized banks is that the former is permitted to accept demand deposits (current accounts) from the public, carry on the business of an authorized Primary Dealer in the same books and engage in a full range of foreign exchange transactions, whereas the latter is not. This has created an anomaly in the banking industry with respect to the roles of LCBs and LSBs in the domestic financial markets, the range of activities which both types of banks engage in, for which by the very nature of their licensing, each has inherent advantages and disadvantages. Yet some strong financial institutions are barred from participating fully in the financial markets.

At the end of June 2006, there were 22 LCBs (11 local and 11 foreign banks) and 16 LSBs..

## **Anomalies Created in the Industry**

### **Background**

The banking landscape globally underwent a drastic change with the introduction of the Glass Steagall Act which erected firm product boundaries between investment banks, money centre banks and other financial institutions. This act introduced in 1932, in the wake of the Stock market Crash to create barriers between investment banks and commercial banks, was repealed in 1999. The original intentions were to create different animals in the banking industry as far as equity investments were concerned. In the stock market crash, the commercial banks, which had invested heavily in equity, collapsed and impacted the system to a great extent as the investments were made with depositors' money. In the absence of Basle requirements at that time, it was permitted for commercial banks to carry out investment banking activities provided the deposits were insured.



The Federal Reserve Board introduced the Gramm-Leach- Bliley act later in 1999 which broke the barriers between the commercial and investment banks. In the post Enron modern day banking and the Basle regulatory climate, banks need to conform to stringent capital adequacy and risk management systems which enable a high level of transparency in their activities.

The entire rationale for the repeal of the Glass Stegall act and the establishment of Gramm-Leach-Bliley act was that over restriction itself was unhealthy for the development of the banking industry and diversification of the activities with sound controls and systems was more appropriate.

The monetary control act of 1980 by the Federal Reserve Bank of Boston sought to bring in all types of deposit taking institutions with phased in reserve requirements under the same brush of regulation.

Given the above the following anomalies exist in the banking industry locally;

### **Payment and Settlement Systems**

In the pursuit of its objective of financial system stability, the Central Bank is responsible for maintaining a well-functioning and safe payment and settlement system. In order to enhance efficiency, the Central Bank introduced the Real Time Gross Settlements System (RTGS) in 2003 to facilitate large value (over Rs.1 million) or time critical payments, electronically, in real time, rather than at the end of the day, thus eliminating settlement risk

LSBs are unable to participate in the payment systems to provide a smooth service to their customers whereas all LCBs and Primary Dealers (PDs) both bank and non-bank and both bank and non-bank subsidiaries of strong as well as weak financial reputes are permitted to participate in the payment systems. The main types of transactions settled through the RTGS are inter-bank call market transactions, government securities market transactions, foreign exchange transactions, open market operations and net cheque clearing transactions. The LSBs too engage in some of the same transactions and are compelled to go through a participant to service their customers. At least three LSBs as at June 2005 have been identified as having systemic importance based on their asset size which is sufficient vindication that an anomaly of this nature should not bar them from being protected in the case of a systemic failure by being outside the payment systems.

The Central Depository system which is a fully owned subsidiary of the Colombo Stock Exchange is expected to join the RTGS in the near future. This inclusion of an institution through which certain LSBs transact equity while the latter are excluded is a case in point.

### **Removal of Product Mix Barriers**

There is a large overlap in the LCBs lending activities with those of LSBs and vice versa. Earlier the criteria for lending activities for LCBs were essentially short term and of a revolving nature whilst the LSBs were active at the long end of the market and developmental lending. Currently most of the LCBs are actively engaged in long term lending, micro financing and project lending which were the enclave of the development banks which are LSBs. Similarly LSBs are granting working capital and short term loans. The advent of universal banking is an admission



that banks could provide the whole range of activities under one roof. However universal banks are LCBs.

### **Primary Dealership to Deal in Government Debt**

Currently a LCB could allocate capital of Rs 250Mn within their books or incorporate a separate subsidiary and obtain the primary dealership to buy and sell government debt. However a LSB cannot do the former. There is no other requirement than possessing the stipulated financial capital and staff trained in the debt markets to commence a primary dealership. However LSBs are barred from obtaining this status within their banking books despite the fact they are measured for capital adequacy and liquidity risk akin to LCBs.

### **Statutory Ratios**

Currently the LCBs are subject to Reserve ratio, Liquid Asset Ratio and minimum Capital adequacy requirements. The LSBs are subject to all except the reserve requirement. This would create a pricing advantage in the case of fixed deposit products for LSBs which at the same time does not have interest free funds in the form of current accounts permitted at LCBs. Since the objective of the reserve requirement is to control the creation of money which could happen only through current accounts, this is not felt to be a deterrent to LCBs.

### **Regional Experience**




India and China both carried out banking sector reforms in the 1990s. Despite a gradual approach, India's reforms have been the more comprehensive and took place at a faster pace than in China.

The main thrust of India's reforms is that banks should diversify their business to prevent taking excessive risks in the face of declining net interest income in a interest rate liberalization in the market. A new bank is encouraged to commence business provided it is well capitalized and technology oriented with sound risk management systems.

### **Entry Deregulation**

India has also encouraged deregulation and entry of foreign banks to enable the large state owned banks to be more competitive rather than changing the latter's ownership. The subcontinent believes that entry barriers and any licensing differences will give rise to inefficiencies in the system and could be justified only if commercial banks provide a unique role which cannot be undertaken by other bank and non- bank financial institutions. They also promote Financial Conglomeration. The diversification of a bank's range of services enhances the opportunities for decreased reliance on interest income, improves cost of funds, provides economies of scope. Economies of scope could be derived from the range of products as well as delivery channels.

In India, banks have been allowed to engage in diverse activities including securities and foreign exchange transactions, brokerage and dealing activities, and other fee-based business



even before the 1991 reform programs had been launched. At the same time, the Reserve Bank of India (RBI) is aware of problems arising from banks' engagement in nontraditional business and has tried to cope with them by encouraging banks to engage in such businesses through subsidiaries, thereby putting in place firewalls between traditional banking and securities services to some extent. The expansion of the scope of banks' business has certainly helped offset a decline in net interest income from advances, driven by interest rate deregulation. India has been more interested in supplementing offsetting the decline in interest income through other avenues of earnings rather than differentiating among banks. Thus a bank's risk profile improves due to the lack of necessity to take high risks to maintain interest margins.

Reserve Bank of India issues one licence called a full licence to all commercial banks which are called scheduled commercial banks. However the lesser complications in licensing is offset by stringent liquid asset ratios, priority sector lending and mandatory investments in government securities.

### **Recommendation of a Unitary Framework to Regulate Banks**

In conclusion, the recommendation is that the regulatory framework should follow the objectives of Central Bank closely.

A level playing field among the banks is necessary for an efficient banking system and the healthy development of the capital markets in the country. The anomalies created by the different licensing requirements prevent strong private sector financial institutions from serving the large pool of small and medium enterprises that form the bulk of most banks' customers. The diversification of all banks has enhanced the need for uniformity in statutory requirements, use of payment systems to promote fair competition.

The governing criteria should be the ability to provide effective banking solutions with sound technology and risk management practices rather than granting licences based on certain activities which only narrow the economies of scope for banks resulting in an erosion of profitability and costly services to the borrowing public. Rather, the superior alternative would be to measure a bank's ability to conduct a line of business from a capital point of view and grant permission accordingly.

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