CURRENT CHALLENGES TO GLOBAL AND SRI LANKAN BANKING SYSTEMS

Nihal Welikala

Introduction

The role of banks in society comes under intense scrutiny in times of crisis. Banks have been no strangers to crisis in the last three decades, during which economies in countries and regions as diverse as the US, Latin America, Japan, Sweden, UK, East Asia and Africa have been disrupted by 115 systemic crisis. The latest example is the acute and ongoing problems of the Nigerian banking system. The most severe is undoubtedly the financial crisis which started two years ago in the US, which infected the global banking system and triggered the longest and deepest world economic recession since the 1930s. Some lessons from this crisis are discussed below.

The fundamentals of bank failure

The Russian writer Tolstoy commented "All happy families resemble one another; every unhappy family is unhappy in its own way". So it is with banks. There are a myriad permutations of greed, fraud, mismanagement and hard luck stories emanating from individual distressed banks. Despite the differences, there are two common threads of connected and potentially fatal diseases which can threaten their health.

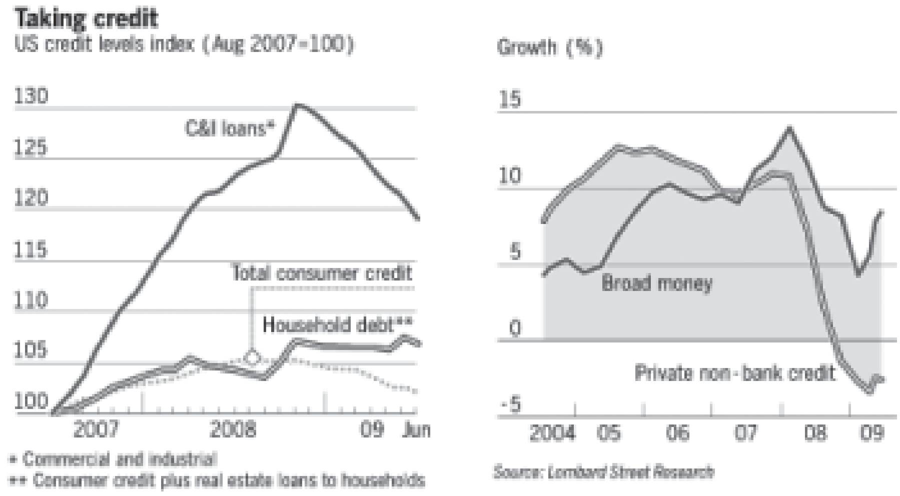
One relates to solvency (the excess of assets over liabilities, represented by shareholder funds) and the other to liquidity (the availability of cash to repay liabilities as they fall due).

The erosion of solvency or capital by losses arising from bad debts, mismanagement or fraud, is akin to cancer, in that it is usually a long wasting disease, whose symptoms are often not recognized early. It can at a late and acute stage lead to a heart attack or liquidity crisis, when depositors and lenders lose confidence in the solvency of a bank and withdraw cash simultaneously. Since the funds of banks are largely invested in illiquid assets, i.e. loans, the simultaneous withdrawal of deposits or credit lines, can lead to collapse within days or weeks.

The dangers of the domino effect

While liquidity crises usually start at "bad" banks with long standing but long concealed problems which suddenly come into public view, they can quickly lead to systemic contagion. Depositors and lenders act rationally and individually to protect their own interests by transferring their funds from perceived unsafe banks to perceived safe banks. As depositors have no foolproof means of distinguishing between banks in terms of their soundness, "rational" panic can follow, leading to a flight to the safety of government securities or cash or gold. As more and more banks become short of liquidity and risk aversion takes hold, lending stops and the arteries of the financial system get blocked, with dire consequences for the real economy and for economic and social stability.

Chart 1



Source: Financial Times: 'Money versus credit' published August 11, 2009

What lessons can be learned from the global financial crisis?

"Never waste the opportunity offered by a good crisis" – Niccolo Machiavelli

This complex question of how to fix the global banking system is likely to keep analysts busy for a generation, but four simplistic answers are discussed below, some aspects of which may have relevance for Sri Lankan banks as well.

1. Bad economics leads to bad banking

The profligate Bush Administration turned a budget surplus into a large and recurring deficit, as taxes were cut despite the costs of two major wars. Simultaneously, monetary policies were loosened, with negative interest rates prevailing in the US for thirty one months to April 2005. Additionally, political pressure to lend to the "bottom of the pyramid" (which later became the orphan child known as sub-prime lending) increased. In an era of cheap money, bankers relaxed their lending standards leading to asset and in particular to real estate price bubbles. The level of household debt increased sharply, as both lenders and borrowers assumed that house prices were on an endless upward spiral. Equity released from houses stoked a consumption boom in the US and led to the creation of destabilizing global trade imbalances. In reality, a housing asset comprises its present value plus an option on future growth. When the option component gets too large, consumers effectively turn their homes into speculative financial derivative instruments. The property bubble burst, and consumers and bankers discovered that increased borrowings supported illusionary wealth, and lending and spending stopped dead. In summary, the unintended consequences of excessive government spending and loose money can be severe for banks and the economy.

2. Systemic bank failure leads to economic and social upheaval

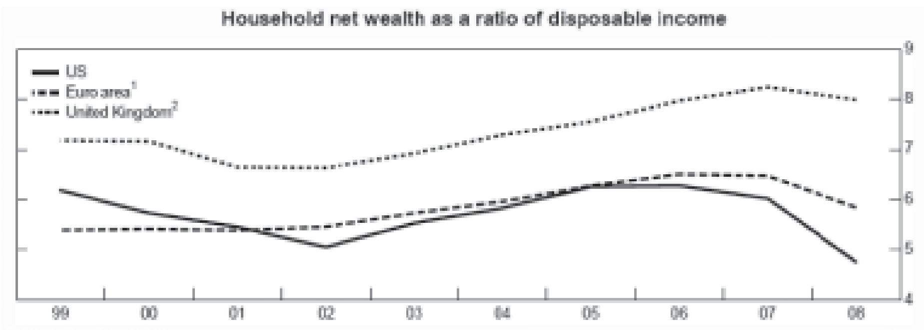
Studies of systemic bank failures and the resulting fall in lending, show that they coincide with a sharp contraction in national output, from which it takes several years to recover. Estimates of GDP loss from the Asian crisis of 1997 illustrate the point.

	Estimated Cumulative GDP Loss %
Indonesia	50.7
Thailand	33.2
Malaysia	13.8
Korea	9.3

Source : Financial crises and economic activity (Cecchetti, Kohler & Upper, August 2009)

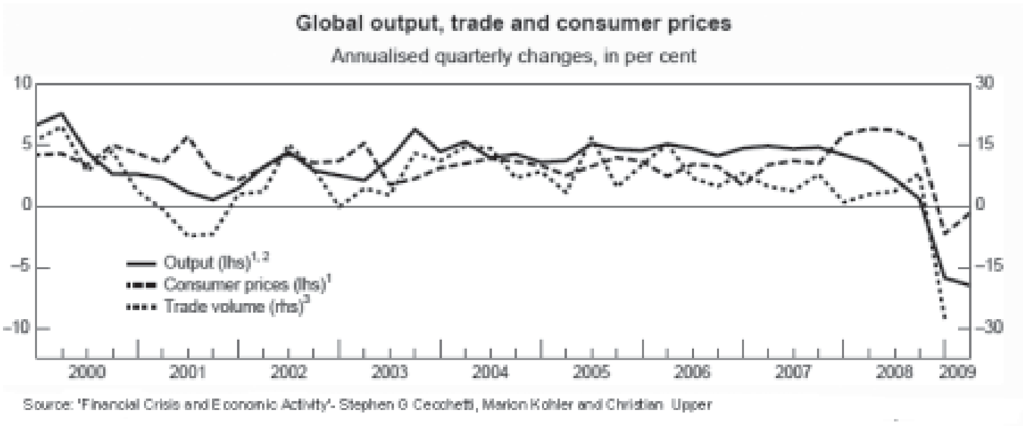
The impact of the current crisis on global output trade and on household wealth is also severe. Additionally, unemployment has risen to post war highs in many economies, resulting in what Keynes termed “the paradox of thrift” i.e. at an individual level people act rationally to curb consumption and savings in a recession, but collectively this behaviour aggravates the slowdown. It has resulted also in changed migration patterns e.g. It is estimated that 70 million people have left cities for villages in the last year in China causing strain to the fabric of society.

Chart 2



Source: 'Financial Crisis and Economic Activity'- Stephen G Cecchetti, Marion Kohler and Christian Upper

Chart 3



3. Bank failure and the dilemma of governments: too big to fail or too big to save?

The cost to society and the tax payer of bank failure compounded by contagion of non-bank financial institutions (NBFI's) is enormous. The IMF in its Global Financial Stability Report of April 2009, estimated that the total bill for saving the global financial system will amount to over US$ 4 trillion. Resulting increases in fiscal deficits and debt, and the easing of monetary policy have raised concerns about the impact of higher taxation and inflation and currency devaluations in the future, as evidenced by the rising price of gold and the falling value of the US dollar.

Two particular issues are worth noting in this context

(a) The size of banks, implied Government guarantees and moral hazard

In order to compete with the returns of the so called "shadow banks", commercial banks took the high risk option of increasing their borrowings to fund massive asset growth. Thus, the debts of US financial firms grew from 39% to 111% of GDP in twenty years, while industry concentration increased, with the top three private banks holding one third of the deposits of the banking system. The profits of US banks increased exponentially from $65 billion to $ 232 billion in ten years. So did their risk.

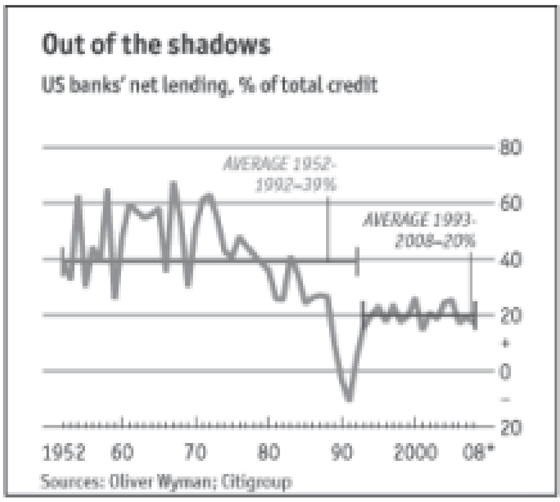
There is little doubt that in a capital intensive industry, banks need to be of minimal size to derive economies of scale. Small banks with small revenues cannot cover the enormous fixed costs of modern banking (distribution, technology, brand building and people). The resulting suboptimal returns cannot attract the capital needed for growth. Professor Buiter of the London School of Economics suggests an optimal Balance Sheet size of US$100 billion is needed to derive economies of scale, but avoid the problem of moral hazard.

When banks get over large and interconnected with non-banks, stakeholders assume that the entire range of their activities will be too economically significant for governments to permit failure. This implied guarantee of solvency and liquidity was at the heart of the reckless behaviour of global banks. When the guarantees were finally called, an estimated US$ 2.7 trillion of government support in the form of loans and guarantees was needed to bail out the global banking system.

(b) "Shadow banks" and the contagion effect

Banks and NBFI's are closely connected. The failure of one is likely to result in the failure of the other. In the US, this is a particular problem as commercial banks provide only about 20% of total credit to the economy. The balance is provided by "shadow banks" comprising the former investment banks, hedge funds, money market funds and exchange traded funds. These entities were subject to "light touch" regulation in terms of capital requirements and leverage in particular, and were therefore able to generate exceptional returns on equity on bloated Balance Sheets. In Sri Lanka, although the NBFI sector is small, its connection with and potential impact on commercial banks has been made clear in the recent finance company crisis.

Chart 4



4. Prevention is better than cure : Life after Lehman

There is little doubt that for an economy to grow, bank lending must resume. You need to fix the banks to fix the economy.

The Group of 20 largest economies are now trying to achieve consensus on a new regulatory framework to do just that. Some reforms that are being considered include the following -

(a) Banks must raise much more equity capital than envisaged in Basle 2, and also reduce their leverage. This will not be an easy task as investors are still wary of undisclosed and unprovided toxic assets and of the secondary impact of the recession on credit card and commercial real estate exposures in particular. They are likely to insist on much more accounting transparency before parting with their money. Ultimately, you cannot legislate for ethics or morality, but you can enforce transparency. Those banks which identify problem loans early, value them realistically and make provisions accordingly, are much more likely to attract capital than those that don't. Banking is all a matter of trust, and trust comes with openness. Significantly, sustainable returns on equity for the industry are likely to reduce, with the equity risk premium falling from around 17% in dollar terms over the last decade to 12-15% in the future. Banks need more capital but their attractiveness to investors is falling. This is also a looming problem in Sri Lanka.

(b) The G20 also agreed that large and complex financial institutions should develop "living wills" to plan for their orderly liquidation should that ever became necessary, without falling back on the tax payer. There will be a move away from implicit to more transparent or explicit sovereign guarantees where necessary, and to the strengthening of self funded deposit insurance schemes. Both these may be important policy measures to consider for Sri Lanka.

(c) Banks should be required to retain on their Balance Sheets and support with capital, some portion of assets that they securitize.

(d) The G20 will take more time to decide on two thorny issues. Firstly, how to reform the regulatory watchdogs whose failure to bark or to bite allowed the culprits free rein for too long. Secondly, how to de-risk bankers' remuneration. Incentivised by stellar bonuses, and cushioned by the "invisible wallet" of taxpayers, bankers bet their banks to increase revenues, with disastrous consequence for their own institution and the global economy. As Milton Friedman once observed "you don't spend other people's money, the way you spend your own".

(e) Governance

Independent directors were another line of defence which failed. There has been criticism of collegial boards packed with eminent people, who had neither the experience in banking nor the inclination to challenge powerful and knowledgeable CEOs on crucial issues of business direction, risk management or product innovation. They also failed to build balanced boards e.g. with representation from senior management who could provide an alternative voice to the CEO.

Independent directors have perhaps unkindly been compared by a British journalist, to many husbands. They talk a lot, don't do much work, give numerous instructions and expect to be lavishly fed at regular intervals.

Professor Sonnenfeld in an article in the Harvard Business Review "What makes great boards great", identified four characteristics of successful boards. Firstly, they operate in a climate of trust, based on timely access to relevant information and people, without meddling in day to day operations. Secondly, they foster informed dissent and discourage silent board members. Thirdly they don't typecast board members. You need "big picture" individuals who have the technical capacity to probe individual businesses and products, not just sector specialists. Fourthly, they ensure individual accountability and evaluate performance of directors as rigorously as is done for management. There may be lessons here for Sri Lanka.

Can "Mission accomplished" be declared in the global war against bank failure?

One year on, banks have emerged from intensive care units, but have not been restored to full health, as illustrated by the continuing fall in credit and the uncertainly about future losses. e.g. Moody's recently estimated that a further Pounds 130 billion of losses would emanate from UK banks, despite Pounds 110 billion of losses recognized so far, and new capital raised of Pounds 120 billion.

Critical policy responses are now being worked on to ensure that there is no relapse, particularly raising capital requirements, reducing leverage and removing explicit and implicit state guarantees.

Banks will then become smaller, less complex and risky institutions. "Narrow banks" are the new buzz word, with returns to shareholders coming down from the giddy heights of the last decade.

However, banks are pushing back against reform, confident that the government will bail them out again in a crisis. The risk is that they can afford to ignore calls for lower leverage and saner compensation policies, and that history will repeat itself. There is still much work to be done.

Sri Lankan banks and the challenges ahead

Sri Lanka banks have been insulated from the direct impact of the global banking crisis, though not from its economic consequences. While there have been recent instances of significant institutional losses, and failure of non-bank financial institutions compounded by contagion of mainstream banks, the problems are of domestic origin. These have been contained and financial sector stability maintained. Nevertheless, continuing stability cannot be taken for granted, and the need remains both for high vigilance and for structural reform in a changed environment.

Our banking system now faces a new and welcome set of challenges arising from post conflict economic opportunities. The long conflict with the LTTE has drained this country of blood and treasure for thirty years. Its conclusion has opened a unique and exciting opportunity for Sri Lanka to join the ranks of those other Tigers, the Asian countries who have grown their economies at 10% and more a year consistently over long periods, thereby uplifting and transforming the lives of their citizens. While the road to prosperity has finally been opened, the task is now ours to embark on and complete the journey. The end of the war is a necessary but not sufficient condition for the achievement of high growth.

Sustained high levels of economic growth cannot be achieved without a supportive banking system, which efficiently allocates scarce investment towards its most productive application, and which does so at affordable cost.

How ready are Sri Lankan banks to meet these twin challenges? Some answers to this question are explored below.

The Sri Lanka economy and its capital dilemma

The opportunity to grow the economy sustainably at high pace is now at hand. There are many preconditions to be met before this goal is achieved, but high on the list is that of capital. Sri Lanka presently suffers from a comparative disadvantage in this respect. Its current level of savings, investment and the efficiency of its usage is mediocre compared with emerging regional countries (More mature economies of Asia have high savings but lower investment levels on higher bases and better productivity). Savings which came under pressure from high inflation and government dissaving last year, are insufficient even to fund pre war investment levels. It is also noteworthy that around 80% of investment and more than 100% of savings, comes from the private sector.

Chart 5: Investment & savings % GDP

	2006	**2007**	**2008**
Investment	28.0	28.0	27.5
Private	85	81	76
Government	15	19	24
GDP Growth % p.a.	7.7	6.8	6.0
Savings			
Private	19.4	19.2	16.1
Government	(2.4)	(1.6)	(2.0)
Domestic Savings	17.0	17.6	14.1
National Savings	22.3	23.3	18.2
Savings/ Investment gap	(5.7)	(4.7)	(9.3)

Source: Central Bank of Sri Lanka

Chart 6: Regional savings and investment 2007

	Gross Capital Formation	National Savings	GDP Growth
Bangladesh	24.3	29.1	6.5
India	38.4	49.3	8.7
Malaysia	21.9	37.2	6.3
Singapore	22.6	46.8	7.7

Source: Central Bank of Sri Lanka

If the economy is to grow at 8-9% p.a. at its present level of capital productivity, investment will have to increase to around 35% of GDP i.e around USD 3 billion of incremental investment will be needed each year in the context of falling global investment trends. According to UN statistics FDI globally fell from US$ 1.85 trillion in 2007, to an estimated US$ 1.2 trillion this year, with recovery likely only in 2011. If additional capital of this magnitude is to be attracted annually to Sri Lanka, three structural issues need to be addressed. Firstly, savings will have to increase significantly. Secondly, returns on investment will need to match regional rivals as we compete for scarce capital. Thirdly, incremental investment will no doubt come partly from equity, but will also need to come from debt. Bank lending and capital markets capacity will therefore need to increase proportionately.

Are Banks ready to respond to the challenge?

Bank lending has been supportive of the 5-6% economic growth model, and banks have been resilient to the adversity of recent years as demonstrated below. It is seen that lending has broadly reflected economic conditions, particularly growth in money supply and GDP. The capital structure and business models of banks has been conservative, and nominal profit and profit growth has been high.

Chart 7: Stability and resilience of Sri Lankan banks

	2005	2006	2007	2008	2009 (1q)
GDP growth % p.a	6.2	7.7	6.8	6.0	1.5
Reserve money growth % p.a	15.8	21.2	10.2	1.5	-0.8
Loan growth % p.a	22.4	28.6	18.9	6.0	-0.8
Deposit growth % p.a	18.0	17.4	16.5	7.8	3.9
Tier 1 & 2 ratio %	13.4	13.3	14.1	14.4	14.1
Leverage ratio	13.0	13.2	12.5	12.3	12.3
Profit Rs bn	20.0	22.8	25.4	28.9	6.8
Profit growth % p.a 1	5.3	14.1	11.2	13.8	-5.7

Source: Central Bank of Sri Lanka

However, while recognizing the positives, there are numerous structural issues which need to be addressed if banks are to support the drive for growth.

1) The business model

The present banking business model is based on high interest margins which offset high overheads with consequent reliance on the more volatile "other income" line to generate profits. Profits are then eroded by high taxation, resulting in low returns on shareholder funds.

Chart 8: The Sri Lankan banking business model (DuPont Analysis)

	%
Net interest	**4.2**
Overheads	3.2
Credit Losses	0.4
Taxes	1.1
Costs	**4.7**
Net Loss	(0.5)
Other Income (after tax)	1.6
Profit	1.1
Return on assets	**1.1**
Return on equity	**13.8**

As a % of total assets Rs. 2.6 trillion (average 2008)

A clear conclusion is that profit is very vulnerable to net interest income reduction unless there are compensating cuts in costs and taxes.

2) The scale and composition of bank lending

Bank lending growth has reduced significantly in the last year or so in response to less favourable economic conditions, tighter monetary policy and rising non performing loans.

Chart 9: Loan growth and non performing loans

	2005	**2006**	**2007**	**2008**	**2009 Jun**
Loans and Advances (Rs bn)	1,003	1,290	1,534	1,640	1,605
Loans and Advances Growth %	22%	29%	19%	6%	-2%
NPL (Rs bn)	71	73	79	101	139
NPL Growth %	-5%	3%	8%	28%	38%
NPL Ratio %	7.0	5.6	5.2	6.3	8.7
NPL Cover %	66	61	54	47	38

Source: Central Bank of Sri Lanka

Additionally, the composition of lending has changed with credit growth to the Government increasing at a much faster pace than to the private sector (59% versus negative 1%). The private sector has been described as the engine of growth of the economy, but its fuel supply has been curtailed.

Chart 10: Composition of Credit Growth : Public versus Private Sector

Credit Growth	Credit to GOSL % Growth p.a.	Credit to private sector % Growth p.a.	Total Growth p.a.
2005	25	26	26
2006	44	24	28
2007	17	19	19
2008	25	8	12
June 2008 to June 2009	59	(-1)	5

Source: Central Bank of Sri Lanka data

The problem of preemption of banking resources by the Government is apparent.

3) The architecture of the banking system

The present architecture of the banking system is one of government dominance with around 45 -50% of assets held by three state banks, and fragmentation of the balance between 22 private and foreign banks. The relative market share of assets has held steady over the last five years. This contrasts with the Indian experience, where aggressive private banks have significantly eroded public sector market share, though from a higher base.

In the Sri Lankan banking paradigm, government banks effectively set the benchmark for pricing deposits and loans because of their market dominance, while the private banks compete to generate sufficient revenues to meet the high fixed costs of distribution, technology, brand creation and people, which are being separately built at 25 different institutions. Additionally, reliance on “other income” to generate profits can create profit volatility and increase risk profiles, especially for banks, where management may be tempted to take exceptional risks in Treasury to fill profit gaps. A combination of complexity and lack of scale, is a high risk formula.

4) Margins

Three major industries in Sri Lanka namely telecommunications, garments and hotels, have seen their margins slashed, and are dealing with the resultant and painful cost and productivity problems of overcapacity. The banking industry locally has enjoyed stable margins of around 5% over the last five years or so, which are amongst the highest in Asia.

Chart 11: Net Interest Margin (%)

Country	2008
China	2.9
India	3.3
Indonesia	6.8
Malaysia	3.0
Philippines	4.0
Singapore	2.0
Thailand	3.9
Bangladesh	6.0
Sri Lanka	5.2

Source: Financials of banks

Why have these levels of margins prevailed for so long, and not been competed away? The reasons are probably twofold. Firstly, banks price loans and deposits effectively on a cost plus basis, with the dominant state banks setting the standard on pricing, which the private banks are content to follow. Secondly, financial products are usually complex or long term, and therefore pricing is not fully transparent.

However, margins can quickly compress, if as in the telecommunications or hotels industries, the problem of overcapacity is dealt with by price wars for market share rather than by planned cost reductions and industry consolidation. Also, as interest rates reduce to single digits, high margins become more transparent to customers, and resistance is more likely. Depositor and borrower pressure backed by political and regulatory intervention, can force the issue. The root problem of high costs and taxes must be addressed, before the law of unintended consequences reduces shareholder returns to a level that new capital needed for loan growth cannot be attracted.

5) Taxation

An effective tax rate of around 60% on banking profits is clearly counterproductive in terms of capital formation. The request to policy makers for a reduction in rate is invariably met by the argument that the Government needs the revenue. While undoubtedly true, the corollary is that the Government also needs banks which have the capacity to lend. It cannot have both.

The pragmatic solution is for the government to help fix the non-tax structural issues of banks immediately, which will permit them to lend more freely. This will kick-start a virtuous cycle of higher growth and higher revenues in the economy, which will increase the government's tax take, thereby enabling it to reduce the disproportionate burden on the banks

Chart 12: Comparative Taxation

Country	Effective Tax Rates 2008
Australia	26
China	23
Hong Kong	15
India	28
Indonesia	30
Malaysia	27
Philippines	31
Singapore	16
South Korea	31
Thailand	26
Sri Lanka- all banks	59

Source: Financials of banks

6) The myth of banking profitability and the reality of capital needs

Banks have earned for themselves a reputation for generating high profits and profit growth. In reality, if bank shareholders are generous enough to provide substantial funds at zero interest cost to meet regulatory requirements, banks will undoubtedly show high nominal profits especially when interest rates are high. However, the reality is that there are few shareholders generous or irrational enough to persist in providing funds to banks, which they could otherwise invest in risk free government securities, unless they are assured of a premium on returns in excess of the risk free rate which justifies the equity risk that they carry. Additionally in Sri Lanka the implicit subsidy created by the expectation of government bail out in times of crisis, has artificially reduced the cost of capital and increased returns. If the costs of explicit guarantees or risk weighted deposit insurance are factored in, profits would decline further. Sri Lankan banks generally fail the test of achieving competitive returns on equity and will therefore have problems attracting the new capital that they need for growth.

Chart 13: Comparative returns on equity 2008

Country	Return On Equity (1)	Risk Free Rate (2)	Equity Premium (1-2)
Australia	19.1	4.0	15.1
China	14.0	2.0	12.0
Hong Kong	6.4	0.7	5.7
India	17.3	4.2	13.1
Indonesia	17.4	7.1	10.3
Japan	10.7	0.2	10.5
Malaysia	16.2	2.0	14.2
Philippines	9.5	4.3	5.2
Singapore	11.0	0.4	10.7
South Korea	11.3	3.3	8.0
Thailand	13.00	1.8	11.2
Sri Lanka	13.6	19.1	(5.5)

Source: Financials of banks

Why banks need new capital

While the industry is strongly capitalized at present at over 13%, fresh capital will soon be needed for four reasons in 2009, as non performing loans have risen, provisioning cover has fallen. There is probably a one off need for capital infusion or profit retention to repair Balance Sheets at individual banks. If provision cover collectively is to be restored at least to 2008 levels of 48% from 37% currently, additional provisions of Rs. 16 billion (Rs. 7 billion after tax) will be needed for the industry. Provision cover in Sri Lanka even at the higher 2008 levels falls below the norms for Asia.

Chart 14: Non Performing Loans Cover (%)

Country	**2008**
Australia	191
China	150
Hong Kong	79
India	68
Indonesia	155
Korea	136
Malaysia	104
Philippine	66
Singapore	117
Thailand	71
Sri Lanka	47
Sri Lanka June '09	37*(i)

Source: financials of banks

*(i) 50% including general provisions against performing loans

Secondly, the minimum regulatory capital requirement of Rs. 2.5 billion will come into effect shortly, but more compellingly, key stakeholders such as wholesale lenders globally and locally, now expect the cushion of equity capital to exceed minimum requirements comfortably. Additionally, as economic growth accelerates, bank lending will be expected to keep pace with nominal GDP growth and to meet the higher investment needs of the economy. Lending will probably have to grow at 20% (or around Rs. 320 billion) a year to meet these expectations. Further, Sri Lankan banks have regional growth ambitions. The commercial logic of such expansion is sound, but if we are to compete in India for example, we must recognize that there is a gap between vision and reality. We need to build scale and capital locally, if we are to be taken seriously in larger economies. Does the industry have the capital to do so?

A simplistic sensitivity analysis shows that it doesn't. Fresh capital infusions will soon be needed to support growth. Meanwhile returns on capital are likely to reduce because of falling margins for reasons described earlier, assuming that levels of overheads and taxation remain unchanged. The vicious cycle of increased capital needs and falling returns needs to be broken if the banking industry, and by implication, the economy is to grow at a faster pace.

Chart 15: Sensitivity Analysis of capital and returns 2008

	Rs bn
Estimated Capital Needs	
To support loan growth	41
Capital Sources	
Retained Profit	16
Annual Capital Shortfall	25
Return on equity 2008	
Before 1% margin reduction	13.8%
After 1% margin reduction	10.5%
Adjusted equity premium (discount)	(8.6%)

Assumptions

1) Loan growth of 20% p.a.
2) Margin reduction of 1%
3) No change in overheads, taxes or leverage
4) No change in existing tier 1 & 2 capital levels
5) No "one off" provision adjustment

The way forward

There is little doubt that the industry needs to consolidate to build scale and reduce overheads if it is to build a sustainable low margin, low cost, high return business model. Given the savings shortage domestically, fresh capital will most likely have to come from abroad. We will need to compete for capital in international markets. What stands in the way of consolidation? I would suggest that three policy changes need to happen if we are to achieve this objective. Firstly, the discriminatory and punitive tax rate needs to be phased out. It is hard to attract serious capital with a 60% tax rate on profits.

Secondly, both the industry and the regulators need to debate the rationale for consolidation, and publicly endorse the policy if accepted. Regulators also need to implement industry proposals to reduce the procedural roadblocks to achieving this goal, in particular, those relating to stamp duty and customer documentation.

Thirdly, the ownership and governance rules may need review in the post war, high growth scenario, when attracting new capital is a priority.

The present rules of ownership of banks restrict the holdings of a single owner to 10% of voting shares (or up to 15% with Monetary Board approval).

This rule was introduced to deal with alleged problems of concentrated ownership of private banks, often using non transparent means such as offshore trusts, non voting shares and employee share ownership trusts to exercise control. A time period of five years for divestment, where excesses were known or apparent, was permitted. The clock is ticking.

Examples of both models of concentrated or diversified ownership are found worldwide. Each has their advantages and disadvantages. The reason for selection of either model rests ultimately on the philosophy of governance which is to be adopted.

When share ownership is concentrated, dominant owners have the motivation and commitment to ensure that the bank is run as productively as possible. The downsides are that it needs strong watchdogs (independent and knowledgeable directors, strong regulations and regulators), to ensure that the interests of minority shareholders and depositors are protected from possible abuse by dominant owners. Further, the financial capacity of the dominant shareholder to contribute new capital when needed, becomes an important issue.

The diversified ownership model reverses these advantages and disadvantages. The risk of abuse by dominant sponsors is minimal at least in theory, but so is shareholder commitment to the business. If a shareholder's stake in a bank is small, it is more economical for him to sell his shares than to invest time and money in implementing change. Passive shareholdings lead to the risk of over powerful boards and management, with little accountability to stakeholders. However, the main problems with the diversified ownership model are those of ownership transparency and difficulty of enforcement. A determined and devious attempt to gain control of a bank using opaque ownership devices and concert parties, are hard to recognize and harder to repel.

Which ownership model is the right one? There is no right answer, only one that is more appropriate for the times.

What is best for the post war Sri Lankan environment? It is submitted that the diversified model was the most appropriate when the concern was of the takeover of banks by individuals and when governance rules were weaker. The priorities now are different. The country now needs fresh capital for aggressive growth and efficient management of capital productivity. The case is stronger in changed circumstances, to relax the ownership rules in order to attract new capital, and owners with commitment and professionalism, provided certain conditions are met. These include (1) transparency of ownership. Where beneficial ownership is doubtful the law must clearly err on the side of caution and disallow registration of shares. (2) approval of increased ownership should go hand in hand with demonstrated strengthening of the institutions of good governance, such as the quality of independent chairmen and directors, and stringent standards of disclosure in order to manage principal agent conflicts e.g disclosure not just of related party transactions at year end, but of those undertaken during the year, and of transaction pricing. (3) the demonstrated institutional capacity of sponsor shareholders of high repute to bring in new capital and relevant skills. A rebalanced ownership model should result in more effective boards, governance and performance.

Conclusion

Sri Lankan banks face problems both of perception and reality. Their public image is one of unjustifiable profit seeking at the expense of depositors and borrowers. The reality is that their returns on capital are among the worst in Asia, and are jeopardizing their prospects for raising new capital for growth. The issues of economic perception and reality both need to be addressed. Public recognition is needed of the facts that high growth cannot happen without vibrant banks, and that intermediation costs cannot be reduced without structural change, to improve their efficiency and performance. The time for debate, communication and reform is now.