GLOBAL SOVEREIGN DEBT ISSUES, REGULATORY DILEMMA AND CHALLENGES

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Synopsis

The 2007–2009 financial crises, followed by the 2011 sovereign debt crises in the USA and European Union have made financial conditions and banking operations volatile and uncertain across the world. The crisis affected financial systems are yet to be fully repaired. As was in the past, the present crisis may also pass without a serious collapse of the global banking and financial sector, but a number of regulatory challenges have emerged calling for significant changes in the regulatory system.

The global trends of bank regulations will impact on the existing regulatory frameworks of all countries in different degrees. National regulators cannot therefore be complacent about the strength of their financial systems nor should they act unilaterally compelling banks to strictly comply with regulatory target dates set for crisis affected countries.

The history of financial crisis was full of blame games. Asia was branded as a threat to the rest of the world during 1998/1999 and advanced countries insisted that rigorous regulatory reforms be introduced to avoid future contagion. Asia gradually implemented national and international standards and strengthened their regulatory frameworks to ensure that Asia will not be blamed for lax regulation and supervision. Sri Lanka was insulated from the Asian crisis to a large extent but having seen bitter lessons experienced by its neighbours, the authorities introduced appropriate measures to strengthen the regulatory framework to promote a stable banking and financial sector. Accordingly, the Central Bank of Sri Lanka (CBSL) has initiated a number of measures during 1999-2010, ensuring that the country's financial system is resilient enough to withstand pressures from external and internal shocks and provide financial services under tumultuous conditions.

The blame game shifted to the US with the sub-prime crisis during 2007 and post Lehman financial crisis in 2008/2009, which spread across the world with serious consequences in the US, Europe and Japan. A credit mania of several years that no one wanted to end suddenly turned into a financial panic in 2008. Some of the big UK and European banks were bailed out by their respective governments and the crisis naturally had a serious dampening effect on the growth

rates of the US and European economies despite injecting a large amount of public funds into the system through quantitative easing (QE I and II) and measures taken to reassure investors. Almost all countries affected by the sub-prime and post Lehman financial crises have put in place necessary regulatory reforms to avoid a recurrence of a crisis of the same magnitude but enforcement has been lax in many instances. On the whole, Asia had minimal or moderate impacts largely due to its regulatory readiness and constant vigilance in the post Asian crisis period.

Pre and post Lehman financial crises generated severe impacts on the world financial system, the US, in particular. While, the US is trying hard to reassure the confidence in its banking sector, the onset of the sovereign debt crisis has aggravated market conditions and eroded confidence in the sovereign as well as the banking sector which holds sovereign debt. Both, US and Europe have now realized that their banking systems are not only shaky, but are also in a more dangerous position than pre 2008 crisis. Prior to 2008, the common notion of bank failures was "***too big to fail***", and the post Lehman collapse illustrated, ***"anybody can fail***", irrespective of how big they are. Although the Dodd-Frank Reform Kit of 2010 addresses some of the pre Lehman issues, many of the covenants are not yet applicable to big cross border conglomerates despite them being Systemically Important Banks (SIBs). Big banks, while lobbying for postponement of regulatory requirements imposed during and after the financial crisis, have begun risky lendings.

Tightening regulations is easy when the economy is doing well and the macroeconomic fundamentals are behaving satisfactorily. During the first half of 2011, the US economy grew by less than 1.0%, accompanied by a downgrading of the sovereign debt ratings for the first time from AAA to AA+. Following the historical downgrading of the US economy, the Fed Reserve Bank (the Fed) has announced plans to keep its benchmark short term interest rate close to zero for at least another two years. By implication, it means that instead of buying more bonds as expected by market operators, the Fed may help drive investors into riskier assets, like stocks through zero interest rates. From point of view of the Fed, buying more bonds would be inflationary but a zero interest rate regime may not fuel inflation that quickly. Similarly, GDP figures for the entire Euro Zone are expected to be a marked slowdown from the Q1's 3% plus growth pace to an annualized rate of 1 to 1.5% and the present sovereign debt crisis is likely to hit European Banks in varying degrees.

It is an uphill task to introduce new regulations or amend existing regulations when all economic agents are struggling to survive. Naturally, the circumstances lead to regulatory gaps and dilemma, the situation which can be exploited by banks and financial institutions. This is specially so for the US and European regulatory authorities whose regulatory action had to be halted or postponed due to a series of crises since the sub-prime episode. Due to on-going global debt crisis, the Fed, the European Central Bank (ECB) and other central banks are trying to be flexible on the application of regulatory measures on banks in order to ensure that credit growth supports the resurgence of their respective economies. However, the rescue effects should shore up European banks ensuring that they can withstand a potential sovereign default. This would require giving some breathing space to the solvent European governments as well as the banks to complete their reform programs. The more recent (Sept 2011) IMF, ECB and European Commission (Troika) assistance to European countries illustrates this position.

The article sheds light on the need to recognize several important features that dictate diverse regulatory philosophies and enforcement patterns. Firstly, regulatory enforcement is difficult during economic downturns and recessions. More than two dozens of the legislations/ rules were behind schedule as of June 2011. Long delays can lead to lobbying for delaying enforcement or not to tighten regulations, given the need to avoid recession. Secondly, it is dangerous to leave regulatory gaps as banks and financial institutions tend to enjoy regulatory arbitrage and often misuse flexibility. Once regulatory arbitrage sets in, the herd instincts take place and without hard measures, it will not be possible to eliminate it. There remain signs that the tightened regulatory measures could still be undone creating uncertainty about whether the actions that have helped to stabilize the US banking sector will be in place when the next crisis hits. The longer it takes to plug regulatory gaps, the longer would be the time taken to undo damage from excessive risks taken by banks. Thirdly, the introduction of stringent laws but with little enforcement is worse than not having laws. The post subprime and Lehman crisis followed by the recent sovereign debt crisis show ample examples of non-enforcement of sophisticated rules and regulations. In contrast, the Asian regulatory authorities have been able to enforce simple regulations announced by them in consultations with banks and financial institutions. India, Sri Lanka, Malaysia, Singapore, Thailand have been effective in enforcing regulations in the post Asian crisis period. Fourthly, there is a need to reassess the zero risk rating attached to sovereign debt primarily for capital adequacy calculations and also for collateral purposes. The ongoing sovereign debt crisis in Europe and the downgrading of the US credit rating have raised a number of risks attached to sovereign debt, in particular, how it should be treated in Basel III when it is given effect to, around 2017. Fifthly, there is a need to augment stress testing by banks including both macroprudential and microprudential simulations and also taking into considerations the new developments, such as sovereign debt risks. So far, stress tests have not been forcefully effected by the Asian regulators but they have forced banks to increase their entry capital as well as tier I and tier II capital. Sri Lanka has made sure that its banks comply with Basel II capital adequacy requirements on agreed dates. The rapid demand for credit in the post conflict Sri Lanka has promoted the enforcement of capital adequacy and other statutory requirements on banks. Although Asia escaped a serious impact of crises that took place during 2007-2011, there is no room for regulatory complacency among other things. They should note the ill effects of regulatory inefficiencies on the banking systems of US and Europe.

This article contains 5 sections. Section I deals with Facets of Regulatory Battle and Challenges and Section II with Debt Crisis and the Downgrading of Sovereign Ratings. Section III Analyzes the impact of debt crisis on Asia's Banking and Regulatory Arrangements, while, Section IV sets out the Growth Prospects of Sri Lanka, Rapid Credit Expansion and Regulatory Action by the Authorities. Section V sets out Concluding Remarks.

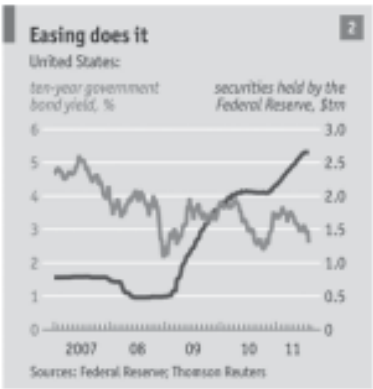
Section I - Facets of Regulatory Battle and Challenges

Capital of some SIBs had been less than 5% of risk weighted assets: The 2010 stress tests revealed that some banks in particular, the southern European banks, under- performed. Despite regulatory tightening in the post sub-prime and Lehman crises, capital of some of the US and European banks have been less than 5% of risk weighted assets. How much capital should these banks raise would not only be a shareholder concern but also a regulatory challenge. The real truth surfaced due to the unprecedented increase in the disclosures of the loan portfolios and the risks of holding of sovereign debt by banks, specially, the banks in Greece. Regulators thus prefer to continue the rigorous stress tests as such tests would force banks to be honest about potential risks. It is also noted that the French and German banks which have been the leading holders of the Greek Sovereign debt will be faced with severe ramifications as and when Greek debt restructuring takes place. The outstanding overall debt of Greece is said to be approximately Euro 350 bn. Altogether, EU banks hold almost 14 bn Euros in Greece and under the proposed bailout (still being worked out) Greek, French, Cypriot, German, Belgian and UK banks are expected to lose some or all of such debts.

Some US and European big banks are struggling to raise additional capital: The post crises regulatory battles are multifaceted. From the banking industry point of view, despite disruptions, setbacks as well as loss of public confidence since 2009, some banks have not been able to raise required capital upto pre 2008 level, but they continue to argue and resist regulatory measures and leverage caps introduced by authorities. On average, the four largest US banks, now hold capital equal to about 11% of the outstanding loans. Although the US Treasury Secretary, Timothy Geithner in 2009 insisted that *"**capital, capital and capital for all**"*, even the Basel III capital requirements may end up with higher capital for SIBs and that too could be upto pre-Lehman level. More recently, the IMF also held the view that "urgent recapitalization" of Europe's weakest lenders is needed to shore up the banking system.

Many of bankers believe they have got off lightly: 46 % of financial services sector personnel felt that banks have escaped regulations, because of the priority placed on the revival of the crisis hit economies, while 44 % the opposite. Interventions under QE2 with a US $ 600 bn bond purchases, seem relatively minor compared with the possibility of a third bout of QE3.Although it is considered a powerful measure, QE is a tool the Fed is reluctant to use again. The last round, completed in June 2011, with a major goal being preventing deflation, has been accomplished (Chart I). It could also mean a new round of asset purchases by the Fed aiming at reducing longer term interest rates.

Chart 1



National regulators criticize the regulatory regimes of other regulatory authorities: At national level, a number of countries criticize the regulatory regimes of other regulators. Recently, the US Treasury Secretary warned global regulators for undercutting US financial regulations which endorse the need for higher capital requirements and tougher rules on derivative trading. The US felt that while it is tightening banking regulations, Singapore and Hong Kong are luring business in every regulatory environment and emphasized on the "***light touch***" regulatory approach and its consequences on US big banks. The Monetary Authority Singapore (MAS) rejected US allegations on ***"light touch regulation on derivatives",*** while Hong Kong and China have also argued on similar lines. The US's approach to a global application of "simple equity surcharge" however, has been strongly backed by the IMF stating that European banks need more capital and if necessary, EU should be allowed to "***gold plate"*** capital requirements if radical circumstances warrant such an action.

Regulatory battles are worse in the EU: Given the unwillingness of ECB to support losses for senior creditors for mismanaged Irish and Greek banks and its insistence on stress tests has been controversial. EU is drafting legislations that apply new Basel III standards across the 27 nation bloc. The debate is, should Basel III capital requirements be the "***maximum standards***" or "***minimum requirements***", so that the national regulators can introduce capital ratios as and when local/international circumstances warrant change. While some EU countries still protest about the 7% minimum equity requirements under Basel III, the UK seems to be supporting the standards that exceed Basel III minimum. The UK Independent Commission has recommended that big banks should have minimum 10% of tier 1 even under Basel III, so that adding expensive capital (gold plating) can be avoided.

Stress testing is a must and authorities are at loggerheads on stress tests: The Banking and Financial Authority (BAFIN) criticizes the European Bank Authority (EBA) for conducting illegitimate "***stress tests***" on banks. 91 banks in 23 countries have been subjected to "***rigorous stress testing***", while 8 out of 91 banks, have failed stress tests (before the Irish Bank failure) the criticism was especially for exceeding the "***hybrid capital***" by banks. The uncontested outcome of the stress tests pointed towards banks having good quality capital, i.e. Tier 1 core capital. For

years, banks did their own rigorous stress tests by stimulating a 10 – 20 % decline in share prices; decline in interest rates; increase in unemployment rates; changes in GDP growth and inflation; variation in government bond yields and house price fluctuations etc, which are more macro indicators. The banks comforted themselves by looking at computer generated simulations, but never looked at crisis prone indicators such as potential sovereign debt defaults, capital shortages and their impacts on worldwide financial crisis and liquidity dry ups which are the trigger points that have surfaced at present time.

Stress tests have been excessively optimistic: The EBA has requested banks to revise stress tests and rectify inconsistencies by reducing excessive optimism. Many banks are still reluctant to insert negative stimulus of market failures or regional financial crisis, which have already strained some regions. EBA has also advised banks to be cautious on the debt rated Triple C ("CCC") - lowest possible rating before default and the ratings that are currently applicable to debt laden countries. EBA feels that approximately 36% chance of defaulting should be factored into the models of stress testing by national banks and re-simulate to get more realistic results. In the 2011 April stress tests, the assumption made by national banks and their respective regulators was that there will be no sovereign debt default by Greece even though Greece and other heavily indebted European countries may not face a catastrophic default. It is rational, however, for banks to work on a potential collapse scenario and get ready to adjust their capital cushions accordingly. Banks however, continue to argue that making rigorous stress tests in a highly stressed environment is not a meaningful exercise, although in the interest of global financial stability, such tests would help confidence building of investors and savers.

Regulators too have not forced banks to factor in crisis prone indicators: The inclusion of systemic risks due to interconnectedness and contagion effects into bank's internal stress testing modules have been missed out by regulators. They are now awakened to the rigorous stress testing in the post sub-prime and Lehman financial crises, which had ripple effects on most financial markets during 2007–2010. The European governments rushed to set up an Euro 40 bn European Financial Stability Facility (EFSF) - a rescue fund to address the new woes in Spain and Italy and assist banks in the recapitalization process. This was thought to reduce the overheating in the banks' funding markets and help confidence building.

Regulators demand publication of stress test results: Currently, there are fears over stress tests and also detailed disclosure of risks. EBA is planning to release the details of the debt data for 91 of the EU's largest banks, including 13 from Germany. German banks feel that publishing the results with the present level of details would exaggerate the sovereign debt crisis, although they will be compelled to do so due to new regulatory requirements. Some banks, however, feel that the level of details needs to be significantly reduced to avoid further capital market turmoil. However, the EBA does not seem to agree with BAFIN – Germany's bank regulator of the disclosures and transparency that are required from European banks. Rigorous or not, the stress tests however, forced banks to raise capital through new money or using retained profits which totals approximately Euro 10 bn. The failed banks in Greece ranked the top most banks which require capital immediately, while the UK banks managed to pass the rigorous stress tests without rushing for capital augmentation. The "near failed banks" which should augment their capital are

given time till April 2012 to complete balance sheet improvements. According to the European Commission, the latest Europe- wide stress tests show more stability.

Banks move forward with low capital and risky credits: In the UK, the Vickers Commission requires some banks to have higher core capital of at least 10% in their retail banking operations and have primary loss absorbing capital between 17%-20% of risk weighted capital (like in Switzerland). The Commission wanted to build a firewall between high-street retail operations of big private as well as state controlled banks and their risky investment operations thus "ring fencing" retail banking. The aim is to protect the systemically important retail operations while allowing the investment arm of the bank to fail in a crisis situation. Amidst hard lobbying by banks, the political level decision to implement the proposal and its effective dates are yet to be announced. According to far reaching proposals made in the Commission's Report, the industry may have to spend £7 bn (US $ 11bn) a year. UK's big four banks (i.e. Barclays, HSBC, Lloyds and Royal Bank of Scotland) are likely to fight hard to stop risk weighted capital going beyond 13%- 14% and also to postpone the returns to 2015. The lazy attempts to recover debt has also aggravated the situation. The financial Services Authority in the UK revealed that 63% of arrears by borrowers in the year to March 2010 indicates a significant recovery forbearance by banks.

Sovereign debt crises have aggravated regulatory challenges while cross border promotional activities have slowed down: The planned integration that was taking place prior to the sovereign debt crisis has now come to a halt with no cross border promotional activities taking place. Similarly, HBOS and Lloyds in the UK as well as Dresdner Bank and Commerce Bank in Germany and Fortis in Belgium which experienced capital and other issues during the post Lehman financial crisis are not in a position to spread on cross border basis. Moreover, these banks which have been provided with an implicit guarantee by their respective sovereigns are not attractive propositions for cross border share ownerships.

Threat of default continues on Greek Sovereign Bonds and Italian debt: Latterly, the European markets have focused on banks in Greece and Italy. The numerous problems in Greece will inevitably affect banks due to the bleak outlook for the country's economy and, more importantly, the threat of default hanging over Greek sovereign bonds. Almost all big Greek banks own sovereign bonds in large quantities. According to the IMF, the level of debt in Italy is moving closer to that of Greece and it is ahead of 64% in Spain. Greece's budget deficit in 2011 is expected to increase to 8.5% of GDP or beyond and the proposed sovereign debt restructuring of Greece in September is being awaited by all European banks to handle their own bank restructuring programs. The German "***bad bank agencies"*** that hold billions of Euros of Greek debt are yet to decide whether to join a bond swap intended to cut Greece's refinancing burden as part of the European Union's bailout.

Regulatory Reforms and Dilemma: **Plugging all regulatory gaps is impossible**. Although banks do not wait to take advantage of every regulatory gap, returns of regulatory arbitrage is not a good proposition for banking. Since the collapse of Lehman in September 2008, the authorities have worked in close coordination and have agreed on the following:

- November 2010: G-20 intensified international cooperation for strengthening regulations and international standards.
- April 2009: Financial Stability Board (FSB) which coordinates with world regulators announced regulations and central banks upgraded their regulatory requirements.
- September 2009: G-20 agreed that all derivative contracts (at $ 600,000 bn of outstanding OTC contracts in 2011) should be centrally cleared and where appropriate, traded on exchanges or trading platforms by end of 2012.
- July 2010: the US Congress passed Dodd-Frank Law and regulations under it requiring US banks to have a code of conduct and demand collateral from parties to uncleared derivative contracts wherever business is done.
- September 2010: Basel Committee announced a core capital ratio of 7%, (equity) to risk weighted assets plus capital surcharge on bigger banks.
- December 2010: the European Union passed regulations and rules on the bankers' pay.
- April 2011: the FSB indicated that banks which will not be able to comply with derivative regulations by 2012 will be named and shamed.
- July 2011: draft legislations for EU Countries.
- August 2011: Emergency G-20 meeting to discuss sovereign debt crisis.
- November 2011: G-20 to agree on extra capital regulations for SIBs.
- June 2013: begin phasing implementation of capital regulations.
- January 2014: banks to be fully compliant on capital adequacy.

Asia as a whole, has not yet adopted some of these measures nor have they agreed to comply on the target dates set for G-20 countries. The US is working towards developing regulations under the Dodd-Frank Law, while Asia is in the process of picking the most relevant measures for them. The first comprehensive regulation under Dodd-Frank Law with 2300 pages and possible 5000 pages of new rules as well as numerous studies is expected to be completed by end 2011 or early 2012. Consolidation that is expected through this law/ regulations is not seen as a favourable move for US banks.

Regulatory Gaps vs. Regulatory Dilemma: "In the post crisis period, banks have begun to use derivative trading through exchange traded funds (ETFs), which promises investor returns from index or assets without having to own all the underlying securities. There are a number of products like plain Vanilla ETFs (funds own at least some of the assets) or synthetic ETFs (return is earned through derivatives). The rapid growth of these funds and banks' appetite to use them are obvious risks, which may not be clearly seen by investors. The growth in ETFs (2670 by end of April 2010) is also indicative of potential changes in the trading assets from equities to commodities, which can pose serious threats at times of market volatility. The exposures were clearly demonstrated in May 2010 when "Flash Crash" took place in Wall Street equity markets during which 70% of the cancelled trades were accounted for by ETFs and 11% in US securities. If ETF withdrawals take place in large quantities, it can trigger a serious liquidity crisis, due to difficulties in selling collateral. The rising synthetic ETFs in Asia and Europe too are a worry for regulators. In March 2010, the US SEC categorized new synthetic ETFs similar to the sub-prime units.

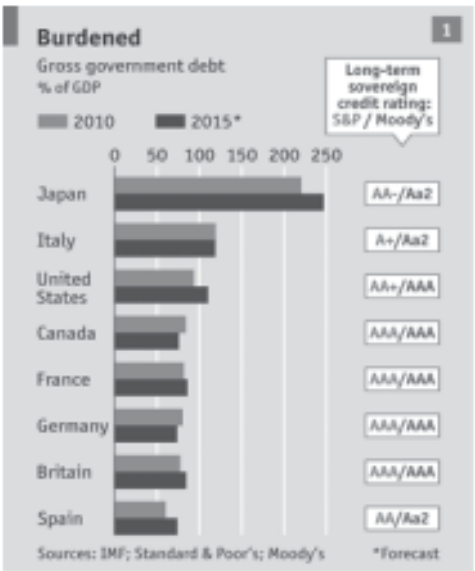
Unplugged Regulatory gaps is a common phenomenon: In the past 30 years, many US big banks experienced severe financial problems. In 1982/1983 due to bad lending to developing countries, including Latin America; in late 1980s, the US banks collapsed due to reckless lending on real estate; in 2008/2009, US residential estates triggered the crisis; also in 2008 Lehman collapsed partly due to lack of regulatory surveillance. Post 2008/09, some of these regulatory gaps have been closed, while new gaps or ones that are slightly different to previous ones have emerged.

Boards of Directors Live in Fear: Post 2008, Boards of Directors of banks do not wish to make same mistakes twice during their tenure. However, the high risk credit they are now making can cause problems in the short to medium term as they have made use of apparent regulatory gaps, some of which cannot be plugged instantaneously by the regulators. Some regulators in particular those in the advanced countries are in a dilemma due to concerns over recession and their assumption of contribution to pop up economic growth. Naturally, political pressures on the regulators are also forcing them to ignore such gaps.

Section II –Impact of Debt Crisis and Downgrading of Sovereign Rating

The net US Fed Reserve/Government debt held by the private sector has now risen from 40% to 75% of GDP: As shown in the graph below, government debt/GDP ratio in advanced countries do not indicate a significant improvement in the projections made for 2015.The biggest banks are still suffering from bad debts and there is no grand bank restructuring program in place either. Several small US banks have gone under (approx. 715 at end 2010 and 35 so far in 2011). The choices for US are twofold: to follow the Lehman type resolution allowing the institutions to go under or to establish a continuous bailout process, both of which are not acceptable to US authorities. Nevertheless, they are continuing small scale Troubled Asset Relief Program (TARP) type bailouts as a large number of banking institutions have failed thus far in 2011. In the wake of the gloomy recovery of the economy as well as the large debt outstandings in the Fed, partly held on behalf of the US government, the rating agency, Standard and Poor downgraded US sovereign rating from AAA to AA+ which is a historic embarrassment to the US.

Chart I



Tensions prior to raising of USA debt ceiling called for assurances: The Fed as the principal regulator of the US financial system and the agent of the US government with responsibility to pay treasury checks, process its electronic payments and issue treasuries, and redeem treasury securities. However, prior to the announcement of sovereign rating, US big banks repeatedly requested the Fed to explain the impact of US sovereign debt crisis on banks:

- The contingency plan the Fed will come up with, given the downgrading of US securities rating from AAA to AA+.
- The impact on capital ratios, potential effect on repos and short term bank financing if a run on money market funds that hold bonds were to take place.
- Fed's position to support the refinancing of treasury securities by buying any unsold stocks at auctions and the support Fed would offer if there was a run on money market funds.
- The way the Fed would handle regulations on liquidity if treasuries fall in value or if there is a large volume of inflows or outflows of deposits.

Although the Fed did not explain its stance on these issues precisely, the decision to keep interest rates at zero level for two years and the potential pursue of QE3 seems to have stabilized short term markets.

Supporting weaker economy through near zero and zero interest rates: The Fed already holds US$ 2.6 Trillion of treasury securities and mortgage backed bonds and is not willing to

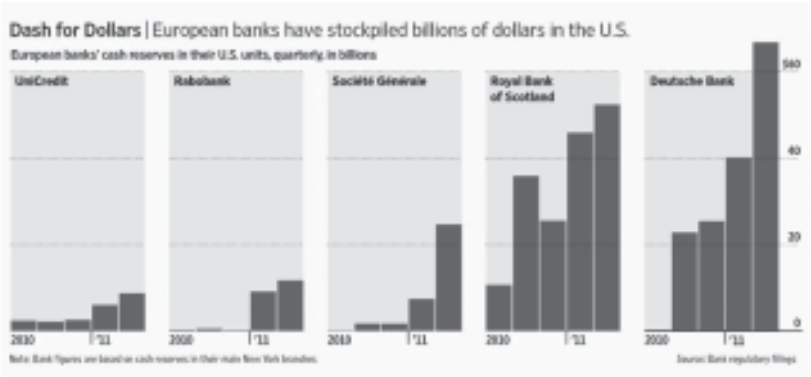
embark on an additional purchase of securities as the last round of securities purchased failed to boost growth. The other option is to keep the interest rates at near 0% for some more time. The Fed faced the stiffest internal opposition but decided to support the weak economy.

Reviving the world economy

Central bankers to the rescue: "Flat on its back, feeble and growing weaker, the rich world's economy is in a sorry state. In the past week the signs of alarm at its condition have multiplied. In Europe, yields on Italian and Spanish ten-year bonds rose above 6%. America fretted at seeing its credit downgraded by one of the big ratings agencies. Around the world, stock markets tumbled, with some recording their biggest one-day falls since 2008. Bank shares were hit especially hard, a sign of stress in the financial system. Then the central banks stepped in." (Economist August 13th – 19th 2011)

Regulators guard against European banks siphoning funds out of their US operations: Anxiety about European banks' U.S. funding comes amidst broader concerns about whether Europe's struggling banks will be able to refinance maturing debt in the coming years. According to Morgan Stanley, while top European banks already have satisfied about 90% of their funding needs for 2011, they still need to raise a total of roughly Euro 80 billion ($115 billion) by the end of the year (Chart II) .The Fed and state regulators, signaling their growing worry that Europe's debt crisis could spill into the U.S. banking system began to intensify their scrutiny of the U.S. arms of Europe's biggest banks. The Fed is demanding more information from the banks to assess whether they have reliable access to the funds needed to operate on a day-to-day basis in the U.S. and, in some cases, pushing the banks to overhaul their U.S. structures.

Chart II



Regulators are seeking to avoid a repeat of the 2008 financial crisis: The operations of foreign banks that lack extensive U.S. branch networks worry U.S. authorities. They can borrow dollars from money-market funds, central banks or other commercial banks or can swap their home currencies, such as Euros, for dollars in the foreign-exchange market. Most of those options can vanish in a crisis. This time the worry is that the euro-zone debt crisis could eventually hinder the ability of European banks to fund loans and meet other financial obligations in the U.S. The regulators recently have put pressure on European banks to transform their U.S. businesses into self-financed organizations that are better insulated from problems with their parent companies.

Crisis – led credibility issues, beware the ECB's brave new world

Source: (Martin Sandbu - Financial Times - August 10, 2011)

"Jean-Claude Trichet, president of the ECB, has torn up his institution's implicit rule book by buying Italian and Spanish sovereign debt. ECB which was known to be a tough regulator has broken its long standing stance of "no bailouts" in order to avoid a potential financial crisis across Europe. While such a revolutionary measure is arguable, such action can also be justified for purpose of stability and avoiding a repeat of a financial crisis. It is debatable whether ECB's action will have much effect. ECB has already intervened (in May 2010 – first Eurozone response) reluctantly though in the sovereign bond markets of Greece, Ireland and Portugal but in smaller

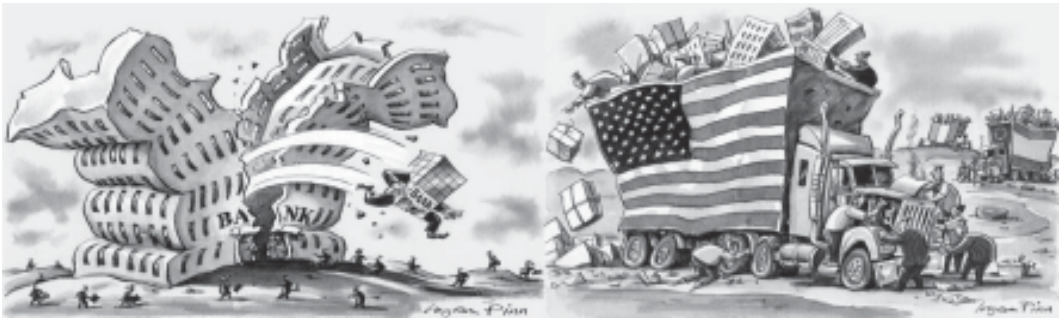
numbers (Euro 74 bn worth of Government security from these three countries) - than those of Spain and Italy (approximately Euro 300bn).

The bullets yet to be fired to stop the crisis: "At the root of today's credibility deficit is a failure to come to grips with the long, slow growth period that is typical of post-financial crisis recovery. Too many decisions, for example, the recent withdrawal of monetary stimulus by the ECB and the US Fed have been predicated on overly rosy growth projections. Time and again, policymakers counted on rapid post-crisis recovery to help them avoid painful decisions on how to deal with badly overstretched private and public balance sheets, whether household debts in the US or sovereign debts in the periphery of Europe. Time and again, rapid growth did not materialise or – if there was a burst – did not last. Every effort to delay a critical decision has ended unsatisfactorily. So the downturn has treated US and Eurozone leaders, with each successive stumble further undermining their credibility". (Kenneth Rogoff –Financial Times -August 09, 2011)

"Loans to a king do not always pay": revealing the eroded public confidence in the major countries and their sovereign borrowing instruments John Kay said, in Iceland and Ireland, the public does not readily understand why it should be responsible for the follies of financiers. In the US, a minority seem to believe the federal government represents a hostile occupying power. Europe suffers from deliberate blurring of the distinction between the obligations of individual states and the obligations of the Eurozone. These different phenomena are all manifestations of the same underlying cause – loss of confidence in governments and trust in the financial system. (John Kay - Financial Times - August 10, 2011)

The coming crisis of governments

The incredible shrinking banks: **The coming world of smaller banks**



Source: (Robert Barro - Financial Times - August 4)

Collective responsibility and action by policy makers and regulators: Bank regulators should have flexible operational frameworks, to avoid crisis deepening and if necessary, to ease liquidity pressures of banks by providing funding against a broad range of collateral. Although it creates moral hazard, in this instance too, pledges by G-7 helped ease situation. On the regulatory

side, central banks and monetary authorities in France, Germany, G-7 and the ECB have pledged to stabilize financial markets and ensure stability and liquidity in such markets, while G-20 issued a similar communique. ECB spent Euro 22 bn in buying Spanish and Italian bonds but without specifying how long the commitment would be, while Japan warned that it may intervene again to stem gains in the yen.

Avoid recessions: Can moral hazard be side stepped? During the recent crises, the Fed was motivated to avoid recession at all costs. In 1937 with the US economy seemingly reviving, President Roosevelt cut government spending and raised taxes, while the Fed raised interest rates. A new recession hit the country and the Fed was blamed. The Fed is naturally worried about keeping interest rates at zero level for 2 years as it can lead to a protection of stock markets, traders and investors but it fears being a party to the recession. This type of moral hazard may be even worse in Europe as expectations ripe that governments will protect the banks from defaulting government bonds. Similarly, Japan has experienced moral hazard by trying to keep the Yen from rising too far against the US Dollar.

ECB's position was considered aggressive: ECB's aggressive stance on monetary policy itself was premature by most analysts. "Alone among the big central banks of the rich world, the ECB has started to tighten policy rates at the beginning of 2011 thus raising its main interest rate in quarter-point steps from 1% at the beginning of April to 1.5% in July. That stands in marked contrast not just to the Fed's behaviour but also to that of the Bank of England, which has kept the base rate at 0.5% and looks set to leave for some time, judging by its quarterly report on the economy published in August. The tightening looked premature when the ECB embarked on it this spring. It looks worse still now." (Economist August 13th – 19th 2011)

Choices for mitigating the impact of deteriorated confidence on the sovereign are limited: Risks of sovereign action has emerged as the main challenge to global financial stability - an issue not limited to Europe or US alone. With rising sovereign debt levels in advanced countries, the risk free status of such debt is in question which raises risk ratings assigned for calculation of capital adequacy requirements, be it Basel II or III. In addition to focusing on a "neutral" stance, it is imperative for regulators and bankers to discuss the broader implications of heightened sovereign risk for financial stability. How does deteriorating sovereign creditworthiness affect overall bank funding and what options are available for mitigating that impact will be a regulatory challenge.

The Central bank's monetary tightening is an own goal, but the broader malaise in the euro area has a clear resemblance to those of USA, UK and Japan: As Kenneth Rogoff, co-author of a recent 800-year history of financial crises, has pointed out, "the recovery of debt-laden Western economies was bound to be slow and halting. Central banks may be the last people standing, but they cannot produce better growth out of nowhere. The emerging markets which provided a cushion during the financial crisis look less helpful now, especially if they put up capital controls in the face of a new round of QE. The sharp equity declines in August, suggest investors understand the grim reality of a long period of slow growth". Assessing the impact of QE on the UK economy, the Bank of England concluded that its QE between March 2009 and January 2010 through purchases of £200 bn worth of governmental bonds prevented a recession in the UK.

Issuing of Euro bonds at lower interest rates is an option: Joseph Stieglitz, a renowned economist, proposed "to issue Euro bonds at lower interest rates to reduce the amount of debt and to pass on interest rates impact to individual countries. It was also suggested to set up a "Solidarity Stability Fund" together with the European Investment Bank, ensuring that big businesses do not suffer and growth continues. The general feeling is that after the restructuring of Greek bonds, they should be more acceptable than before and that Europe should accept such bonds by facilitating trades. It is also important to involve the European private sector to accept the restructured interest rates on old debt and reduce interest rates on new debt as well." The more recent German and French attempts to issue Euro bonds or joint Euro bonds to enhance market liquidity has been opposed although it is not ruled out altogether.

"Informal Living Wills" - Banks should hold extra capital to smoothen winding down: In July 2011, the global regulators endorsed the twin proposals to force the biggest banks to hold extra capital and write "living wills" that will enable the banks to shut down safely in a crisis. In the US, living wills are mandated by the Dodd-Frank financial law and they are intended to allow regulators to understand the structure of "too big to fail" financial firms, or those that could pose a risk to the financial system, before a crisis strikes and make it easier to wind them down in case of a failure. The uncertainty surrounding living wills for foreign banks underlines the challenges faced by regulators as they strive to rewrite the global rule book for the financial industry. Under the current wording, the US rule would apply to all banks holding companies with total worldwide assets of $ 50 bn or more, or about 124 banks. The Financial Services Board (FSB) endorsed that the biggest banks should hold extra capital and write "living wills" that will enable them to smoothly bring down operations in an emergency.

Large parts of the financial system are not directly under regulators' control and the impact of the downgrade on these markets is not clear: Often referred to as the "shadow banking system", this sector includes the derivatives, repurchase or "repo" market, and asset-backed securitisation, all of which are used extensively for financing. In the run-up to the crisis, the sector grew enormously, with liabilities in the US reaching $20,000 bn in 2008. According to the New York Fed, shadow banking has shrunk as the amount of leverage in the financial system has decreased but it is still bigger than the traditional bank liabilities that are the focus of regulators' attention. While considering whether to regulate money market funds, securities lending and

repos, and to raise short term funds by selling assets, FSB agreed to buy them back. FSB will step up work on supervision of multi- trillion dollar "shadow banking sector" focusing primarily on the links between banks and shadow banking entities, return on money market funds and securitization. For the purpose of stability, FSB endorsed the idea of having a "bail in" procedure for bond holders and to cover losses associated with them.

Banks are required to adjust their balance sheets: The BIS Committee on Global Financial System explains the role of government debt in financial markets, the costs, market access through direct losses on sovereign holdings, lower collateral values for a wholesale and central bank funding, depressed bank credit ratings and reduced funding benefits from government guarantees. Banks are required to adjust both sides of the balance sheet i.e. on the assets side, to diversify sovereign portfolio and avoid clusters of maturing such debt (maturity/term of debt bunching) and on the liabilities, to raise capital from more stable sources. The BIS Bank Supervision Committee too has recommended that the Systemically Important Financial institutions (SIFIS) should hold additional capital by way of equity against unexpected losses. The surcharges equivalent to 1.25% of each bank's assets adjusted for risk, will be phased out in between 2016 -2019 on top of the global minimum capital ratios of 7% adopted last year for all top banks. They are now required to hold 9.5% against risk weighted assets. In addition, the regulators will be given a "tool kit" to categorize banks into viable and non-viable ones.

Big banks agree to mergers and combined entities: two of the Greece's largest banks, Alpha Bank SA and EFU Euro Bank Ergasias have agreed to combine as a means of getting through the country's debt crisis. Both banks have announced sizeable write-downs on their holdings of Greek government bonds and recording losses in the Q2 of 2011. Write-downs of bad debt is a condition by EU when aid was provided to Greece. Greek banks have agreed to accept new securities worth less than their original holdings. The Central Bank of Greece welcomed this move as a firm step towards reorganizing its banking sector. The banks also would pursue with rights issues to boost capital in early next year and convertible bonds (Euro 500 Mn). Following these steps, the combined capital to assets ratio of banks is expected to be around 14% even after taking Greek government bonds into consideration. In mid-September 2011, the Greek Government announced a two year property tax to raise Euro 2 Bn in this year thus closing an Euro 1.7 Bn budget gap, the EU and IMF would help to solve. The IMF's more recent statements indicated a softer attitude towards Greek debt, while the EU Financial Services Commission indicated a positive outlook for the more recent Europe-wide stress tests on banks. In the meantime, IMF has released approximately Euro 3.98Bn to Portugal as a part of a three year rescue strategy. S&P has now reduced Italy's credit rating for A+ to A given the "fragility" of the Italian economy and uncertainty over future policy decisions.

Section III – Impact of the Debt Crisis on low / Middle income and Emerging Countries in Asia

The Impact of the Global Crisis on Banking Sector in Asian Low Income countries by Jack-Joo K Ree, published in May 2011 revealed that -

- despite relatively low financial integration, impacts of the 2008/2009 crisis on the Asian banks particularly the largest ones, were non-significant;
- the Asian emerging economies' banks appear to have been less affected by the sudden stop of capital flows despite higher globalization of funds;
- the macro prudential supervision has been nascent. Despite vulnerabilities to internal liquidity and capital inflow cycles; and
- even the large banks jump into a new trading technology without understanding the underlining risks.

Asian regulators were in control: From an experienced regulatory foresight, the Asian regulators started gradually tightening regulatory requirements, in consultation with banks and with feasible implementation dates. Nevertheless, Asian regulators too have been concerned of a potential knock on effect due to spiralling downward trends in European and US economies and also other financial markets. On the other hand, taking advantage of the situation, the fast growing countries like India and China as well as the emerging countries like Sri Lanka, Malaysia, Thailand, Indonesia etc. are now facilitating their banks to borrow cheaply from national or international markets and also lend to both local and international borrowers.

The Asian banking stocks remained volatile and banks with debt funding feel the pain: The sell off by the biggest lenders of stocks prompted the financial services commission in Korea to announce that lenders should have contingency plans to survive without the government or central bank support at least for a few months in the event of a crisis and that stress tests need to be continued as the country's banking system could be vulnerable to volatile stock market operations. The global wholesale lending market where big banks lend to one another can dry up when markets get tight as happened in 2008. Korean and Australian banks are not 100% deposit funded as they have a wholesale debt market funding albeit less reliance compared to the recent past. South Korea has close to 75% of its total funding from debt, while Australia has about 40 – 50% of such funding, including inflows from offshore markets. If the market continues to see a slump in shares in the near future, it could raise serious concerns as most Japanese banks still hold cross-shareholding, a common phenomenon in Japan where banks and large companies often hold stocks in each other to enhance business ties. The cozy ties mean Japan's banks will have to take in book losses on their shareholdings at the end of September, 2011.

Chinese banks may face capital stress after Basel III: China's banking system, although growing at a faster pace, is thinly capitalized compared to many of the emerging countries. Chinese banks are likely to face substantial stress in capital in the run up to and post implementation of Basel III Accord, the norm stipulated by G-20. Banks of systemic importance are likely to face

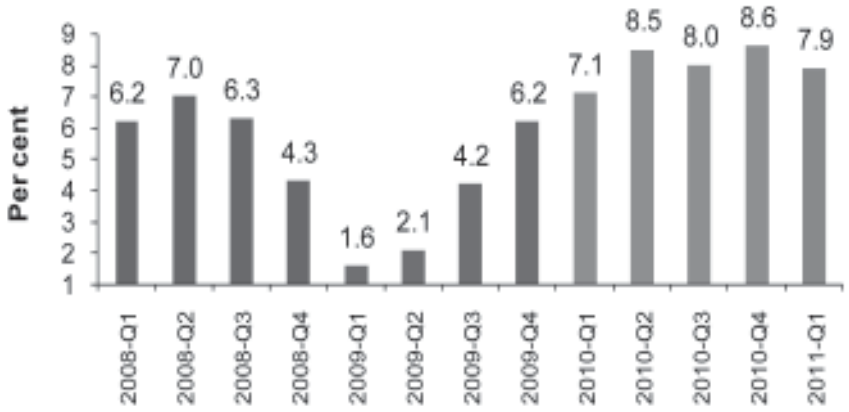
a financing gap of Yuan 400 to 500 bn (USD 77.51 billion) in the next five years. Chinese banks i.e. China Construction Bank, Bank of Commercial and Agricultural Bank of China are increasingly looking to enhance their capital base mostly by selling debt ($ 93Bn through sale of bonds over stocks) in the face of strengthening regulatory requirements. At present, Chinese banks are able to meet the new standard of the Basel III framework, with core capital adequacy ratio of most banks reaching 9 per cent. The capital gap however, will grow as Chinese banks' lending scales expand at a relatively rapid pace and they are looking for more market financing or government financial support that ensures government holdings in the banks. The new rules announced by the Chinese regulatory authority will keep the minimum capital adequacy ratio for banks of systemic importance at 11.5 per cent, while raising the ratio for banks of non-systemic importance to 10.5 per cent. In 2010, the four biggest Chinese banks sold 413 Yuan ($ 65 bn) of equity convertible debt to restore capital, following the government encouraged lending to cushion the impacts of the global crisis. They are also worried about potentially problematic loans to real estate and government projects. Approximately, 20 Trillion Yuan has been guarantees on government's crisis combating stimulus package over the last 2 years. Some big banks have already made provisions or set aside funds for potential loan losses.

India's SIBs hold more capital (equity) to avoid public bailouts: Indian banks maintained a minimum of 12% capital adequacy ratio and that has helped them to survive during sub-prime and post Lehman 2008/2009 financial crisis as well as the ongoing debt crisis without much damage.

Asia is concentrating on sovereign debt related issues: The Asian regulatory authorities by themselves and as a group are focusing on the following questions. Should Asia tighten regulatory requirements of banks to the same degree as US has done? What is the rationale for following all regulations adopted by US and Europe, if Asian banks do not engage in large cross border international transactions which can trigger worldwide threats to stability? What type of credible path back to solvency can be established for the present debt crisis? Does a significant restructuring of debt holding is warranted not only for European banks but also for Asian banks? How big would the restructuring be and who should bear the costs?

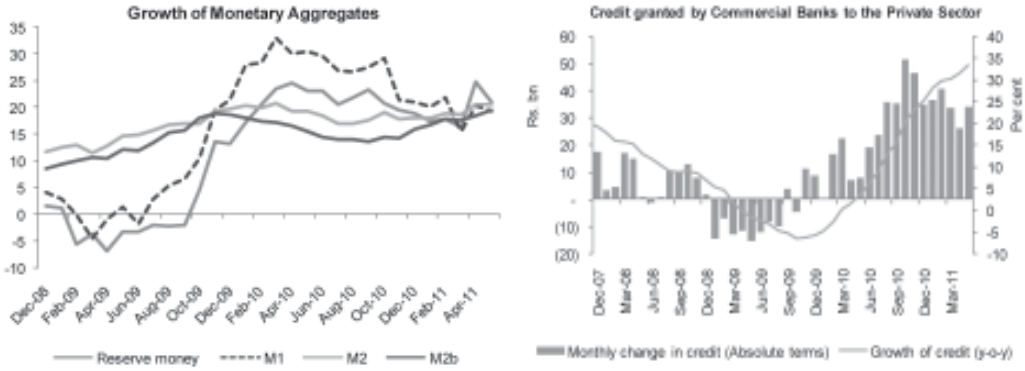
Singapore to be a leading Asian fund centre: In August 2011, Singapore financial market regulators and the Monetary Authority of Singapore (MAS) reiterated its intentions of strengthening the city state's fund administration services. Pragmatic regulation including exempt licensing provisions for smaller managers, has largely been applauded by the investment community and has helped Singapore extend the depth and diversity of local and global fund managers operating there.

Section IV – Sri Lanka's Growth Potential and Regulatory Challenges



Source: CBSL

Sri Lanka's economy is growing at impressive rates demanding more finances: Post conflict Sri Lanka is somewhat unique, in that the economy reached an impressive growth of 8% in 2010 followed by a 7.9% and 8.2% in Q1 and Q2 of 2011 respectively. The growth has been dominated by the industry (9.4%) and service sectors (8.8%) in Q2, followed by agricultural sector (7%). Productivity and value addition in all these sectors have been supported by a rapid disbursement of bank credit in both 2010 and thus far in 2011. Demand for credit across all sectors continues to rise and that has encouraged banks to be on a race to secure loanable funds to accommodate rapid credit demand. Private sector borrowings in the first half of 2011 reached Rs. 200 bn with a cumulative figure of approximately Rs. 1.7 trillion. Almost all private banks have raised capital through shareholder funds and aggressive deposit mobilization. The present low interest rate regime and intense competition amongst banks in Sri Lanka have resulted in a borrower's market. On the whole, 2010 was a good year for banks in terms of enhanced lending, reduced NPA and revised loan loss provision. In the reduced interest rate regime, the upcoming infrastructure projects have encouraged banks to look for opportunities to lend even for longer tenures.



Source: CBSL

Banking sector accounted for 68% of total financial assets: As at end 2010, 22 licensed commercial banks (LCBS) and 9 licensed specialized banks (LSBs) operated in the country. LSBs' notable reduction was due to the formation of 6 regional rural banks into a newly incorporated state bank as Regional Development Bank. Banking sector accounting for 68% of total financial assets in Sri Lanka, consisted of 1932 branches, 965 extension offices, 2977 other banking outlets and 2006 ATMS by the end of 2010. The assets/liabilities of banks recorded a 18% growth by the end of 2010. With these developments, the balance sheet exposures grew by 19% compared to a negative growth of a 4% in 2009. Banks have met all regulatory requirements while liquidity ratio stood at 37% in 2010. The exposure in banks in Sri Lanka to real estate investments is still not very significant.

Cautious supervisory and regulatory approach: Over the last 2-3 years, CBSL has taken necessary precautions to ensure that the country's banking sector is resilient to ride on turbulent conditions. The regulatory philosophy has been to strengthen supervision, while providing necessary flexibilities to banks to work within the regulatory framework which has been announced at the beginning of the year. To share information and coordinate the wider financial sector regulations, in 2009, CBSL appointed an Inter-Regulatory Institutions Council, which facilitated the exchange of information in the interest of financial system stability. Accordingly, the Banking Act was amended in 2010 to introduce changes to align the provisions of the Companies Act No. 7 of 2007 and to facilitate exchange of information with the other regulatory institutions. Amendments are being finalized to facilitate current developments of the banking sector in relation to consolidation and mergers of banks, strengthen bank resolution measures and CBSL's capacity to supervise bank dominated financial conglomerates on a consolidated basis.

Regulatory framework is aimed at risk mitigation: To closely supervise the operations of large conglomerates which engage in banking, stock brokering and insurance, CBSL further strengthened its supervisory and regulatory framework and improved the safety net and risk management systems of banks in 2010. The on-going supervisory systems have been strengthened to identify large exposures to top 20 corporate customers, their subsidiaries, associates and other investee entities and followed up to ensure corrective action being taken on them.

CBSL introduced comparable financial reporting system: In its regulatory process, it was considered important to have a comparable financial reporting format and in 2010, CBSL in consultation with the Institute of Chartered Accountants and audit firms facilitated the adoption of IAS 32 and 39 which are corresponding standards to International Financial Reporting Standards (IFRS). Regarding SLAS 44 and 45, CBSL provided practical working experience of other countries regarding the adoption of these two standards and the banks are being trained to adopt IFRS with effect from 2012.

CBSL introduced further supervisory measures and prudential regulations to ensure capital adequacy of banks:

- The minimum capital of LCB's was raised from Rs. 2.5bn to Rs. 5bn and of LSB's from Rs. 1.5bn to Rs. 3 bn on a staggered basis during 2010 – 2015. CBSL's regulatory stance has been two-fold: First, to strengthen the system by pushing thinly capitalized banks to raise fresh capital (equity) and second, to convince the region and the world of the resilience of the banking system and reassure investors from within and outside.
- The implementation of Sri Lanka Deposit Insurance Scheme (mandatory) with an insurance premium between 0.10% and 0.15% per annum to be paid by member banks to the Deposit Insurance Fund.
- The relaxation of loan classification, income recognition and provisioning requirements as NPA.
- The reduction of the general provisions to be maintained from 1% to 0.5% by 31st December 2011 by reducing at a rate of 0.1% per quarter commencing from 31st December 2010.
- The assessment of the fitness and propriety of officers performing executive functions of banks.
- Requiring unlisted locally incorporated private banks to list on the CSE by 31st December 2011.
- Issue of directions on outsourcing of activities.
- Directions to restrict credit exposure of banks through margin trading of shares.
- Introduction of Integrated Risk Management and the Customer Charter.

Main banks are well capitalized: The ratio of capital funds to assets (leverage ratio) marginally improved from 8% in 2009 to 8.3% in 2010 which was higher compared with the 4% regulatory minimum applied in some countries. The total regulatory capital adequacy ratio (CAR) remained high at 15%, well above the minimum requirement of 10% as at 2010, while, the Core Capital ratio was at 13% well above the minimum requirement of 5%. The composition of the regulatory capital of the banking sector in 2010 indicated that Tier I capital accounted for 87.5%, while Tier II capital was only 12.5%. The share of subordinated debt in Tier 2 capital has declined from 10% to 5.7 % by end of 2010. The Core Capital ratio of 13% of risk weighted assets and the share capital (high quality capital which enables banks to absorb unexpected losses) of 5% was already above the prudent levels of 6% and 4.5% respectively, as required under Basel III. More recently, banks are requested to raise their Tier II capital to acceptable levels preferably from foreign sources.

Banks were encouraged to be resilient to external and internal shocks: At present, the potential threats and delays experienced by the banks in the USA, UK and Europe are not seen among banks in Sri Lanka. This is partly due to the gradual regulatory tightening since 1998/1999 Asian crisis, risk mitigation guidelines issued to banks on complex transactions and effective enforcement of mutually agreed rules and regulations. During 2008-2010, CBSL raised the entry capital of all new entrants and also has given time to banks to raise capital to ensure safe and sound banking. Banks in Sri Lanka are required to hold more capital against risky assets but like in the UK or Europe, banks are not forced to cut the size of their balance sheet to comply with the 2.5% rule of Basel III which will come into force in 2012.

Section V – Concluding Remarks

History warns central bankers and financial regulators to inspect a wide range of economic and financial data and identify all relevant facts and potential threats in assessing financial systems. More recently, prices of real estate, the flow of credit to unsustainable constituents particularly, to shadow banking sector and sovereign debt issues have been the main sources of disruption.

Hard on the heels of the sub-prime crisis in 2007 and the post Lehman collapse in 2008, the US and the European authorities have been confronted with the sovereign debt crisis raising a number of threats to their financial systems. Both the US and European policymakers and regulators have attempted to prop up their economies through a combination of QE and low interest rate regimes. The degree of success of the use of these two policy instruments is debatable. The disarray of advanced country financial systems has impacted on the financial systems of other countries at varying degrees.

The economic down-turn and the series of crises has led to postponement of regulatory action and dilution of the strength of regulatory provisions. Banks were given more time for compliance and that has resulted in regulatory gaps, regulatory inactiveness and regulatory arbitrage. Taking advantage of the circumstances, banks have continued to expand credit to the shadow banking sector as well as to risky ventures and brought in pressure to further postpone regulatory action when the economic down-turn was announced in the US and Europe. The EU regulatory authorities emphasized on rigorous stress testing and the use of realistic assumptions by banks in their simulations, the publication of stress testing results. National regulators and the banks have disagreed with the publication of stress test results, although rigorous stress tests have made banks to raise capital funds of their banks.

Getting US, European and even Japanese banks to augment their capital to comply with the proposed Basel III is a main regulatory challenge. Given the significant capital gaps in the major banks and restrictions introduced on derivative transactions and shadow banking operations, the Systemically Important Financial Institutions (SIFIs) are expected first to raise their capital to pre-Lehman period, and secondly, towards the recommended capital ratios under Basel III. The blame game, regulatory arbitrage and strong lobbying by banks continue unabated with a few banks and financial institutions raising capital from their shareholders. The emergence of the US budget

deficit, the downgrading of the sovereign debt in Greece and more recently in Italy have aggravated the situation and revealed the lack of confidence on the sovereign debt instruments. This too has become an unprecedented challenge for the regulators.

The nation's central bank is singularly ill equipped to handle what may well be a global problem (although it might need to participate in an internationally coordinated series of policy rate changes). As seen in the recent crises, national stock markets react not just to the country's own macro fundamentals (such as overall GDP, accruing profits from share trading, price earnings ratios, and coverage ratios for quoted companies), but also to movements in equity values abroad. For example, this has happened in Japan in the 1980s. In these circumstances, governments, central banks and national securities regulators should start with warnings to markets.

There is a strong case for penalizing riskier banks. Earmarking different risk weights on different classes of assets is one way of achieving this, but the formulae (which are likely to be backward looking) may sometimes need to be reinterpreted, overridden or adjusted in individual cases. The regulatory delays, inaction and lack of enforcement lead to regulatory arbitrage at national as well as international levels. The overall framework of capital adequacy ratios has to be agreed internationally and ideally by as many countries as possible to stop cross border regulatory arbitrage. If riskier banks simply migrated to countries where regulation was lax, there might well be an enhanced threat of severe global financial instability. The task of detecting unduly risky activity and responding to it speedily and appropriately could become far more difficult for most central banks.

Immediately after the subprime crisis, the US authorities were discussing the merits of reintroducing Glass-Steagall Act which was abandoned in 1999 which divided the commercial and investment banking. The links within and among financial institutions, especially with investment banking arms and hedge funds have become a serious threat to the global banking system. It is important for legislators and regulators to ensure that speculators cannot gamble by relying on an explicit or implicit state rescue guarantee. Hence, the case for letting an investment arm of a diversified bank fail without endangering it's retail banking arm. In a similar vein, the UK Vickers Commission recommended to separate retail and investment banking which is being assessed at political level.

Since subprime crisis in 2007, the US, UK and the European central banks and regulatory authorities have adopted a liberal approach towards funding of commercial bank operations due to liquidity constraints by purchasing debts of banks and financial institutions and also carrying fiscal or quasi fiscal debt on central bank balance sheets. Central banks do not consider risk of moral hazard a reason for inaction in the face of recession or even when the country is faced with growth constraints. During the ongoing sovereign debt crisis however, the Fed decided to use near zero or zero interest rate policy instead of a QE3 although the latter is not ruled out altogether. At the same time, the Fed recognizes that its action including bringing interest rates to zero level or reducing them significantly, pumping money to the economies and bailing out troubled banks and financial institutions can produce undesired market volatility. This is a case in point where economic recovery objective prevails over that of the regulatory responsibilities and enforcement.

The most recent attempts by Troika also illustrates the solidarity in helping debt laden European countries in order to avoid a Europe wide financial crisis.

If the urgent task is to contain a banking crisis, policy rate cuts have been considered as desirable, i.e. at zero level, but in other respects, they may add fuel to the fire. This is for two reasons. First, a policy rate cut should stimulate borrowing, lending and the expenditure, typically capital expenditure that will now become attractive. If sustained for several years, it could lead to a lending boom that ends abruptly in a still graver crisis later on. The monetary policy reaction to the dot.com crash and 9/11 outrage in 2001 kept policy rates far below neutral for some three years. In these circumstances, the financial stability objective has to be achieved amidst loose monetary policy aimed at propping economic recovery. Hard and intrusive regulatory action does not augur well in these situations. The Walter Bagehot message for responding to a liquidity shortage at a fundamentally solvent institution was to lend freely – but *at a premium*. On this premise, what ECB has done for Euroland's debt crisis, and the already completed QE2 and proposed QE3 in the US too, could be justified as no big bank has failed since then. Similarly analysts believe that QE (£200 bn by the Bank of England) saved UK from double-dip recession. During TARP bailouts, instead of buying bad loans directly, the US government decided to inject cash directly to banks to boost lending although it did not happen as expected. Also the QE program did not seem to have done anything to address the fundamental problems within the banks' cost structures and mortgage operations.

The explosion of sovereign debt in advanced countries questions the wisdom of regulatory incentives that encourage investments on so –called "sovereign risk free assets" which may be an illusion in the current context. Global regulators should take into account the incentives that are being set and be mindful of the impacts this will have on long term investors as well as the wider financial system stability. Even in crisis, requesting central banks and bank regulators to ditch their stability objectives and to pursue other goals i.e. propping up economies from recession could do more harm than good, particularly if it left people less certain about central bank's ultimate commitment to prudence and stability.

Given what we know about the origins of the global liquidity crisis, sovereign debt crises and the mispricing of risks, there is only a small window of opportunity for regulatory changes for financial market stability over the long term. As the global economy is not yet self-sustainable, the planned regulatory changes can run the risk of a global capital misallocation. Should one therefore, compromise on the regulatory tightening of banking and financial institutions and close regulatory gaps thereby not letting banks to misuse regulatory arbitrage? The US, UK and to some extent, the European regulatory authorities are suffering from this dilemma, while Asian regulators including Sri Lanka have adopted a cautious regulatory approach. The firm commitment from banks and financial institutions for compliance would help avoid repeats of Asian/ subprime/ post Lehman type crises. The interesting feature in Asian regulatory framework is that national regulators decide on what is best and workable for their countries rather than attempting to replicate what the West has done or is planning to do. China and India have tightened their capital adequacy requirements more recently and Sri Lanka has introduced new regulations since 2008 onwards. Asia certainly is

looking forward to keep up with international standards on regulatory norms after ensuring commitment of banks for implementation. The US regulatory authorities have to back tougher capital requirements of banks to i.e. to Tier I capital to be equal to 7% of their risk bearing assets under Basel III capital adequacy proposals. Similarly, the US regulators are also willing to encourage SIFI's to hold an additional 2.5% buffer and also an additional 1% surcharge if a bank becomes significantly large.

The key messages that are brought out from the above analysis are: **First**, there is no escape from credit hangovers and their impacts on financial systems. **Second**, the dangers of allowing banks to boost earnings simply by levering up, masking poor returns on assets with debt. The US banks held about $ 30:1 assets/equity ratio while some of the European banks enhanced their balance sheets upto 80 times more assets than equity. **Third**, when rewriting the rule book for retail and corporate lenders as well as investment banks, although it makes sense in terms of financial stability, it may be risky to reduce the supply of credit and raising the price of such credits as banks seek to bolster returns. **Fourth**, and perhaps the most important would be that leaving regulatory gaps or deliberate regulatory inaction which lead to serious repercussions irrespective of whether the economy is in recession or in a booming state. It is even more risky to leave room for regulatory arbitrage as banks and financial institutions would naturally exploit the situation while lobbying for postponement or in some instances, withdrawal of important regulations.

Since the Asian crisis, Asia has taken significant measures to ensure that regulatory arbitrage is kept at minimum levels while focusing on timely enforcement of regulatory measures. The European and US regulators should pay attention to enforcement of mutually agreed regulatory requirements while establishing coherent policy solutions to reduce sovereign risk contagion. Asian regulators, to a large extent, have been able to insulate their banking systems from the serious impacts of the three recent crises but they too should continue with credible efforts to strengthen the resilience of the financial system.

The views expressed in this article are those of the author and do not necessarily indicate the views of the Hatton National Bank Plc