DEVELOPING SRI LANKA AS A FINANCIAL CENTRE

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Although the idea of developing Sri Lanka into a regional financial centre (or hub) has been envisioned and discussed since the 1980s, achieving the transformation of vision into reality has proven difficult. The basic legal framework for setting up Sri Lanka as a financial hub was in place when the Banking Act came into effect in 1988. On the other hand, offshore banking, which is an integral part of a financial hub, existed in the country since the mid 1980s when foreign currency banking units (FCBUs) were established and the required legal framework was introduced to the Banking Act in the 1990s. Banks such as the Indian Overseas Bank and the Overseas Trust Bank initially used the FCBUs for offshore operations in taking foreign currency deposits from non-residents and lending or investing overseas and thereby building up significant balance sheets in their FCBUs. Another important initiative was the amendments made to the Banking Act in the 1990's to permit the operation of numbered foreign currency accounts by non-residents. It can be said that in the 1980's and 90's, Sri Lanka was positioned better than any other neighbouring country to stake its claim to be a financial centre for the region. The question is why we did not progress beyond those early initiatives.

The process of evolving into a financial centre first got derailed when the domestic market opened up for foreign currency assets with the Government deciding that Board of Invesment (BOI) approved export companies should be able to borrow in foreign currency. This resulted in the large domestic banks shifting their focus to build local relationships in this new sector almost totally ignoring the development of their relationships outside. They used the expatriate Sri Lankan remittances as their resource base to lend to domestic export businesses. The surplus, they just placed in deposits with overseas banks, which did not give them any institutional visibility in those markets. Much later some of the banks did some project lending in the Maldives but that was too little too late. While the banking system did meet the domestic development need at that time they did so at the expense of placing Sri Lanka on the international financial map. With hindsight we should have looked at getting our presence established in other markets by undertaking offshore business although some markets such as India were closed to foreigners until somewhat later. The numbered account scheme was also short lived. Due to international pressure, imagined or actual, the scheme was stopped in the late 1990's to comply with anti money laundering and anti terrorism regulations that were receiving the attention of the international community.

Another reason that impeded the evolution into a financial centre was the ongoing civil strife since 1983 and the political instability of successive governments since the late 1980s. Also, from a political perspective, a financial hub did not have much mileage because the benefits are not very tangible like building a road or a port. Thus, this aspect of development did not get the political priority it deserved. The net result is that despite being the first to start, we have allowed many opportunities to slip by with centres such as Mauritius, Labuan and Dubai entering the landscape. This article highlights the basic features of a typical financial centre, evaluates Sri Lanka's potential of becoming an international financial centre in the future, and presents some measures that could catalyse the realisation of such a vision.

Financial Centres

A financial centre or hub is a marketplace where those who need financial services of a kind not catered to by their own domestic financial markets meet others who supply such services. A location where international suppliers of financial services set up regional offices, providing a convenient concentration of financial services to those seeking them can also be defined as a financial hub. The common thread is that in a financial centre, the participating customers are significantly offshore. Typical activities of a financial centre would include foreign exchange trading, equity, debt securities and derivatives trading, wealth management, payments clearing and settlements, mergers and acquisitions, and securities underwriting. Not every centre will provide the same type of services or cater to the same range of participants, as there is some degree of specialisation amongst them.

London and New York can be considered global financial hubs that feature very liquid markets and provide a wide array of financial services and products to sophisticated offshore participants. Although Tokyo is a very big financial centre, its global role is limited. There are smaller centres such as Hong Kong, Frankfurt, Singapore and Dubai, which are regional in scope. Another type of centre includes Labuan and Mauritius, which primarily deal with the requirements of a limited number of countries. Finally, there are established centres such as Switzerland, Channel Islands, the Bahamas and Luxembourg, which are global in scope but cater mainly to niche products and services. More recently Dubai is emerging as an offshore centre for the Middle East, broadening its scope of activity beyond the limited services offered by Bahrain.

In general, successful financial hubs have some common characteristics. They function in a stable political environment and in an open macroeconomic environment with low budget deficits and stable interest rates and exchange rates. These factors, although not always directly relevant to offshore transactions, are critical for building confidence among potential users of the financial hub who need to feel very comfortable that local problems will not spill over to affect the security of offshore transactions. In such centres, there will be a free flow of international capital and capital account convertibility while the economy will be characterised by a high service sector contribution to GDP. The successful centres will be in accessible strategic locations close to large markets, and their domestic financial markets will be well developed and boast a wide range of instruments and a high level of human talent and financial sector skills among not only service providers but also regulators. Very importantly, financial hubs have efficient and equitable legal systems for property rights, contract enforcement and bankruptcy, and a transparent regulatory system with policy consistency to ensure integrity and efficiency in markets. Other features would include a sizeable market in tradable securities, financially strong and credible banks and capital market institutions, relatively easy entry to foreign banks, financial institutions and human talent that meet specified transparent criteria and minimum non-prudential bank regulation, a conducive tax regime with low taxation, an educated and literate workforce and good living conditions in terms of quality of life and cost.

Sri Lanka as a Financial Centre

Sri Lanka benefits from its excellent geographical location, which can enable it to cater to the South Asian region. The services sector contributes over 60% of GDP, and is bolstered by a fast growing financial services sub sector. The telecom infrastructure is well developed, the stock exchange is technologically advanced, and the country has a sophisticated payments system for domestic inter-bank settlements and SWIFT connectivity for international payments. The workforce is literate and trainable. There is an even playing field for local and foreign banks although there are some regulatory barriers to entry. These features are positive indicators of Sri Lanka's potential to become an international financial hub; however, it should be noted that many of these features are not competitive advantages as many other countries in the region can also boast of them.

Several factors impede Sri Lanka's chances of transforming itself into a financial hub. The ongoing conflict and the law and order situation that has deteriorated over time are significant deterrents, while the high budget deficit, double digit inflation (for much of the last 3 decades) volatile interest rate and perpetually depreciating exchange rates diminish the lustre of the fast-growing financial sector. Partial capital account convertibility and the fact that the economy is not entirely free-market works against the building of a critical mass of international capital flows. Apart from telecommunications and the Colombo port, local infrastructure is not up to standard and regional air access to the country was not, until recently, convenient.

Very importantly, the overall financial sector is not that well developed, and is dominated by commercial banking institutions that are very small by international standards and offer only plain vanilla financial products. The banking sector, in particular, is a cradle to grave employer and management generally resist lateral infusion of talent resulting in serious skill gaps in the industry. There is little diversity, liquidity and depth in capital market activities, with a relatively low volume of trade in equities, bonds, commodities and derivatives. Although regulations are fairly strong, they fall short in ensuring transparency, integrity and efficiency in markets, and are only weakly enforced. Despite the fairly comprehensive legal framework, there is insufficient legal knowledge and understanding of laws relating to new financial products and financial services delivery systems, with emphasis being on form and process rather than substance. Also, the legal administration system to resolve disputes is protracted and cumbersome.

Given all the above unfavourable factors we may be looking at a time frame of 5 to 10 years, perhaps closer to 10 years, before we can realistically establish Sri Lanka as a financial hub. That too would depend on the implementation of reforms and an action plan to upgrade the size, stature and sophistication of the domestic financial sector. We can only hope that by that time we will also have relative peace in the country, which is a fundamental pre-requisite for any financial centre.

Closing the gap

There are several preparatory steps that will have to be taken on the road to establishing Sri Lanka as a financial hub. Reducing the Government's share of the financial sector is one such step. The bulk of private domestic savings in the country is still captive to government-controlled entities, and the share of Government control on financial sector assets through state-owned banks and institutions is very high. The strength, depth and independence of the domestic financial sector is a key factor in attracting foreigners to participate in the financial market, and the Government's dominance of the sector could prove a potential stumbling block.

Allowing greater autonomy to the state banks to determine lending strategies, improving their efficiency to help reduce the financial intermediation cost, and commencing partial privatisation of these banks will be positive steps. Regulations should also facilitate the formation of larger private banks through consolidation, and the current policy of enabling consolidation only between the strong and the weak will not allow local financial institutions to become significant in an international context. Policymakers should encourage consolidation among strong institutions for the reason that even our larger financial institutions are weak and small compared to global and regional banks. Instead of concentrating on ownership, the sector would be better served through the imposition of more stringent measures to ensure good governance, in particular, greater management accountability, good practices, the composition of the board of directors, and stringent control over related party lending.

Encouraging the entry of global financial institutions and promoting the continuous training and exposure of local bankers and regulators at international level will also be important, as facilitating the growth of professional financial, legal and investment advisors whose expertise is on par with international counterparts will also be essential for the sector's development.

The regulatory framework will have to be revamped comprehensively, instead of tinkering with a 20 year old Banking Act, to enable the financial sector to function more efficiently in an increasingly sophisticated international financial milieu. Ensuring minimum non-prudential regulations to promote healthy competition for business amongst banks, perhaps through a common banking licence, and encouraging financial institutions to offer a wider range of investment products besides traditional deposits will be important. Initiating regulatory reforms governing the insurance sector will also be beneficial, as insurance companies gaining greater flexibility in asset allocations will increase the depth of the market with regard to investments in equity and derivatives. Apart from creating a sustained climate to attract foreign portfolio funds into Colombo's stock market, the Government should reduce its almost total hold of captive funds in EPF and ETF paving the way for substantial investment in the capital market and management of funds by private fund managers. Above all, ensuring policy consistency will be paramount. While the issues identified above relate mainly to the development of the domestic financial sector, as stated earlier, a strong and well developed domestic sector is required to build confidence among foreigners and project Sri Lanka to a hub status.

Looking Ahead

Even if the above measures are implemented, it will be necessary to proceed with caution and be realistic about the country's prospects as a financial centre. Instead of trying to compete with already established financial centres, the country would be better served by narrowing our focus on a more attainable goal: seeking to serve South Asia as our target market. The rapid rise of India as an economic giant is an opportunity that must be seized , and although Sri Lanka has been slow to capitalise on its growth, swift and decisive action may make up for lost ground. Given Sri Lanka's good relations with its other neighbours, especially Pakistan and Bangladesh, the potential of developing the country as a regional financial hub is encouraging. It may also be possible to position Sri Lanka as a provider of more diverse products in a wider geographical context. As some observers have pointed out, Sri Lanka can form a triangle with Dubai and Malaysia through which opportunities in Islamic Banking can be expanded.

One final consideration that must be taken into account in the current geopolitical landscape is the need for transparency and stringent restrictions relating to money laundering and international terrorism. Most countries that have become significant financial hubs such as Singapore and Hong Kong did not have to contend with these requirements in the early stages of their development. Those countries benefited from the general distrust that citizens of less developed countries had on their Governments and evading taxes and exchange controls were some of the main reasons why offshore centres started to develop. The situation today is different. We have to abide by international requirements that are imposed on us when handling financial assets and this can at times be cumbersome and make it difficult to take off. Of course, there is a lot of perfectly legitimate business as well and we will obviously have to restrict ourselves to that part of the business to avoid the risk of becoming international outcasts. Yet , with sufficient planning and prudence, the momentum of establishing Sri Lanka as a legitimate financial hub could be allowed to gather pace, however slowly.