SRI LANKA AS A "FINANCIAL HUB": ANOTHER LINGERING ILLUSION OR AN ACHIEVABLE GOAL? SOME REGULATORY AND LEGAL ISSUES[1]

By Aritha Wickremanayake

Precedent Partner, Nithya Partners

Introduction

There has been much said and envisioned in recent times about the possibility of Sri Lanka blossoming into a financial center. Beginning at the tail end of the 70's, when the country became one of the first in the region to transit to a market economy after years under a command regime, the goal of transforming the island's commercial capital into a regional financial hub has been touted by policy makers and politicians alike.[2] Despite much ado, hardly any planned effort has been expended in making the dream a reality. After many years during which the idea was shelved due to political instability and uncertainty, caused by the heightened ferocity of the civil war, visions of creating a regional financial hub have reemerged with the dawn of peace. However, what is conveniently overlooked is that neither peace, nor disunity and unrest within and amongst neighbors, nor strategic geographical location, nor accelerated economic activity *per se* will lead to the metamorphosis of Colombo into a financial hub[3]. To the contrary, the stark reality is that the creation of a financial hub requires that Colombo should be able to offer a host of features, which amongst other socio - economic and political factors, include a sound and robust regulatory, legal, and trading environment conducive to large scale financial activity, and a "sea change" in our economic, political and social outlook.[4] This article briefly examines some of these aspects, primarily from a legal and regulatory standpoint, critically evaluating whether Sri Lanka is ready, or can realistically achieve the status of a financial centre in the foreseeable future.

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[1] Arittha R. Wikramanayake, MALD (Fletcher), LL.M (Brussels), LL.M (Georgia); Nirusha Ranjitkumar LL.B (London), (Attorney at Law) and Shayanga Fernando LL.B (LSE), (Barrister at Law) all of NITHYA PARTNERS, Attorneys at Law.

[2] Being a "financial centre" is not new to Sri Lanka. Ironically, Sri Lanka (then Ceylon) dominated financial activity in the region for several decades prior to independence. Amongst the many features it offered were a stock market that traded shares of foreign as well as local companies, and a centre where commodities futures were traded.

[3] The term "Colombo" as against "Sri Lanka" is used deliberately: financial centers usually being cities rather than nation states since the former constitutes mediums of habitation that concentrate population, commercial, industrial, legal and administrative activity. See, Mainelli, Michael, "Global Financial Centres: One, Two, Three ... Infinity?" Journal of Risk Finance 7 (2), March 2006.

[4] See, generally, Jarvis, D, "Race for the Money: International Financial Centers in Asia", Lee Kuan Yew School of Public Policy. National University of Singapore. http://www.spp.nus.edu.sg/docs/rr/RR 6%20Race%20for%20the%20Money.pdf.

A "Financial Hub"

Although there appear to be various perceptions amongst politicians and policy makers of what is required to elevate Colombo into a regional financial hub, there are some minimum conditions that have to be met if such a goal is to be realized. Essentially, a financial hub requires a heavy concentration of financial institutions capable of, and in fact, delivering, a gamut of financial services, not only within the jurisdiction itself, but also regionally.[5] However, creating conditions that will attract the entry of institutions that can meet such standards is no easy task. Besides the fact that unlike in the early 80's, Sri Lanka is no longer the sole aspirant within the region to establish itself as a financial hub, the standards have also been raised due to intense competition.[6] Laying a foundation for a financial hub will therefore require a sustained, coordinated, and determined national effort. An appropriate starting point would be to perform an inward examination of where we stand. What follows is a discussion on some of these aspects.

Where does Colombo stand?

A question that one has to confront at the very outset is whether Colombo offers, or has the potential to offer, a strong and vibrant business environment or facilities that could be regionally competitive. The answer to the first aspect of the question is relatively free from doubt, and there is perhaps universal agreement that existing financial institutions in Sri Lanka can hardly claim to meet the criteria for being truly competitive on a regional scale. Quite apart from the fact that Sri Lankan financial institutions suffer from relative insignificance in terms of size and capacity on a global or even regional scale, they also exist in a highly insulated environment, where they have been accustomed to being sheltered from global competition.

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[5] A "financial hub" does not necessarily have to be capable of offering the entire spectrum of financial services on a global basis. The modern trend appears to be on focusing on the delivery of specialized services in sectors in which a jurisdiction can command a competitive edge. This has particularly been so necessitated due to the intense competition between practically every city to establish itself as a financial center in its own right. A pragmatic approach for Sri Lanka would therefore be to identify the regional strengths and advantages and concentrate on creating a platform from which such services could be delivered on a mass scale within the region. There are several such examples, like the Luxemburg platform for Global Depository Receipts, or Nigeria, (and for that matter several other Arabian states) which is seeking to establish itself as an "Islamic Hub". GulfNews.comhttp: //gulfnews.com/business/banking/nigeria-on-track-to-be-africa-s-islamic-financehub - 1.640710.

[6] See, for instance, Ferrell, Diana *et al.*, Mapping Global Capital Market: Fourth Annual Report.McKinsey Global Institute, McKinsey & Company, January 2008.

The other avenue to achieving status as a financial hub would be to offer physical operational and trading infrastructure with a capacity to provide services to the region, or else within Sri Lanka, on a scale significantly large enough to merit wide participation by large foreign participants. Unfortunately, Colombo also falls way short of these criteria, having perhaps only the trading platform operated by the Colombo Stock Exchange on offer. However, despite having once laid claim to be the most technologically advanced exchange in the region, the advantages boasted of by the Colombo Stock Exchange have gradually slipped by.[7] Moreover, gauged on market capitalization, turnover, and liquidity, Colombo does not merit more than a "frontier" tag in the eyes of the international financial community.[8] In these circumstances, the sobering truth is that Colombo presently cannot boast of infrastructural capability to be a financial hub.

What is required at a minimum?

Given the fact that large financial institutions and / or efficient infrastructure through which financial services can be delivered are a *sine qua non* for a financial centre, it is imperative that concentrated efforts be taken to: (a) transform existing local institutions into regionally competitive entities, or else, attract the relocation of global or regional financial institutions to Colombo; and (b) create a trading infrastructure that can offer delivery of financial services on a regional basis.

The strengthening of local financial institutions to be regionally competitive is no easy task. Not only does it require a concentrated and sustained effort at strengthening the institutions themselves, but it would also mean the creation of a regulatory and policy framework within which institutional building can be achieved. Singapore provides an excellent case study of the effort required, where, in a carefully planned program spanning many years, the Monetary Authority of Singapore actively coaxed local banks to consolidate and thereby enabled domestic institutions to become regionally and globally competitive.[9] Unfortunately, the lack of a clear policy and

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[7] The Colombo Stock Exchange once boasted of being the ninth exchange in the world to offer scripless trading, and one of the first in the region to be completely automated. Even though this gave Colombo a head start over its neighbors as a "safe" and efficient Stock Exchange with comparatively liberal regulations, it was unable to translate this advantage into playing host as a regional trading platform. Unfortunately, these technological advantages have fast eroded, with several regional Stock Exchanges migrating to, or already having implemented similar features.

[8] There is a plenty of self-patting and euphoria in recent times over the fact that Colombo has been deemed to be "a best performing market". However, what is conveniently overlooked is that this tag does not bestow any permanent benefits to Sri Lanka. In any event, it is common knowledge that the markets performance is largely a result of concentrated trades of selected stocks by a small cartel of "investors" who exploit the lack of depth and illiquidity of the market. Not only is this alarming since it clearly indicates the immaturity of the market, but it would also scare away any sophisticated market participant.

[9] "Consolidation and Liberalisation: Building World-Class Banks", DPM Lee Hsien Loong, Chairman MAS, http:// www.mas.gov.sg/news_room /statements/2001 /Consolidation_and _Liberalisation __Building _World_Class_Banks__29_Jun_2001.html; See also, comments by Minister Mentor Lee Kuan Yew, 28th June 2010, reported by Channelnewsasia.com; http:// www.channelnewsasia. com/stories/singaporebusinessnews/view/ 1066287/1/.html.

master plan for creating a financial center, and the absence of enabling laws which vest the authorities with the power to require such behavior, prevents the exercise of muscle or will to coax the financial industry in Sri Lanka in that direction.[10] These observations not only apply to the banking industry alone, being equally true of all other sectors of the financial services industry.[11]

Considering the paucity of material available to mould regionally competitive market participants from within, it becomes imperative that corresponding efforts should be taken to create an environment that will encourage foreign entities to relocate their regional operations in Colombo. However, this is an equally daunting task that requires more than dangling the prospect of a mere gateway to the Indian sub continent.[12] Attracting global financial institutions to Colombo would require the satisfaction of a number of prerequisites before they would even consider relocating their operations to a new jurisdiction. Foremost among these prerequisites would be the assurance of a legal and regulatory framework that will permit easy entry; operational freedom; and protection of their legal rights.

[10] The absence of a road map would undermine and even challenge the rationality of consolidation since such fundamental changes cannot be implemented on a vacuum. For instance, the merger of smaller banks with larger banks would inevitably impact domestic SME's and the small scale consumer since they would, for instance, lose out on advantages such as service standards and lower interest rates. Hence, such measures must be accompanied by a clear, comprehensive road map which addresses how these resulting voids will be filled.

[11] It is important to emphasize the need for consolidation and strengthening of domestic financial institutions. Even though foreign institutions may be the vehicles through which regional services could be delivered in the context of a financial hub, the survival of domestic institutions would be equally vital domestically, and care must be taken to ensure that basic conditions enabling them to survive the competition as a result of the entry of foreign institutions are maintained.

[12] There appears to be a very common perception that being the stepping-stone to its giant neighbor India, Sri Lanka could be what Hong Kong is to China, or Singapore is to East Asia. However, it is a fallacy that mere geographic presence elevated Hong Kong or Singapore to their positions as financial centers. Hong Kong actively benefited from political and economic turmoil in China during various stages of its history including periodic influxes of Chinese political and economic émigrés, the relocation of western business headquarters out of Shanghai, and massive capital in flight as a result of hyperinflation between 1947 – 1949. Singapore on the other hand engaged in an aggressive and concentrated program since the 1960's to create an international services centre, and also benefited from being able to exploit financial and economic conditions that existed in the region during such periods. Ng Beoy Kui (1998), "Hong Kong and Singapore as International Financial Centres: A Comparative Functional Perspective," *Mimeo*. Applied Economics Division, School of Accountancy and Business, Nanyang Technological University, Singapore. Sagaram, J.P.A and Wickramanayake, J., (2005), "Financial Centers in the Asia Pacific: An Empirical Study on Australia, Hong Kong, Japan and Singapore," BNL Quarterly Review, (LVIII) 232,March, pp.21-51.

Entry barriers

An examination of the laws that govern the financial industry in Sri Lanka will indicate that there are considerable barriers to entry, and that the local industry is sheltered from foreign competition by a paternalistic regulatory framework. Even though this is admittedly not necessarily negative in itself, since a surge of foreign competition can result in weakening domestic financial institutions, a substantial level of liberalization would have to be engaged in, if Colombo is to be transformed into a financial hub. The methods adopted by Singapore have previously been referred to in this regard, and they clearly highlight the level of regulatory herding required for the task. In these circumstances, it would be prudent for policy makers and regulators to carefully review entry barriers and requirements; formulate strategies and guidelines within which they may be gradually liberalized, while protecting domestic interests; and, creating conditions in which financial institutions with a global presence may be encouraged to establish themselves in Sri Lanka in order to elevate the stature of Colombo to that comparable to a financial hub.[13]

Operational freedom

The liberalization of entry barriers will not in itself lead to foreign institutions deciding to establish their presence in Sri Lanka. Such decisions will also be guided by the availability of several other conditions, not only on a stand alone basis, but also in terms of competitiveness *viz a viz* other cities in the region.

One of the key concerns in this regard would be the state of the institutional and regulatory model that governs the financial industry in Sri Lanka. On an objective evaluation, one could venture to state that it is very likely that our regulatory model will probably be perceived as being unattractive, in comparison to those that exist in markets that are generally perceived of as being efficient financial centres. Firstly, the general regulatory paradigm in Sri Lanka is clearly outdated, inefficient, and cumbersome. The fact is that most existing laws and regulations in the financial sector have been introduced piecemeal, during the period of transition to a *laissez faire* economy in the early 1980's, with minor amendments having been introduced from time to time, in response

[13] The stock market in Sri Lankan provides a sound example of such restrictive attitudes. For many years the mutually owned exchange limited the number of seats, jealously safeguarding participation in the market to barely a dozen members of which less than half were dormant. Not only does this remove the incentive to strive for efficiency but it also deprives the consumer of choice.

to periodic crisis. A survey of the regulatory landscape will therefore, not only demonstrate the existence of a multiplicity of regulators, overlapping regulation and regulatory gaps, but also several remnants of anachronistic legislation.[14] Adding to this is the considerable concern about a lack of transparency in regulatory rule making, supervision and oversight.[15] Even though the local industry has grown accustomed to operating within these conditions, adapting to these issues, and even turning a blind eye to many requirements prescribed by law, such regulatory inefficiencies would deter relocation by large global financial institutions, not only because of the increased costs of compliance but also because it does not offer the level of efficiency and predictability required for modern financial transactions. Several examples stand out: for instance, certain financial institutions are presently governed by two and at times up to four regulatory bodies. On the other end of the spectrum, one finds many unregulated "financial institutions" that operate on the fringe of legality, causing deep concern that their costs of failure could result in severe systemic damage, through the proverbial ripple effect. The continuous inability of the regulatory authorities to deal with such situations, either through the implementation of supplementary laws or otherwise, is a clear manifestation that neither the regulators nor the legal system are equipped to deal with market needs. Connected to this issue, is concern about the lack of transparency with regard to regulatory supervision and oversight. The lack of skilled regulators, the absence of guidelines or literature, and a disjoint between the regulatory bodies and the industry in communication, compounds this situation. It is therefore crucial that a solid rapport should be built up between the industry and the regulator to ensure a responsive regulatory framework.[16]

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[14] There is a clear acceptance that financial markets will drift to those financial centres with the fairest regulatory framework, lowest transaction costs, high transparency and robust financial infrastructure. The conditions in Sri Lanka fall considerably short of these standards. For instance, the idea that regulation of the financial services industry should be focused on a function based paradigm rather than a sector-based paradigm is fast gaining widespread acceptance. The financial crisis faced by the industry on virtually a global basis highlighted the fact that regulation of sectors divorced from each other was ineffective and permitted a large area of activity to fall within regulatory gaps. Given the fact that countries like Sri Lanka also suffer from a shortage of professional regulators, the idea of a super regulator of the financial services industry would be a useful model to consider.

[15] There are many instances where regulations and directions relating to the financial products have proved to be vague and ambiguous. A sound example, of this would be the Direction on Financial Derivative Products issued by the Central Bank of Sri Lanka, which has effectively brought the development of these products to a standstill. A procedure for discussion and dialogue with the industry prior to formulating such regulations might therefore be a prudent mechanism for the future.

[16] It should be emphasized that neither the blame nor responsibility for this situation is solely with the regulator. The financial industry in itself should be held responsible for this state of affairs since it rarely, if ever, seeks to intervene and demand that they be consulted in the process. There are also many instances where regulators have sought industry comments on crucial legislation but received little in response.

Apart from the compliance cost of regulatory inefficiencies, many of our existing laws and regulations, effectively prevent or hinder financial institutions from engaging in many standard transactions. For instance, provision of financial services that are routinely associated with a financial hub requires freedom on the movement of capital. A perusal of our laws and regulations indicates that Sri Lanka falls far short of international standards in this regard. Foremost among these concerns would be limits on the convertibility of the Sri Lankan Rupee and the underlying exchange controls. Until and unless these controls are abolished or substantially relaxed, there is little likelihood that Colombo will be able to compete or offer services usually associated with a financial hub.[17]

Numerous studies have highlighted the adverse impact that high taxes and erratic fiscal policy have on financial centres. These effects are felt in two particular areas: the first, in inhibiting transactions, and the second, in reducing the attraction of the jurisdiction for relocation. It is a universally accepted premise that financial transactions are particularly sensitive to transaction costs. Frequent and *ad hoc* imposition of levies and taxes in Sri Lanka, and in many instances those imposed without consideration of their consequences,[18] prevents long term financial planning, financial innovation and product development.[19] Hence, it is unlikely that Colombo will be able to even attempt at being a hotbed for financial activity within the region unless policy makers can demonstrate that they are capable of laying down a fair, consistent and predictable tax policy on which the industry can depend on over the long term.

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[17] It is not the intent of the authors to argue for a liberalization of these rules. The decision to abolish or relax these rules on the convertibility of exchange would obviously have to be dependent of overall monetary and fiscal policy. However, the point made is that as long as these rules remain, the ability to create a financial centre is limited and that we should be realistic with our expectations.

[18] An example of this would be the withholding taxes that are presently applicable to bond trading. Reportedly, the uncertainty caused as a result of this levy has severely disrupted and hindered the development of the bond market in Sri Lanka.

[19] The competition in establishing financial centres means that participants would generally engage in a considerable amount of regulatory arbitrage, thus demanding that policy makers should be concerned about "deadweight" costs of regulation and market intermediation. The current rate of taxation on banks for instance, effectively exceeds 52.5 percent when Corporate Taxes, Value Added Taxes and Withholding Taxes on dividends are factored.

These concerns are not limited to the random fiscal policy. There is also an abundance of empirical studies that clearly demonstrate that high transactional costs severely deter large-scale financial activity in any jurisdiction. Besides taxes and levies on transactions, high levels of corporate and personal taxation have also been proven to drive out financial institutions even from established financial hubs, not only making it unattractive for the institutions *per se* but also in terms of attracting and retaining key personnel working within them.[20]

Apart from these strictly industry specific issues, there are certain other matters which would have to be addressed in order to make Colombo conducive for the relocation of large financial institutions. One of the key criteria that has contributed to the development of many financial hubs has been the availability of skilled industry specialists. Unfortunately, Sri Lanka does not appear to possess this resource on the required scale.[21] In these circumstances Sri Lanka may have to carefully re-examine its immigration policies and facilitate the free movement of persons in order to address this issue. Apart from liberalization of entry requirements, *per se*, simultaneous steps would also be required to review restrictive laws which impact perceptions on social and political conditions, ranging from property ownership, intellectual property to right to information and censorship.

Protection of legal rights

An examination of literature on what makes a successful financial hub clearly highlights the importance of the availability of a legal system that is built on respect for the rule of law, and which guarantees a responsive regulatory system. Respect for the rule of law is crucial from several perspectives. Firstly, large financial institutions are extremely sensitive to political and social instability. A fair and transparent legal system based on respect for the rule of law helps mitigate concerns that commonly exist in this context. Secondly, given the nature of their operations

[20] As stated, there is an abundance of studies done on the impact of high taxation rates. See generally, Revealed: how higher taxes send London to top of the table, Financial News, 8th March 2010, http://www.efinancialnews.com/story/2010-03-08/higher-taxes-make-london-most-expensive; The Impact of Taxation on Financial Services Business Location Decisions, CRA International, February 2008, http://www.cityoflondon.gov.uk/NR/rdonlyres/EAB21107-2E8E-4338-9243-D0E37995D54F/0/BC_RS_taxreport_ES.pdf.

[21] This problem has been highlighted in several instances, even at a less sophisticated level. For instance, even the relatively modest level of BPO activity that has taken place in Sri Lanka in recent times has resulted in not only creating a significant spike in hiring costs but also in a dearth of skilled, English speaking, computer literate personnel.

and investments, large financial institutions are particularly concerned that their rights and status within the jurisdiction are soundly protected, not only from changes to the operative framework but also in terms of guarantees of investment and predictability of outcomes of transactions. Recent events in Sri Lanka, such as the reversal by the courts of high profile divestitures of government assets and the "nullification" of the infamous petroleum hedging transaction suggest that such concerns would not be unfounded in relation to Sri Lanka. Thirdly, sophisticated financial institutions engaged in "cutting edge" transactions will also require the comfort of the knowledge that they are operating within a legal environment that has the ability to deal with situations that commonly arise in such matters. Here too there would be concerns arising from recent trends and the perceptions created that our legal system is incapable of responding to such situations; prime among them being the abject responses to recent financial fiascos such as the Golden Key and other similar schemes.

Conclusions

What has been expressed above are just some of the broad and perhaps obvious concerns that come to mind when one considers what has to be addressed by policy makers and the financial industry in creating a financial hub in Colombo. No attempt is made to even claim that the issues that have been discussed are comprehensive. Neither is it the intent of the article to highlight faults of any particular authority, regulator or the industry. The hard truth is that the financial industry, like every other industry, has been buffeted by the effects of the brutal and destructive civil war that the country was exposed to for over three decades and forced to survive in a general environment of change and uncertainty. Now that the war is behind us, it becomes necessary for Sri Lanka to take stock of where it stands and adopt a serious plan for what it hopes to achieve over the long term. However, the place to start would be to accept that despite Sri Lanka's expectation of being the financial hub for the region, the idea is yet no more than a pipe dream. Financial hubs don't happen. Rather, they are built on years of careful planning and thereafter sustained through responsive policies, laws and regulations aimed at maintaining the competitive edge gained by them. It is therefore prudent for us to appreciate these hard realities, and either put in the effort to achieve this goal, or else limit our expectations.