THE CHANGING ROLE OF BANKS AND SRI LANKA'S RE-STRUCTURING EFFORTS

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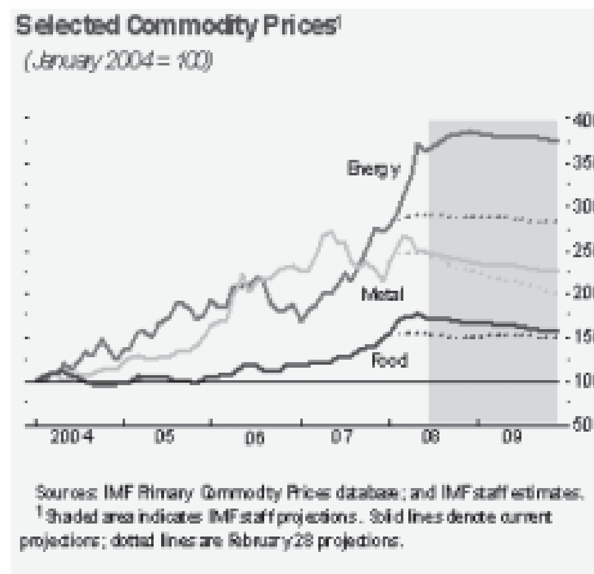
Volatile commodity markets and turbulent financial markets have posed a major threat to the world economy and the global financial industry. The surge in crude oil prices from US$ 60 per barrel to US$ 135 per barrel within a space of two years not only widened the trade gap of many countries, but caused severe inflation pressure around the globe. Rising commodity prices, above all food and oil prices have caused concern among emerging and developing economies compelling such economies to tighten monetary policy so as to contain inflation pressures, thus dampening world growth prospects to some extent. Global growth, measured over four quarters earlier, decelerated to 4½ percent in the first quarter of 2008 down from 5 percent in the third quarter of 2007.



Meanwhile the turmoil in international financial markets caused by volatile currency exchange rates and interest rates has been compounded by the US sub-prime mortgage crisis that triggered a widespread financial upheaval in 2007 and 2008.

The following table illustrates the growing share of sub-prime mortgage in total US mortgage market.

Table 1

Year	Share of Sub-prime Mortgage to Total Mortgage of US market
1994	5%
1996	9%
1999	13%
2006	20%

The high default rates associated with sub-prime lending to high-risk borrowers brought about colossal losses (in excess of US$ 500 billion) to major banks and financial institutions around the globe. The enormity of the crisis is such that profits of the US banks insured by the Federal Deposit Insurance Corporation (FDIC) declined by 89% from US$35.2 billion to US$646 million during the fourth quarter of 2007 compared with the prior year, due to soaring loan defaults and provisions for loan losses. Several mortgage lenders registered for bankruptcy. European banks and financial institutions including IKB Deutsche Industriebank, Citigroup, UBS and Merrill Lynch suffered heavy losses. Table 2 below illustrates the sub-prime write downs and losses incurred by some of the key international banks and financial giants as well as the capital raised in response to the crisis.

Table 2

Bank/Financial Institution	Subprime writedown & loss – US$ billion	Capital Raised – US$ billion
Citigroup	55	49
Merrill Lynch	52	29
UBS	44	28
HSBC	27	4
Wachovia	22	11
Bank of America	21	20
IKB Deutsche Industriebank	15	12
Royal Bank of Scotland	15	24
Washington Mutual	15	12
Morgan Stanley	14	5
JBMorgan Chase	14	8

Source: Bloomberg

The sub-prime crisis set-off widespread repercussions on the banking system and led to the discontinuation of thousands of jobs. IKB Deutsche Industriebank required state bank intervention. Northern Rock, UK's fifth largest mortgage lender that experienced a run on the bank was rescued by the Bank of England and subsequently nationalized. Bear Stearns, an investment bank was acquired by JPMorgan Chase for US$ 10 per share, a fraction of it's previous value. IndyMac was shut down by the FDIC. The collapse of the US Bank, the third largest in US history and the chain of consequences from the crisis forced authorities worldwide to revisit regulations and to take immediate measures to strengthen the banking industry.

Risk is inherent in any business whether big or small. Banking business is basically the managing of risk, be it credit risk on lending, operational risk in shifting money around or market risk in managing the positions that the bank takes in it's treasury and investment banking business. The sub-prime mortgage calamity was a shocking revelation of the banking system's inability to successfully manage primary risks relating to credit, liquidity and asset price despite implementing sophisticated risk management measures. The reasons for the crisis are however wide and varied, some of which are alluded to hereafter.

The Changing Role of the Banking Sector

The traditional banking landscape comprising dedicated commercial banks, specialized development banks and savings banks has gradually given way to "universal banking", with the industry now offering the entire array of banking services. On one hand, development banks have moved towards "all purpose banking" rather than focus on the original objective of project lending. Conversely, commercial banks have set up "development banking units" to deal in project loans. The business scope of the banks expanded to offer consumer banking, investment banking, fee-based activities, venture capital, fund management, stock broking and bancassurance. The sub-prime calamity has forced the banks to re-assess the wisdom of this strategy. In the wake of the crisis, Switzerland's biggest bank, UBS skimmed off part of it's investment banking arm, cutting down on over 5000 jobs.

Mergers and Acquisitions

In the past few decades there have been a significant number of mergers and acquisitions taking place in the banking sector. Whilst mergers and acquisitions may bring about huge cost saving and synergies, they also denote firstly; there is over capacity in the banking industry and secondly; unless managed properly, a weak bank which merge with comparatively a stronger bank could erode the latter's standing.

Demand from Customers

As more banks enter the playing field leading to over capacity, customers have the opportunity of demanding a higher level of service from the industry. Customer loyalty is rare with business being moved from bank to bank based on the terms offered, especially rates of interest. This leads

to the banks taking a greater risk simply to attract business, thus accomodate high-risk borrowers with income barely enough to support monthly payments. Overly aggressive lending practices where adjustable rate mortgages were made to higher-risk borrowers, led to high default rates and ultimatley, the sub-prime crisis. The low rates offered at the outset on these so called ninja loans (no income, no job, no assets) subsequently was escalated with the revision of interest rates, in some cases, rising by 30-50%. The low income borrowers were clearly unable to service the resultant increased monthly payments.

Aggressive Competition

In a fiercely competitive world, banks are forced to deal with thinning margins. Lending standards may be lowered leading to imprudent credit expansion. Aggressive competition also spurs the banks to offer various incentives and innovative products to attract customers and to remain profitable. Innovations in securitization facilitate credit risk be often transferred to third party investors. Investors in mortgage-backed securities (MBS) and in collateralized debt obligations (CDO) expect the originator to maintain the credit standard. However with securitisation, lenders have little incentive to do so, as they do not retain the loans, thus exposing the investors.

Shareholder Expectation

Shareholders often are driven by the return they expect on their investment. This expectation is another factor that fuels the banks to pursuit high yields associated with risky transactions.

It is also pertinent at this juncture, to note the impact from the "East Asian Financial Crisis" of 1997, another occasion that spelled disaster. The liquidity crisis that manifested due to private sector over-borrowing, especially in short-term foreign exchange debt, highlighted the over dependency on the banking system and the need to develop deep and liquid bond markets. The development of such markets enabled sound corporate entities to raise funds directly from the debt market, without resorting to banks. This has been another reason for the rise in sub standard credit lending.

The above are some of the reasons why banks are driven to increase earnings by venturing into vulnerable and at times perilous transactions and to take on undue risk. In the current crisis, every participant in the mortgage market contributed to the catastrophe. Borrowers, lenders, brokers, rating agencies, regulators, investors and central bankers have all been lax to some extent thus as to who carries the larger portion of blame is open to question.

The lesson for Sri Lanka is that implementing sophisticated risk management techniques alone is no assurance against failures. What is clear is that by assuming unwarranted risk, even international banking giants and securities firms were still vulnerable to failure. This is clearly evidenced from the extensive losses incurred, the need for aggressive intervention by major central banks to provide liquidity to troubled banks and the considerable number of banks that eventually collapsed when the sub-prime crisis erupted.

The Local Experience

Asian markets have in the main remained calm in the face of the sub-prime crisis. One reason is that these banks have little off-balance sheet financing and not much exposure to financial derivatives. Nevertheless regulators in Sri Lanka need to critically asses the rising share of non-performing bank advances, indiscriminate credit lending practices and the lax risk management standards that could threaten the stability of the banking industry and the economy as a whole.

We have witnessed the collapse of several finance companies in the past. Foremost amongst these are Mercantile Credit Limited, Union Trust and Investment Ltd, House and Property Traders Ltd, Translanka Investments Ltd and Home Finance Ltd. The country experienced it's very first bank failure when the Pramuka Savings and Development Bank (PSDB) collapsed leaving about 16,000 depositors without redress. The Central Bank first suspended PSDB in October 2002 due to,

- The high non performing ratio – in excess of 75%
- Negative networth of Rs 230 million as at 30th September 2002
- Inability to maintain the minimum statutory liquid assets ratio of 20%

The causes for the bank's failure have been analyzed at length and it would be correct to say that we are still in the process of learning. The collapse left the regulator with three options.

a) Rescue the troubled bank
b) Close down the bank and pay off the depositors and other creditors
c) Restructure the bank.

The ultimate decision rests on several crucial factors. The primary concern is to restore credibility and confidence in the banking system. The future viability and whether the bank is worthy of support is another. Whilst bailing out depositors is the easiest option, it involves the highest economic costs as well. A private solution for restructure on the other hand reduces market disturbances.

The following table depicts various stages of re-structuring process of a bank.

.SEQUENCING OF BANK RESTRUCTURING

1. Responding to acute crisis: to stop panic and bank runs

- Crisis: over leveraging, denial of government and bank owners;
- Bank runs intensify, confidence falters: central bank provides liquidity credit with the intention of sterilizing the liquidity support so as not to loose monetary control;
- If liquidity credit fails to stem runs: introduce deposit or blanket guarantee scheme.

2. Stabilizing and restructuring the banking system

- Consolidate, recognize losses, take over, close down, merger;
- Recapitalize viable banks;
- Introduce new rules and regulations.

3. Recovery to normal banking system

- Nationalized banks are privatized, corporate debt restructured, bad assets sold;
- Phase out blanket guarantee and replace with normal deposit insurance scheme

(Source: Lindgren et al., 1999)

In the PSDB crisis the Monetary Board of the Central Bank that initially decided to liquidate the bank also pursed the strategy of restructure. In the event PSDB was liquidated depositors would, in effect, only have been able to recover less than 35% of their deposits. The bank's financial position at the time based on a report by Ernst and Young was as follows.

Assets	Rs (Mn)	Liabilities	Rs. (Mn)
Loans	1,443	Borrowings	810
Liquid Assets	420	Deposits	2,258
Other Assets	367	Other Liabilities	284
Fixed Assets	41	Share Capital	307
		Retained Losses	(1,388)
	2,271		2,271
		Contingent	559

Numerous stakeholders are responsible for the ultimate actions of a bank. It would therefore be reasonable that such stakeholders who often enjoyed above market rate returns associated with high-risk transactions also share the losses in the event the bank has to pay the ultimate price. Mis-management in banks is the responsibility of the management, the burden of which should be carried by its shareholders. Depositors who pursue high returns without due regard to the stability of the borrower are also another such category. A restructuring strategy should therefore, in my view, be evolved based on a risk-reward trade-off.

It is this same rule of thumb that was considered in a proposal made to restructure the failed PSDB. A significant portion of depositors in this case were small timers who probably lacked the knowledge and expertise to fully evaluate the consequences of the risk-reward structure. These depositors need to be protected first. Of the 16,276 depositors, 12,722 (78%) had accounts amounting to less than Rs 100,000/- while just 290 depositors (1.8%) had accounts amounting to more than Rs 1 million.

The restructuring proposal recommended the settlement in entirety of deposits below Rs.1 million while other depositors were to be paid in full through a mix of deposits and debentures issued from a Special Purpose Vehicle (SPV).

The SPV was to be created by transferring a portion of the larger deposits as well an identified portfolio of non-performing loan obligations of PSDB together with the underlining assets. The SPV to then issue zero coupon debentures, secured by the underlining assets, to the depositors and other creditors as per amounts stated in the settlement plan as given below. The debentures were to be redeemed by the SPV periodically and proportionately subject to realization of loans.

Number of Account Holders

Category	*No of Account Holders*	*Total Value Rs (Mn)*	*%*
Over Rs 6 Mn	65	1,304	0.40%
Between 5Mn- 6Mn	16	72	0.10%
Between 4Mn-5Mn	15	96	0.09%
Between 3Mn-4Mn	19	82	0.12%
Between 2Mn- 3Mn	48	106	0.29%
Between 1Mn- 2Mn	127	183	0.78%
Between Rs 100,000 - Rs 1Mn	3,264	1,007	20.05%
Below Rs 100,000	12,722	139	78.16%
	16,276	**2,989**	**100.00%**

Settlement mix offered to depositors

The proposal was centered on the following.

- Small deposits less than Rs 100,000/- and constituting 78% of all depositors, to take precedence over the larger deposits and settled in full within 1 year.
- Deposits over Rs 100,000/- upto Rs 1,000,000/- to be settled within 4 years in equal installments commencing from Year 2 with interest calculated at 4% p.a.
- Deposits over Rs 1 million upto Rs 6 million to be then settled within 8 years commencing from year 2. These depositors were to receive 30% of their deposits in 6 years and the balance 70% in last two years. Further, the interest calculated at 4% p.a. was to be paid.
- Deposits over Rs 6 million upto Rs 7 million to be paid within 9 years commencing from year 2 with 30% of the deposits being paid in first 6 years and balance 70% in last 3 years.
- Finally, the debentures issued by the Special Purpose Vehicle (SPV) as a part of the settlement plan were to be redeemed over a period of 10 years subject to realization of assets. Interest @ 4% p.a. was to accrue and payable at the time of redemption. The debentures were recommended to be listed on the Colombo Stock Exchange thereby enabling depositors to realize value prior to redemption by the SPV.

The proposal was designed to enable all depositors to recover their investments. While small depositors were to take precedence over the others, repayment of larger deposits was subject to the realization of assets of the SPV.

Over Rs 6
Between
Between
Between
Between
Between
Deposits

REVIEW OF ASSETS AS AT 25TH OCTOBER 2002 (In Rs. Mn's)

Description	As per PSDB books	Independent Opinion	As per Due Diligence	As per Final Proposal
Cash & Short Term Funds	420	420	420	420
Money Market Placements	65		50	50
Investment Securities	234	127	156	156
Loans	2,002	1,443	1,126	1,126
Investment Properties	108	186	69	69
Property/ Plant/ Machinery	82	41	20	20
Interest Receivable	18	18	36	36
Other Assets	101	36	39	39
Total Assets	**3,030**	**2,271**	**1,916**	**1,916**

REVIEW OF LIABILITIES AT 25TH OCTOBER 2002 (In Rs. Mn's)

Description	As per PSDB books	Independent Opinion	As per Due Diligence	As per Final Proposal
Deposits	2,275	2,258	2,258	1,371
Borrowings	824	810	810	527
Other Liabilities	206	234	234	26
Conversion of Direct Liabilities		50	50	10
Total Liabilities	**3,305**	**3,352**	**3,352**	**1,934**

REVIEW OF SHAREHOLDERS FUNDS AS AT 25TH OCTOBER 2002 (In Rs. Mn's)

Description	As per PSDB books	Independent Opinion	As per Due Diligence	As per Final Proposal
Share Capital	307	307	307	307
Reserves	2	2	2	2
Retained Losses	(584)	(1,390)	(1,745)	(327)
Total Shareholder Funds	**(275)**	**(1,081)**	**(1,436)**	**(18)**
Total Liabilities & Shareholder Funds	**3,030**	**2,271**	**1,916**	**1,916**

Following are further recommendations made in this regard.

- A team of professionals specialized in debt recovery to be responsible for the recovery of assets transferred to the SPV.
- The SPV was to be managed by a Board comprising of representative directors from Debenture holders. The creation of the SPV was to enable the restructured PSDB to re-commence operation with a clean balance sheet not burdened by non-performing loans.
- A consortium to invest Rs 500 million in the restructured PSDB and further Rs 20 million in the SPV in the form of debentures. The consortium was to manage the SPV.

The Decision of the Central Bank

While the Monetary Board actively pursued the proposal, the Board ultimately decided that liquidation would be a better option in the interest of the depositors based on certain major considerations as announced by the Board in August 2004.

Conclusion

In the PSDB case; despite the option of restructuring, the Central Bank decided to ultimately liquidate the troubled bank for several reasons. The government thereafter decided to bail out the depositors by vesting the assets and liabilities of PSDB in the newly inaugurated state owned Sri Lanka Savings Bank.

In an open economy, corporates as well as banks collapsing are inevitable. What is important is the magnitude and degree of impact of such a collapse, on the banking system. The prudent course to follow, if there has been no major shake up is to allow for liquidation, with shareholders and depositors taking the brunt of the consequences, whilst protecting only the small time savers. Re-stucturing a bank of this nature would otherwise be at the expense of tax payers.

In Sri Lanka today we witness a rising share of foreign currency assets and liabilities in the balance sheets of the banks. The currency mismatch exposes the banks to mismatches in liquidity and interest rates. Given the bitter lessons that Asia learnt in the aftermath of the "East Asian Currency Crisis", it is of paramount importance that we manage these exposures prudently. In the final analysis; however, it is the integrity of the board of directors and management, as well as the level of customer sophistication that would steer a bank away from a disastrous path.