SERVICE BANKING: AN UNTAPPED RESOURCE BASE FOR SRI LANKAN BANKS

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A striking feature of the banking industry in Sri Lanka has been the preponderance of interest income in the total income of banks. The data for 2005 indicate that the interest income accounts for about 80-85 percent of the total income, as against a global industry average of 45 – 50 percent. Though the current results are an improvement from what it was about three decades ago when the almost entirety of the income of banks was drawn from interest income sources, the attainment so far does not allow industry to compliment itself. When the banking industry throughout the globe has grown in terms of sophistication, depth, product range and client orientation, the Sri Lankan banking industry appears to be following a course of stagnancy, with a heavy concentration on only a limited business range of core-banking activities. This tendency is in contrast with the experience in this respect by other South Asian countries in the last decade or so. Banks in India to a large extent and, in Pakistan to a lesser extent, have integrated themselves into the global banking system, thereby benefiting from the immense revenue base open to them by the expanding service banking industry[1]. This need not be the fate of Sri Lanka's banking industry, since the country has been credited for being the front-runner of the open economy policy in the region.

Service banking was created by the banking industry in late 1960s in response to a growing demand by business, commerce and industry for a full range of financial services under one roof. Upto that time, commercial banks had confined themselves to the traditional core-banking activity of deposit taking and lending. The other types of financial services were produced and supplied by specialized institutions such as investment banks and merchant banks. In view of the high transaction cost of receiving such services from numerous institutions, the clientele of banks desired to have them supplied by a single-source, a concept akin to the modern day super-markets.

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[*] *The views expressed in this paper are those of the author and should not be construed as those of the Central Bank of Sri Lanka.*

[1] *Sri Lankan authorities are now increasingly observing the change in the source of expert advice on sophisticated banking products from Singapore and Hong Kong to Mumbai, a relatively unknown* financial centre two decades *ago.*

International banks, seizing the opportunity, ventured into these banking services benefiting from the ever expanding information and communication technology and improved human capital stocks. Thus, the traditional commercial banking system was re-modeled as universal banks, leading to a wide diversification of the income sources from interest based income to fee or commission based income. It also gave rise to a new paradigm of banking – assetless banking through off-balance sheet activities. It has also earned a multitude of designations for banks: service banking, multi-purpose banking, multi-product banking, contingent commitment banking, invisible banking, or simply, investment banking.

The Nature of Service Banking

Service Banking is generated through off-balance sheet activities. Generally speaking, an off-balance sheet activity is any business undertaken by a bank and not recorded in its main accounts. Hence, the volume of such business is not shown on the balance sheet of the bank. If one is interested in finding them, he should look for them below the line or as the term denotes, off the balance sheet.

The examination of modern banking shows that such service banking runs into hundreds of financial services. Drawing mainly on Lewis, Table 1 presents a list of such common service banking activities. It also identifies the main such activities undertaken by Sri Lankan banks as of end - 2005. The list is in no way comprehensive and exhaustible. Day by day, new service banking activities are innovated by banks in response to the growing demand. Hence, there is no limitation for any bank to introduce new market products and thereby raise their income sources.

A customer may demand for service banking mainly on account of the desire to reduce his transaction costs. It obviates the necessity for incurring additional costs on acquiring information so that his search costs are lowered. The supply of the whole range of banking services under one roof also eliminates the inconvenience, saving both time and money. As a result, a customer is generally convenienced by his friendly banker's good gesture of helping him in his all financial service needs.

From the point of view of a bank, service banking has been a necessity for surviving in a fiercely competitive world. It has helped banks to derive numerous economic and financial benefits.

First, by providing all the financial services under one roof, banks have been able to retain their customer base. Since banks have to invest in building a customer by establishing his creditworthiness and making him bankable, his loss to some other competitor would entail a wastage of time, money and other resources spent on him. Lowering the transaction costs and enhancing the convenience, banks have been able to be of help to customers creating a common bond of alliance with them.

Second, the provision of banking services does not, in most cases, entail an additional cost on banks. For their general banking, banks have already invested heavily on manpower and other physical infrastructure, viz; telecommunication facilities and information technology. Hence, banks have been able to produce and supply banking services at a relatively negligible marginal cost without having to over-stretch their installed capacity.

Third, service banking has pushed banks to escape strict regulatory mechanisms that have been introduced to generate and maintain prudence in traditional commercial banking. Hence, the craze to enter new fields of businesses has been the vogue of the day. Regulations such as mandatory credit allocations, interest rate ceilings, licensing requirements, liquidity and capital requirements, branch network approvals, though necessary from a socio-economic or prudential point of view, have raised the cost of undertaking the business of banking. Service banking has provided an important escape gate for them.

Fourth, the need for diversifying the income source by engaging in numerous activities has also prompted banks to venture into service banking. A bank becomes vulnerable to external shocks, if its only income source constitutes interest income. Thus, the need for gaining shock mitigation capability through a diversified income base has been fulfilled by their entry into service banking. Over the years, banks in developed countries have been able to attain a proper balance between the interest income and fee based income. In 1950s, 90 percent of their income arose from lending activities. Today, in most cases, it just exceeds 45 percent.

Potential For Growth in Service Banking

The examination of Table 1 reveals that Sri Lankan banks have a vast untapped market for growth. Of the main service banking activities, only a small fragment of the market has so far been explored by the country's banking institutions. They too constitute activities generally related to the core banking activities. Hence, the larger unchartered area in service banking by the local banking industry has offered a vast growth potential for banks.

The competitive advantage which the local banks have in this respect is no smaller than that of main competitor countries. Sri Lanka has already invested in a most modern payment and settlement infrastructure in the form of a real time gross settlement system. This system has been in operation without any major problem since 2003. The other countries in South Asia are still struggling to automate their payments systems. In Sri Lanka, cheque clearing has been modernized by introducing e-based clearing with image transmission, an effective process-truncation device. Banks have been connected to each other and to the Central Bank through a high band wide area network. The country's telecommunication infrastructure has been brought to modern levels with new investments. To top the physical infrastructure, the country also boasts of a high quality human capital stock which has often been praised by many foreign investors. Even if the current knowledge in service banking is inadequate, the fast learning capacity of the work force would quickly rectify the deficiency. Hence, it is only a matter for banks to expand their business horizons into this new area of profit centers.

At present, the local commerce and industry do source all the requirements of service banking not produced locally to regional financial centres. In this context, the traditional source has been either Singapore or Hong Kong.

However, of late, Mumbai has been emerging as a new service provider to both public and private sectors of the country.[2] With the globalization and effective off-shoring, it is easy for any financial centre to produce these services efficiently and at a low cost.

A massive over-investment in the fibre-optic cable needed to carry all the new digital information, argues Thomas L Friedman in his ***The World is Flat***, wired the whole world together and without anyone really planning it, made Bangalore (in India) a suburb of Boston (in USA) (p 62). Taking advantage of these developments, Male is also trying to become the youngest global financial centre of the region. When compared with Male and Mumbai, Sri Lankan banks do not have any major deficiency in promoting themselves as effective service banking providers.

A pertinent question to be raised at this stage is whether the country's banking system has an adequate market within the country to generate the required economies of scale as a viable service banking provider. With the fast expansion of the service sector (on average, by about 8 percent per annum) and the entry of foreign direct investments in large volumes, the country's commerce and industry are becoming more and more sophisticated demanding for equally sophisticated banking services. The current avenue for the commerce and industry has been to tap the services available in the regional financial centres for risk mitigation mechanisms, revenue enhancing derivative products, credit and loan structuring etc. This market can be tapped easily by the Sri Lankan banking industry. It also could exploit the emerging new market in India which is being opened to Sri Lanka's banks by the Comprehensive Economic Partnership Agreement[3] being negotiated with India. A similar agreement is on the card with Pakistan too. It is therefore to the best interest of the country's banking industry to gain capability of providing service banking now itself. The failure would result in the country's having to outsource it from Mumbai or Karachchi.

This requires a complete paradigm shift in the country's banking industry. Instead of being pure retail bankers in a traditional sense, the country's banking industry has to look beyond the narrow perimeters. Whether Sri Lanka likes it or not, is aware of it or not or an integral party to it or not, the world is flattening very fast. Two giants in the region, viz, India and China, have successfully entered the flow of flattening the world. The laggards may find that the best part of the soup has already been consumed, when they make their belated choice.

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[1] *Recently, when the authorities were looking for suitable hedging products for rising crude oil prices, foreign banks operating in Sri Lanka managed to get down experts serving their regional centres in Mumbai, indicating the shift of the market from Singapore or Hong Kong to India.*

[2] *Under this agreement, banking services would be open to each other. Hence, if Sri Lankan banks do not gain capability of producing efficient financial services, the service flow would be one way from India to Sri Lanka.*

Table 1

A List of Major Service Banking Activities

Type	Whether Sri Lankan Banks are engaged in or not as at end 2005	Type	Whether Sri Lankan Banks are engaged in or not as at end 2005
A. Contingent Claims		33. Trust Management	Engaged trivially
1. Loan Commitments		34. Estate Management	Not yet
1. Overdraft Limits	Engaged extensively	35. Management of Pension Plans	Not yet; but has a great potential
2. Credit Lines	-do-		
3. Back up Lines for Commercial Paper	Engaged moderately	36. Trusteeship for Unit Trusts/ Pension Plans/Debentures	Engaged trivially for unit trusts
4. Stand-by Lines of Credit	-do-	37. Safe-keeping of Securities	Engaged moderately
5. Revolving Lines of Credit	Engaged extensively	38. Off-shore Financial Services	-do-
6. Reciprocal Deposit Agreements	Engaged moderately		
7. Repurchase Agreement	-do-	***VII. Brokerage & Agency Services***	
8. Note Issuance Facilities	-do-	39. Share & Bond Brokerage	Engaged through Subsidiaries
II. Guarantees		40. Mutual Fund/Unit Trust Brokerage	Engaged trivially
9. Acceptances	Engaged extensively re foreign trade	41. General Insurance Brokering	-do-
10. Assets Sales with Recourse	Not yet	42. Life Insurance Brokering	-do-
11. Stand-by Letters of Credit	Engaged extensively re foreign trade	43. Real Estate Agency	Not yet
		44. Travel Agency	Engaged trivially
12. Commercial Letters of Credit	Engaged trivially	45. Issue of Travellers' Cheques	Engaged extensively
13. Warranties and Indemnities (performance and bid bonds)	Engaged extensively	***VIII. Payment Services***	
14. Endorsements	-do-	46. Data Processing	Not yet
15. Guarantees	-do-	47. Net-work Arrangement	Not yet
III. Swap & Hedging Transactions		48. Clearing House Arrangement	Engaged extensively
16. Forward Foreign Exchange Contracts	Engaged extensively	49. Credit/Debit Cards	-do-
		50. Point of Sale Systems	-do-
17. Currency Swaps	Engaged moderately	51. Home Banking	Engaged moderately
18. Currency Futures/Options	Not yet	52. Cash Management Systems	-do-
19. Interest Rate Swaps/Options	Not yet		
20. Interest Rate Caps/Floors/Collars	Not yet	***IX. Export/Import Services***	
		53.Correspondent Banking Services	Engaged extensively
IV. Investment Banking			
21. Securities Underwriting	Engaged extensively	54.Trade Advice	-do-
22. Securities Dealership/Distribution	Engaged through subsidiaries	55. Export Insurance Services	Provided by a separate company
		56. Countertrade Exchanges	Not yet
B. Financial Services			
V. Loan Related Services		**C.Trading Activities**	
23. Loan Origination	Engaged trivially		
24. Loan Servicing	-do-	***X. Dealing***	
25. Loan Pass-throughs	-do-	57. Dealing in Foreign Exchange	Engaged extensively
26. Asset Sales without Recourse	Not yet	58. Dealing in Bullion (Gold and Silver)	Engaged trivially
27. Sales of Loan Participations	Not yet		
28. Agent for Syndicated Loans	Engaged trivially	59. Dealing in Commodities	Not yet
		60. Dealing in Real Estates	Not yet
VI. Trust and Advisory Services		61. Property Development	Engaged through Subsidiaries
29. Portfolio Management	Engaged trivially		
30. Investment Advisory Services	-do-	62. Dealing in Shares/Securities	Engaged only in Treasury Bills
31. Arranging Mergers/Acquisitions	-do-		
32. Tax and Financial Planning	-do-	***XI. Information***	
		63. Credit Information	Provided by a separate Institution
		64. Credit Rating	-do-
		65. Publication of Financial Information/Journals	Engaged trivially

Conclusion

The current state of the development of Sri Lanka's banking industry with over-concentration on traditional banking to the almost exclusion of service banking indicates a vast untapped potential for growth. When the global banking has attained a very safe balance between traditional banking and service banking, Sri Lanka's banking industry is still heavily dependent on interest income as its main source of income. This has occurred despite the fact that Sri Lanka was the pioneer in open economy policies in the region. It is therefore of utmost importance for the country's banking industry to re-assess its capability, model its future course on an increasingly flattening world and be a part of the integrated global banking system by exploiting its hitherto untapped potentials in service banking.

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