IS SUSTAINABILITY IN VOLATILITY A PARADOX FOR BANKING INDUSTRY IN SRI LANKA?

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1.0 Introduction

It has become a hot topic these days to discuss on the role of a bank in a modern economy fueled by knowledge and operated on nano-technology. So much so, people argue that the role of a bank being a supplier of credit to the economy at large has changed to become a facilitator of growth and sustainability whilst facing unimaginable challenges in very unpredictable volatile situations. For this end it is obvious that a bank should be financially ultra sound and equiped with strong capabilities. The question is whether our banks in Sri Lanka could meet those standards at least hypothetically or if not what actions need to be taken at which level to reach those heights. This article attempts to have a glimpse on this aspect in terms of lessons learnt in other parts of the world whilst critically analyzing selected statistics on the economic front and performance indicators of licensed commercial banks of Sri Lanka. At the same time a critical look being taken on organizational setup of banks in Sri Lanka.

2.0 Banking Business

"Business, that's easily defined - its other people's money." - *Peter Drucker*

The above quote is more apt for bankers since their business evolves around other people's money. So much so, ever since banking business has seen the light of day, the "Trust" has been a word synonymous with the industry. In Sri Lanka, banking industry has been fortunate enough to maintain that trust placed by the public except for the crash of the Oriental Banking Corporation in 1884 caused by the coffee crisis. However, the journey of the banking industry in Sri Lanka could not be considered as smooth sailing given the fact that it has experienced both favourable and unfavorable environments. The fortunate thing was that, at times of crisis the Government of Sri Lanka had no second thoughts of coming to rescue affected entities with a workable solution. In this light, Sri Lanka could be a model to many other countries in the region as well as to the whole world, in terms of conservative approach to banks and banking industry of the country.

On the contrary the general outlook of the banking industry in the global arena has painted a grim picture in the minds of many. This is further established from the quote given below from the report published for the term 2011- 2012 by the "World Economic Forum".

Quote

Over the past couple of years, the public perception of the banking industry has dramatically worsened. This deterioration is mostly fuelled by increasing skepticism on the quantity and quality of actions taken as a reaction to the financial crisis. The uncertain economic recovery, ongoing fiscal crises and continuous credit challenges have greatly influenced the public to believe that some of the most critical issues highlighted by the crisis have not been addressed, specifically the level of systemic risk, banks' governance, bankers' compensation and how to deal with problem assets. All of this has contributed to a significant erosion of public trust in the overall financial services industry, including industry players and regulators, and has ultimately created a broad lack of confidence and uncertainty. The industry, regulators and supervisors are part of the same system and a lack of trust in one of these areas has a negative impact on the overall system. In addition, there is widespread fear that current financial system governance is not sufficiently adequate to deal with the potential turbulence that may arise, thereby causing further instability.

Unquote

The above is the stark reality of affairs of the banking industry said to have dominated a few years ago and set trends in processes, procedures, products and governance for the whole world. As in many other cases the common element that render responsible for the dearth in public confidence was "people" behind the veil as evidence from above facts. As such, the following quote is more apt for people who were behind the catastrophe.

"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently." - *Warren Buffett*

Given this status of affairs one could argue back that banks in Sri Lanka could not be totally oblivious to the risk of being affected adversely at one pint or the other considering the wide spread dealings that modern day banks have established with the banks of global repute.

3.0 Lessons Never Learnt

Banking industry is the life blood of any economy. Therefore the current trends and the issues of the respective country would have a glaring impact on the banking sector too. As a result one could not segregate economic well being and the banking sector progress of a country as two different aspects, but two sides of the same coin. The most credible and glaring example for that effect could be drawn from Spain which was affected by financial crisis though oblivion on measures of correcting the same at the very outset and ultimately saddled with a staggering 10% budget deficit and 115% inflation as at end 2011. The following is a quote from Wikipedia on this issue.

Quote

The Spanish banking system had been credited as one of the most solid and best equipped among all Western economies to cope with the worldwide liquidity crisis, thanks to the country's conservative banking rules and practices. Banks are required to have high capital provisions and demand various proofs and securities from intending borrowers. Nevertheless this practice was strongly relaxed during the housing bubble, a trend to which the regulator (Banco de España) turned a blind eye.

Spain's unusual accounting standards, intended to smooth earnings over the business cycle, has misled regulators and analysts by hiding losses and earnings volatility. The accounting technique of "dynamic provisioning", which violated the standards set by the International Accounting Standards Board, obscured capital cushions until they were depleted, allowing the appearance of health as the problems mounted.

It was later revealed that nearly all the Spanish representatives in Congress had strong investments in the housing sector, some having up to twenty houses. Over the time, more and more news have emerged about the informal alliance between Spanish central and regional governments, the banking sector (bear in mind for example the recent government pardon of the second at command at the Santander Bank, while all the major parties are strongly indebted with banks, and such debts are extended from time to time) which increased the bubble size over the years. Most regional semipublic savings banks (*cajas*) lended heavily to real estate companies which at the end of the bubble went bankrupt, then, the *cajas* found themselves left with the collateral and properties of those companies, namely overpriced real state and residential-zoned land, now worthless, rendering the *cajas* in essence bankrupted.

In stark contrast with countries like Ireland, no nationalization took place, instead the problem was rolled-over with the extension of the remaining real state companies' debts, while the central government bailed once and again banks and Cajas alike. For more than three years, there has been a steady process of bank concentration. Spain had the densest bank office net in Europe and this has forced many dismissals of bank employees.

Recently a calculation was made that showed that about 40,000 people were redundant. Oddly, the bank Board of Members have mostly kept their jobs, even for merged entities. Golden parachutes have been ubiquitous. It has been speculated that this was because of fear that laid off senior members would talk about the rampant malpractices inside the sector. No bankers have been on trial for their role in all this process, once again in stark contrast with countries like Iceland.

In May 2012 credit ratings of several Spanish banks were downgraded, some to "junk" status. The Bankia bank, the country's largest mortgage lender, was nationalised on 9 May, and on 25 May it announced that it would require a bailout of 23.5 billion to cover losses from failed mortgages.

In addition to Spanish banks, other European banks have a sizeable presence in Spain. German banks lead with an exposure of $146 billion. Germany's Landesbanks "rushed in" during the early 2000s. Barclays, Deutsche Bank, and ING have large Spanish units.

Unquote

This episode clearly highlights the possibilities of leading to a crisis in many fronts in spite of overarching controls in place, mostly found in documents but hardly in practice. So that, this proves a point that immaterial of regulator or any other party for that matter, it requires greater awareness among the public on the affairs of banks as well as strong voice against any deviations from the norms of prudency. So much so, gone are the days that public plays a role of lassie-fare on banks and their operations.

The irony of the fact is that when one part of the globe has faced a similar issue in the recent past; another part of the globe repeats the same mistake as if it was for the first time. The crux of the matter is that it is People behind the country or organization that brings boom or doom as clearly evident in analyzing all those cases. Therefore, ultimate learning point is going back to basics, in other words not to entrust your fortune to someone else and keep a blind eye.

State of Sri Lankan Economy

The IMF has published a recent report on the health of the economy as a part of its regular review of the progress made by member states on post disbursements of loans. Further, Sri Lanka has sought continuous support of IMF on its long term development initiatives. The following is a quote of the report that appears on its website.

Quote

An International Monetary Fund (IMF) staff mission, led by Mr. John Nelmes, visited Colombo June 4 - 15 to discuss economic developments and policies. The team met with government and Central Bank officials, as well as representatives of civil society and the private sector. The team issued the following statement today at the conclusion of its visit:

"The authorities are successfully implementing a bold package of policy measures to curb the current account deficit and safeguard reserves, and these measures are yielding fruit. Credit growth has slowed and imports have declined. Given the new policy framework—in particular the pursuance of exchange rate flexibility—as well as continued strength in remittances and success in attracting capital inflows, international reserves at the central bank have now stabilized. Government revenue collections and interest expenditures are under pressure, but the authorities remain committed to meeting their deficit targets.

"The Sri Lankan economy should grow by around 6¾ percent this year, as tighter macroeconomic policies work to ease demand to a more sustainable pace. The uncertain global environment poses a downside risk, but the rupee depreciation should provide a boost to the economy going forward. Inflation is likely to rise to the upper single digits, and we thus see the need to keep monetary policy focused on inflation pressures for the time being. While the transition has caused difficulty for many segments of society, we share the authorities' assessment that the new policy framework will strengthen the fundamentals of the economy and lay the basis for sustained economic growth.

Unquote

The Central Bank of Sri Lanka in its recent release also indicates the optimism in relation to the progress that the country would make in the year 2012 and beyond. In other words there is a fare degree of positive expectation that the country would sustain its growth momentum. This is good news for banks in Sri Lanka.

4.0 Performance Evaluation

The Table given in the Annexure I provides a comparison of performance of commercial banks on year on year basis commencing from the year 2007 to 3rd Quarter of 2011. Each section of the table is analyzed below by annualizing Q3 figure of 2011 for the purpose of comparison on equal footing on selected indices.

4.1Assets and Liabilities

The growth of assets of the banking sector is more than 60%, which shows the increasing assets of the commercial banking sector which is a positive trend.

Net loans and advances also registered a growth of over 110% which is commendable given the opening up of North and East for banking activities as in other parts of the country. This is also supported by a growth of over 120% of deposits. Similarly, the borrowing has also increased by 90% followed by increase of contingency liability over 110%.

These figures indicate a healthy and robust asset & liability mix though there is a possibility of adverse impact at the time of an economic down turn. Especially, this would be critical with regard to quality of loan assets and type of contingencies.

4.2 Earnings/Profitability

Net interest income has registered a growth over 54% whereas non interest income increased by 40%. This is an area banks are very keen on improving though the chances are remote for smaller banks considering the credit ceiling imposed by the Central Bank of Sri Lanka, devaluation of rupee against us dollar and rising interest rates.

With regard to major non interest expenses of banks, the most significant is staff cost. Accordingly, the cost has increased by over 51% which is an alarming rate, given the fact that any gain in the increase in net interest income and non interest income will be off set by this cost. As we have seen in the case of banks in Spain, at the time of a serious financial crisis the staff was made redundant which is more difficult as that in Sri Lanka given the complex mechanisms involved in retrenching workers.

On the other hand there is a noticeable decline in provisioning, which is over 66% given the improved recovery and reduced non performing loans.

4.3 Selected Financial Performance Ratios

In this section the capital adequacy could be considered as seemingly satisfactory, whereas there are some smaller banks which requires meeting the minimum capital requirements set by the Central Bank.

With regard to asset quality, net non performing ratio has been quite satisfactory though this may be adversely affected in case of severe drought, declining inward remittances and crisis in export markets.

Notable areas to concentrate on are declining efficiency, staff cost and interest margin.

Although statistics bear out the robustness and the prospects for future, it is a fact that competitiveness of the industry is the key to survival.

However, in order to become competitive and different banks and bankers have to change the way how things are being done whilst not losing focus on fundaments such as honesty, trust, prudence and transparency.

The million dollar question is to what extent are they prepared to modernize and integrate into the new organizational setup?

5.0 New Organization

The following is a snap shot of how banks and bankers of Sri Lanka need to change to stay competitive and alive to the realities of the 21st century. (Table 1)

Table 1: Framework for Taking Action in the New Organization

	Requisites for Taking Effective Action		
Organizational Characteristics	**Individual Skills**	**Organizational Features**	**Managing the Environment**
• Networked	Teamwork	Building team structures	Developing alliances
• Flat	Negotiation	Developing incentive systems	Boundary management
• Flexible	Multitasking	Workforce management	Learning
• Diverse	Listening/empathy	Conflict resolution systems	Stakeholder relationship building
• Global	Cross-cultural communication	Cross-border integration	Local responsiveness

Source*: PowerPoint Presentation by Charlie Cook; South-Western, 2005*

The above is a complete difference to the present hierarchical structures that have been rooted for decades in many banking organizations, thus creating an unusual bureaucracy. On the top of that one could find inbuilt inefficiencies, especially in the processes with lethargic approach on new developments in the market and customer perspectives.

A deep look at the exiting organization structures of many banks in Sri Lanka amply denote that they are hardly in line with the above versatile framework.There are many areas to be looked at in bringing the change that require which needs out of the box thinking. So much so, one could not be totally engrossed with the existing practices, processes and structures, but need a clear vision and translating the same into action within a specified period of time.

In order to make such changes, it is more apt to take a comparison of old and new version of the organization in the context of the individual. (Table 2)

Table 2: Old vs. New Organization

Old Model	New Model
Individual position/job as basic unit of organization	Team as a basic unit
Relations with environment handled by specialist boundary-spanners	Densely networked with environment
Vertical flows of information	Horizontal and vertical flows of information
Decisions come down, information flows up	Decisions made where information resides
Tall (many layers of management)	Flat (few layers of management)
Emphasis on structures	Emphasis on processes
Emphasis on rules and standard procedures	Emphasis on results and outcomes
Fixed hours	Flexible workday, part-time workers

Source: *PowerPoint Presentation by Charlie Cook; South-Western, 2005*

The comparison is self explanatory, though difficult to implement overnight. However, the will to change on top and bottom would make it possible as it had happened in many other organizations across the globe.

At the same time, a gradual change to the organizational culture would be established following from old to the new.

Table 3: Old vs. New Organization

Old Model	New Model
Career paths upward, linear	Career paths lateral, flexible
Standardized evaluation and reward systems	Customized evaluation and reward systems
Single strong culture with strong expectations of homogeneous behavior	Diversity viewpoints and behaviors
Ethnocentric mindset	International/global mindset
Specialist international managers	Boundary-crossers at all levels
Local value chains	Value chains crossing borders
Environment defined in terms of country of location	Environment seen as global

Source: PowerPoint Presentation by Charlie Cook; South-Western, 2005

Conclusion

The series of points discussed above highlights following aspects in Sri Lankan banks;

- Comparatively they are conservative in approach and make decent profits
- No bank crisis has occurred in the recent past since government has always extended its helping hand at the time of impending crisis
- There is a question of competitiveness of banks in the long run when compared with other institutions
- The structures and processes are more bureaucratic than open and modern, which require change in the near future

Coupled with the above the Sri Lankan economy is relatively small and negligible. As a result operating in this environment would not make our banks global in approach. Consequently, it is high time to draw up plans in expanding into countries in Africa, which is a popular destination of many other businesses as well as BRIC countries whilst looking at avenues in South Asia.

The sustainability lies on the strength of facing adversity. It is apt for banks in Sri Lanka to focus on the horizon as entities geared for high growth whilst strengthening the capital base and income sources.

“If you want something new, you have to stop doing something old” - *Peter Drucker*

Annexure - 1

Selected Financial Performance Indicators for Licensed Commercial Banks

	Item	2007	2008	2009	2010	2011, Q1	2011, Q2	2011, Q3**
Assets and Liabilities, Rupees Million								
1	**Assets**	**2,098,279**	**2,259,914**	**2,506,585**	**2,974,559**	**3,094,940**	**3,255,610**	**3,387,630**
	Market Share,(%)-Sector	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Industry	83.8	83.8	83.2	83.8	83.9	84.2	84.4
2	**Gross Loans and Advances**[(a)]	1,366,454	1,456,603	1,406,979	1,764,189	1,838,522	1,984,431	2,106,147
	Market Share,(%)-Sector	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Industry	89.1	89.1	88.1	89	90	90	90
3	**Net Loans and Advances**[(b)]	**1,317,986**	**1,399,026**	**1,341,091**	**1,708,361**	**1,783,881**	**1,931,275**	**2,054,006**
4	**Gross Non-performing Advances**[(a)]	67,775	87,395	115,895	90,313	93,250	89,440	86,947
5	**Net Non-performing Advances**[(b)]	19,307	29,818	50,007	34,485	38,608	36,284	34,805
6	**Provision for Bad and Doubtful Advance**	48,468	57,577	65,888	55,828	54,642	53,156	52,142
7	**Investments**	348,510	454,041	652,837	763,758	782,674	804,815	798,391
8	**Risk Weighted Assets**[(c)]	1,214,846	1,426,645	1,359,096	1,612,687	1,705,801	1,766,723	1,913,089
9	**Capital**[(d)]	161,710	179,050	197,910	236,381	242,748	257,104	284,328
10	**Core Capital (Tier 1 Capital)**[(e)]	144,260	158,771	175,336	209,462	209,350	216,336	230,928
11	**Capital Base**[(e)]	165,040	197,077	209,717	244,948	243,527	248,543	265,828
12	**Deposits**	**1,456,701**	**1,560,247**	**1,850,591**	**2,153,425**	**2,219,205**	**2,323,055**	**2,425,688**
	Market Share,(%)-Sector	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Industry	83.7	83.1	82.9	83	83	83	83
13	**Borrowings**	**373,853**	**400,130**	**334,610**	**450,293**	**483,659**	**526,692**	**521,563**
	Market Share,(%)-Sector	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Industry	85.1	87.3	85.9	89	90	90	90
14	**Commitments and Contingencies**	1,137,724	1,179,123	1,128,041	1,414,470	1,690,812	1,857,574	1,815,959
Earnings/Profitability, Rupees Million								
15	**Interest Income**	231,778	286,560	299,073	268,224	67,087	137,681	212,447
16	**Interest Expenses**	143,502	183,570	184,793	140,146	34,804	71,710	110,325
17	**Net-interest Income**	**88,276**	**102,989**	**114,277**	**127,493**	**32,283**	**65,971**	**102,122**
18	**Non-interest Income**	**36,226**	**46,463**	**49,391**	**51,819**	**12,263**	**24,477**	**39,231**
	Foreign Exchange Income (Net)	9,206	13,843	12,100	11,915	3,233	6,036	10,054
19	**Non-iInterest Expenses**	**67,454**	**79,561**	**85,770**	**94,608**	**23,910**	**49,324**	**75,592**
	Staff Cost	28,946	34,578	39,041	42,236	10,308	21,819	32,833
20	**Provision for Bad and Doubtful Advance**	10,727	15,251	25,129	1,188	1,354	2,118	2,719
21	**Profit Before Tax**	**37,584**	**44,373**	**40,753**	**69,591**	**17,583**	**35,201**	**56,819**
22	**Profit After Tax**	21,796	25,174	20,819	45,183	11,306	23,648	38,001
Selected Financial Performance Ratios, Percentage								
1	**Capital Adequacy**							
1.1	Core Capital (Tier 1 Capital) Adequacy Rat	11.9	11.1	12.9	13.0	12.3	12.2	12.1
1.2	Total Capital Adequacy Ratio	13.6	13.8	15.4	15.2	14.3	14.1	13.9
1.3	Net Non-performing Advances to Capital R	11.9	16.7	25.3	14.6	15.9	14.1	12.2
2	**Assets Quality**							
2.1	Gross Non-performing Advances Ratio[(a)]	5.0	6.0	8.2	5.1	5.1	4.5	4.1
2.2	Net Non-performing Advances Ratio[(b)]	1.5	2.1	3.7	2.0	2.2	1.9	1.7
2.3	Provision Coverage Ratio[(f)]	71.5	65.9	56.9	61.8	58.6	59.4	60.0
3	**Profitability**							
3.1	Return on Assets (ROA) Before Tax	1.9	2.0	1.7	2.5	2.3	2.2	2.4
3.2	Return on Assets (ROA) After Tax	1.1	1.2	0.9	1.6	1.5	1.5	1.6
3.3	Return on Equity (ROE)	15.0	14.8	11.0	20.8	18.7	19.2	19.8
3.4	Efficiency Ratio[(g)]	56.7	56.1	59.1	50.8	54.3	55.1	53.8
3.5	Staff Cost to Operating Expenses[(h)]	42.9	43.5	45.5	43.1	43.1	44.2	43.4
3.6	Interest Margin[(i)]	3.8	3.8	4.1	4.0	3.8	3.8	3.8
4	**Liquidity Indicators**							
4.1	**Liquid Assets Ratio**							
	Domestic Banking Unit Operations (DBU)[(	24.8	25.6	33.0	29.4	28.5	28.5	27.4
	Foreign Currency Banking Unit Operations	47.2	41.9	46.6	51.3	43.0	43.2	38.9
4.2	Credit to Deposit Ratio	93.8	93.4	76.0	81.9	82.8	85.4	86.8

Source: Central Bank of Sri Lanka (Web-based returns) - Annual Audited Accounts

** Provisional Data*

[(a)] Net of interest in suspense.

[(b)] Net of interest in suspense and loan loss provisions.

[(c)] Estimated in terms of Capital Adequacy Requirement.

[(d)] Capital reported in the balance sheet.

[(e)] Capital defined in the Capital Adequacy Requirement.

[(f)] Provision for bad and doubtful advances as a percentage of non-performing advances-net of interest in suspense.

[(g)] Non-interest expenses as a percentage of Operating Income (Operating income = Net-interest income+Non-interest income-Provision for Bad and Doubtful Advances).

[(h)] Staff cost as a percentage of Non-interest expenses.

[(i)] Net interest income as a percentage of average assets.