EVOLVING BANKING CHALLENGES: LEARNING EXERCISES FOR SRI LANKAN BANKS

P. Samarasiri

Assistant Governor
Central Bank of Sri Lanka

(Views stated in this paper are those of the author based on his knowledge on this subject and those views do not represent the views of the Central Bank.)

Although people think that banks are in marbled buildings having lucrative business in the use of others' money, bankers are always under fire. The fire-fighting challenges have been enormous from its ancient days of banking to-date and will continue indefinitely to the future. This article attempts to highlight some of these challenges without technical information.

1.0 A Brief History of Banking and Business Models

The banking has been evolving with numerous challenges from time to time. The history of banking is closely related to the history of money, but banking transactions pre-date the invention of money. The primitive banking was seen in the ancient barter system. The first banks were the merchants of the early ancient world who made loans to farmers and traders in merchandise. The first record of such activity dates back to around 2000 BC in Assyria and Babylonia. Later, in many ancient cities, banks were operated in temples or religious places. The lenders who were based in temples made loans while accepting deposits and changing money. Deposits initially consisted of grain and later other commodity moneys and eventually precious metals such as silver and gold. Temples were the safest places to store money as people constantly gathered around temples and they were well-constructed. Therefore, as sacred places, temples had an extra deterrent to the would-be thieves. The word "bank" was derived from "banco" which evolved from "bancu" in ancient Rome. A "bancu" was a bench set up by money lenders/moneychangers for their routine business to meet the customers. In early days, charge of interest was considered unethical and not permitted by the Christian Church.

The history of the current money and banking began in London with goldsmiths in the 17th century. The goldsmiths evolved from simple artisans to depositories of gold and silver. As the goldsmiths had safe-keeping facility for their gold, the known customers started depositing gold and silver with the goldsmiths for safe-keeping. The goldsmiths soon found money (gold and silver coins) with them without immediate use and then began to lend the money at interest to both the merchants and the government. As substantial profit was made in this business, they

began to solicit deposits from the customers by paying interest. The goldsmiths eventually discovered that the deposit receipts they provided to customers for their safe-keeping deposits of gold were being passed on from one person to another in lieu of payment in gold coin. This prompted goldsmiths to begin lending by way of gold paper receipts rather than gold coins. Accordingly, these paper receipts were the first paper money issued backed by gold. This is like a person issuing a check drawn on a bank nowadays backed by cash to be settled by the banks. By promoting acceptance of the gold receipts as a means of payment, the goldsmiths discovered that they could lend more than the gold and silver coins they had on hand. This is a practice that became known later as fractional-reserve banking in the banking text books.

These practices created a new kind of “money” which was goldsmiths’ debt rather than silver or gold coins. This development required the acceptance in trade of the goldsmiths’ promissory notes, payable on demand. The acceptance in turn required a general belief that gold coins would be available for exchange of notes if encashed by the holders. It required the notes/receipts to be negotiable instruments. In Sri Lanka, today’s banking commenced during British rule as banks were set up basically to facilitate lending to plantations. As such, the banking business has been evolving to be a part and parcel of the day-to-day life of the public and the economy with various business models and challenges.

2.0 Challenges in New Business Models

The banking business models have to be periodically reviewed and redefined to be competitive in providing facilities for money transactions. Nowadays, banking group or universal banking model is being questioned and utility service type banking based on retail clients is being proposed by the regulators.

Banks are the veins through which the money or economic blood is transfused through the economy. In conventional description, banking is the demand deposits-based intermediation business. However, nowadays banking is the business on money which facilitates the money to serve its functions. As we learn from basic economics, functions of money are: medium of exchange, unit of account, a medium of deferred payments and a liquid store of wealth. All banking products are directly or indirectly involved in facilitating the functions of money. Banks will not be in business if the public does not use money for deferred payments, i.e., savings and lending or liquid store of wealth. Banks’ all deposits products and loan products facilitate the public to save or store wealth in highly liquid form. This service of banks is known as financial intermediation, i.e., banks raise funds from the public as their liabilities and lend such funds as their own assets. This intermediation is the maturity transformation of savings. Banks mobilize savings in various repayment periods, generally short-term, and lend same for various repayment periods. In addition, banks offer various fund transfer services/products to facilitate the function of money as a medium of exchange. Current accounts/checkable deposits, credit cards, utility payments services, letters of credit and export-import trade services and various financial guarantees are to facilitate this function of money. This line of banking business is currently known as transaction banking. Modern banking provides a means of unit of account because receipts and payments of customers through

various banking service products are routed through banks where banks provide statements of accounts showing the details of such transactions. The current and future evolution of money is towards electronic money where transactions take place through bank book entries using IT without involving cash and, therefore, future money cannot function without banks. Therefore, banking business models have to be periodically reviewed and redefined to be competitive in providing facilities for money transactions.

3.0 Challenges in Avoiding Future Bank Runs

The banks have to be specifically concerned about ways and means of protecting the public confidence as the likelihood of bank runs has increased. The compliance with good corporate governance principles and rules is the key in this effort. Banks are driven by the public confidence on its soundness. All banks stay in business because of general public confidence and not because of social images of persons managing banks. Basically, the confidence is the confidence in expected solvency of banks. That is, the public believe that banks can repay their deposits/debts whenever they demand. The expected insolvency is the cause for loss of public confidence and bank runs. Unlike in other business firms, the public confidence in banks is contagious across the banking system. The loss of confidence in any bank whether small or big may spread across other banks. In current IT-based on-line banking, bank runs start as electronic runs before seeing conventionally known physical bank runs. At the on-set of a bank run, depositors attempt to withdraw funds on-line through the home computer or other electronic communication devices. Once the access to bank accounts online or through ATMs is congested, they rush to bank branches anywhere in the country since accounts are now on-line irrespective of the location of branches.

In the case of listed banks, runs start as the owners'/shareholders' attempt to withdraw by selling shares resulting in share prices declining in value rapidly. This will be a signal to depositors to suspect the soundness of the bank. The customers now have the financial literacy to understand the basics of a bank because of the required disclosures and regulators' briefings. Banking crises in the past are the good instances. During the current global financial crisis, bank runs occurred in many countries. In the US alone, nearly 417 banks have failed since 2007. Therefore, banks have to be specifically concerned about ways and means of protecting the public confidence as the likelihood of bank runs has increased. The compliance with good corporate governance principles and rules is the key in this effort.

4.0 Challenges in Risk Management

The banks have to reform and realign their governance structures for deciding the prudent banking business models and risk management systems which are by no means an easy task. The key to public confidence is the soundness of a bank which depends on the bank's risk management. The liquidity, solvency and profitability are the core results of a bank's risk management. The liquidity is the ability to meet current or day-to-day financial obligations without making customers concerned about the bank's repayment ability. The solvency is the ability or availability of assets to pay off liabilities. The bank's asset quality, especially the size of the non-performing loans, is the

key element in solvency. The profitability is the return to satisfy owners who have to provide the required capital for the bank. In conventional banking, risk management was relatively easier due to relationship-based retail banking of deposit and lending and integrity of bank officers.

The development of IT and financial world has changed the bank risk management environment during the last two decades in the developed world. The relationship banking diminished as the credit risk was traded through securitization products in the market. The banks did not have to evaluate borrowers as loans were able to be quickly sold in the market. Development of money markets provided the easy access to abundance of short-term funds for lending whereas retail deposit drive was not needed. The securitsation of loans was a regular source of funds for business without holding long-term earning assets. As such, securitation and credit derivatives (credit-default swaps) provided for innovative management of credit and liquidity risks being the main risks of banks. Further, banks diversified their income through investment banking and other financial subsidiaries opening the banks to increased and unestimated liquidity, market and operational risks. Securitisation and other financial markets operated on speculation based on trust in external credit ratings. The remuneration of bank officers was based on risk-taking and high profit which eventually led them to develop innovative, complex, risky financial products for profit. Bank officers were on contract basis or an hourly paid-basis. The corporate governance did not involve in bank risk management as the governance was about the appointment of the Boards and nicely printed annual reports.

During the recent global crisis, this banking and financial model failed as a result of loss of confidence in securitization and credit derivatives markets. According to current views, this model had serious weaknesses that led the bankers to forget elementary rules of banking. First, banks lent to customers knowing that they were not creditworthy (sub-prime customers) whereas elementary banking is to lend only to good customers. Second, banks lent long term loans through short-term funds without maintaining liquid funds whereas elementary banking teaches to manage liquidity. During the crisis, innovatively managed credit risk and liquidity risks returned to banks as liquidity and market risks. Banks' high exposure to asset markets and off-balance sheet transactions, poor credit and liquidity management, heavy involvement in investment banking, complex financial products (derivatives) not understood by both banks and customers and imprudent employee remuneration policies were the key reasons behind the recent global banking crisis. Therefore, banks have to reform and realsign their governance structures for deciding the prudent banking business models and risk management systems which is by no means an easy task.

5.0 Challenges from Enhanced Regulation

The new direction of enhanced regulations will be a significant challenge to both banks and regulatory authorities. The banking prevails as the most regulated sector in the world because of its high importance to the societies and economies. In any country, monetary system is the responsibility of the state. The stability of the monetary system requires sound banks as the monetary system as a whole operates through the banks with public confidence. Banks are the key component of the monetary system as banks are the creators of money and money facilitators.

If banks tend to fail unexpectedly on a frequent basis, the monetary system may not be stable as the public confidence in banks is adversley attected. In this situation, the economy will be impacted due to malfunctioning of intermediation and payments mechanisms.

Therefore, bank regulation has been evolving in two areas, i.e., monetary regulation and prudential regulation. In monetary regulation, banks are regulated to keep the amount of money in circulation under the levels desired by the central banks. The low and stable inflation or price stability is the major objective. The monetary regulation is conducted in terms of the standard monetary theory and practice. Accordingly, bank reserves, short-term interest rates and credit operations are directly or indirectly regulated. In prudential regulation, almost all aspects of banking conduct are regulated to ensure financially safe and sound banks. Capital, liquidity, asset quality, business concentration, loan loss provisions, corporate governance and problem resolution are some of the key areas under regulation. The recommendations of the Basel Committee for Banking Supervision serve as international standards for prudential regulation. In addition, banks have to comply with regulations imposed by other authorities such as financial intelligence authorities on preventing money laundering, terrorist financing and financial crimes and consumer protection authorities on protecting the rights of customers and ethical business practices. In all, compliance cost of banks directly and indirectly is believed to be substantial. All regulations restrict business operations, increase operational costs and reduce income and profit. In the last decade until the recent global financial crisis, there has been a direction of deregulation and more market-based regulation in developed countries. In 1999 in USA, Gramm-Leach-Bliley Act repealed 1933 Glass-Steagall Act which was devised during the Great Depression (1929-32) to separate commercial banking and investment banking. Accordingly, relaxation of branching and permission for investment banking led to financial supermarkets/ conglomerates.

Furthermore, the light-touched and principle-based regulation was followed allowing greater freedom for banks to innovate and diversify. This is considered as a major reason for the current global financial crisis. Therefore, increased regulation is demanded by all participants globally to prevent future financial crises. At present, nearly 60 rule changes per working day are introduced world over. During the last two years, nearly 27,000 rule changes have been effected. Nearly 5,000 pages of new regulations were introduced in the US. Dodd-Frank Act in the US and Independent Banking Commission Report in UK are causing sweeping changes to regulations world-over. Proposed separation of investment banking from commercial banking and making banks smaller are hard-felt changes. New capital and liquidity rules (Basel III), specific regulation on systemically important financial institutions, regulation of shadow banking and macroprudential/ systemic supervision proposed by the Basel Committee are the new international standards. The function of bank regulation is increasingly returned to the central banks from other state agencies in many countries. Proposed new international accounting standards will further add to the regulatory burden. These new regulations will be significant challenges to both banks and regulatory authorities. Whether the new financial world will be safer than the past and the cost of lost- innovations due to tightened regulation will have to be evaluated in due course.

6.0 Challenges for Reform of a Troubled Global Bank

I had the opportunity to read an interview given by Mr. Vikrum Pandit, the CEO of Citibank, to the journal "The Banker" about its reform challenges. The Citibank group was devastated by the global financial crisis. The size of the group is about US$ 1.9 tn, nearly 50 times the Sri Lankan banking system. Its profit which was US$ 22 bn in 2006 went down to US$ 4 bn in 2007 and a total loss of US$ 29 bn in 2008-2009. The bank almost became a state bank having a 34% stake which now has been repaid. In 2010 and 2011 it has come back reporting a profit of US$ 10 bn. and US$ 12 bn. According to the CEO, the transformation of the bank has taken place in four elements, i.e., financial, strategic, structural and cultural. Financial transformation was about capital, liquidity, reserves and lower risks. Strategic transformation was to refocus the business model to basics of banking to cater to customer profitably while closing down various service lines not relevant to banking. The strategy changed from distribution-based strategy with more and more branches to clients-based strategy. Structural transformation is about putting IT, risk management systems and data centers in place and cleaning up of legal entities/special purpose vehicles (SPVs). The cultural transformation was to focus the bank's internal culture to catering to customer interests and rehabilitation of existing customers affected by the financial crisis. Taking note of such success stories will be immensely useful to banks which are interested in new business models.

7.0 Challenges for Sri Lankan Banks in the Emerging Economy

Emerging macroeconomic expectations at present in Sri Lanka that center around doubling of per capita income in US Dollar terms within next five years are the business signals to banks as banks are the transmission system of resource distribution in any economy. In general, if the economy grows, the underlying monetary conditions also grow leading banks automatically to raise their core business of lending and deposit-taking without any changes in business strategies. However, in an emerging economy, what matters is whether the banks are able to take the lead-role in driving the financial system to facilitate the high growth of the economy. If the country's GDP is going to double in the next five years, it should not mean that banking assets or loans should also be doubled accordingly and dependently. For example, total assets of the banking system as at end of 2011 was Rs. 4.2 trillion (US$ 37.2 bn) which was equivalent to 65% of GDP. If so, does doubling GDP mean Rs. 8.4 trillion of banking assets? It took nearly five years to double GDP in Rs. Terms. However, during this period, banking assets increased only by 64%. In fact, the banking assets as a percent of GDP reduced from 72% to 65% in this period. Therefore, the banks' role in the economic expansion is much more than such arithmetic. The banks have to provide business for resource mobilization locally and globally to support the economic growth in addition to leveraging and credit creation in the usual course of business. The conventional opinion practising bankers put forward is that banks in Sri Lanka should get consolidated into a few big banks that will have big balance sheets so that those big banks will have the business strength to perform this role effectively. For example, as at end of 2011, 33 banks were in the industry and only seven banks had assets exceeding 5% of total banking sector assets with a total share of 77% of total banking assets. Does this opinion mean that, at least, those seven banks should acquire

remaining 26 banks with 23% of banking assets? Or should the top four banks with banking assets of 57% in total acquire the remaining 29 banks? Further, if such a consolidation is expected through regulatory support, it is not a desirable development. If the consolidation happens in a market environment, that may hold some justification although market solutions are not always the best. Another point is what the consolidated big banks are going to do. Are they to continue the same domestic business carried out by several banks before the consolidation? If so, what if those same several banks do it as they have better ability to serve different customer groups. Limiting the business competition also is not a desirable option. Further, the option of big banks is not globally supported in new regulatory standards as it involves enormous business, regulatory and social risks. The business risk involves in the complexity of risk management of big banks. The regulatory risk involves in too-big-to-fail moral hazard and the underlying systemic risk. The social risk arises from the cost of limited competition and bail-out in the event of banking crises. Therefore, the attention of bankers should be how they should redesign their banking business models to take the lead-role in the emerging economy. In this regard, some of thoughts in consideration of emerging regulatory priorities are given below.

a) **Banking Groups:** The banks should get involved in all types of financial services such as investment banking and payments services in addition to conventional retail banking of intermediation base. This will lead to banking group/financial conglomerate/universal banking model where some of financial services will be provided through affiliates of the banks. The banks providing diversified financial services have competitive and comparative advantages in business and risk management and effective regulation of systemic/macro-prudential risk. Further, non-banking financial services are necessary for development of financial markets and leverage by way of development of asset markets required for facilitating the high growth of the economy in a sustainable and globally competitive manner. Accordingly, the financial statements of the retail bank will be dominated by deposits and lending business whereas those of the group will have a fair balance between banking and non-banking financial services. This will imply that the dependence of banks on interest margin/spread for profit has to decline whereas non-interest income sources will emerge. The interest margin in the Sri Lankan banking system stood at around 4.4% in the last decade whereas the interest income accounted for 80%-87% of total income as the banking system was dominated by fund-based business. In the emerging economy if the banking system caters to growing financial needs of the economy, interest margin has to decline below 2% with non-interest income accounting for about 50% of total income.

b) **Ring-fencing of Retail Banking:** The retail banking should be ring-fenced from the rest of financial services because it is the customer confidence in the retail banking that gives the stability to the banking group. In this regard, non-retail banking services should be provided through subsidiaries and associates with appropriate ownership structures that will reduce the risks to the bank's capital and public confidence.

c) **Banks to Have Cross-border Presence:** The banks should expand through new capital and cross-border business. Towards this, the first step should be to attract foreign shareholders with new capital who are engaged in international financial business. Colombo has to develop as an international financial center and banks have to offer banking services to international clients. Otherwise, even the whole banking system in Sri Lanka is consolidated into one bank, that bank will only be a domestic bank constrained by the level of the domestic economy. The banks in Sri Lanka will not have a promising future unless their business model is a cross-border one. The regulator may consider big banks to get cross-border and small banks to get localized.

d) **New Governance Structure:** The governance structures have to be reformed in compliance with the applicable regulations so that the banks will have competent Boards to have a responsible and accountable policy-making and oversight role on business models of banks and risk management. The governance is not just about the appointment of Board members and Board meetings. It is about the framework for accepting the responsibility of the whole bank.

e) **Revisit the Compliance Function:** The compliance in a bank is generally geared to monitor the compliance with regulations, especially “know your customer procedures.” However, the compliance should be taken in broader perspective. The compliance framework should be meant to promote the performance of officers and risk management in an ethical, responsible and accountable manner in the interest of the good governance of an institution. The overriding objective of the compliance framework is to support a culture of integrity that prevents wrongdoing or corporate misconduct that leads to financial and operational failures. The compliance function should be the internal mechanism developed and maintained by different layers of the executive staff with appropriate checks and balances to maintain work discipline through rules, regulations, policies and internal controls, to detect any non-compliances with those rules, regulations, policies and internal controls (wrongdoing or corporate misconduct) and to take appropriate corrective action on such non-compliances. The non-compliance risk assessment could be a part of banks’ risk assessment. The compliance function cannot be performed by a Compliance Department staffed with lawyers, but it is a framework involved by different layers of the executive staff with the policy approved by the Board because, in respect of major non-compliances such as fraudulent dealings or breaking of internal controls by some staff members to fraud that lead to huge losses, the Chairman or the whole Board has to step down as seen in some stances. A lot of preparation is required in this aspect. Possibly, the regulator can set the principles for the framework so that the compliance frameworks of different banks are broadly consistent to prevent possible abuses.

f) **Regulatory Approach**. At present, regulation is being tightened globally following the new models being introduced by the regulators of the developed world where the current global financial crises occurred. Therefore, these regulatory models are meant

to prevent recurrence of risks in products and business models of banks in those countries whereas the Asian banking was different and safer. Therefore, countries like Sri Lanka need not blindly follow these new regulatory models as they have to get banks to perform an economic role for the well-being of the countries. The risk management of banks in these countries is already well-regulated compared to banking in crisis-hit countries. Therefore, the challenge of the regulators in Sri Lanka is to facilitate the economic role of banks without constraining the banks. The regulators themselves have to recognize the need to manage the risks of bureaucratic regulatory models and lapses.

8. Concluding Remarks

In summary, banks in Sri Lanka will have to see the banking challenges globally, revisit their business models locally to be aligned with emerging economic needs and redesign the governance frameworks to drive the banks for the next 100 years.