IMPORTANCE OF CONSOLIDATION ON FINANCIAL SYSTEM STABILITY

Dr. S.H.A.M. Abeyratne
Chairman, The Finance Company PLC

Introduction

Theoretical and empirical research has shown that a sound and effective financial system is essential for economic development and growth. Especially, stability in the financial system is crucially important for developing countries to ensurea high level of investment and thereby bring in sustainable growth.However, the political structure of societies, often pre-determined by historic experience, is critical for the structure and development of the financial system. This paper basically focuses on the main features of the Financial System and its role on the stability, and importance in the recent move to consolidate Sri Lanka's financial sector.

Backdrop

Today, the role of the Banking and Finance industry has become one of the major contributory factors in economic development and stability of a country, given the growing trend in information and communication technology (ICT), new financial products and processes, structures,sophistication, and increased risks associated with global financial markets. In the recent years, while advanced economies continued to struggle with various issues in relation to the Banking and Finance industry, the emergence of Asia as an engine of world economic growth has given rise to increased opportunities in the business environment, especially in the service sector including banking and finance.

Meanwhile, the impact of the global financial crisis that emerged in 2007 followed by the world economic downturn has brought an unanticipated new set of problems in both developed and developing countries resulting in the need to align their economies in time to come. Some are of the view that there will be an un-developing world – countries that will shift backwards economically and socially as the cutback takes effect. In the past several years, global economic activities have manifested an uneven growth. For example, advanced economies are estimated to have expanded by about one point six percent (1.6%) while emerging and developing economies are estimated to have grown by six point two percent to seven percent(6.2%-7%) during 2011-2013(**World Development Report 2013**).Needless to say, the world economy was and remains largely dependent on the consumption of Western economies. In the US more than 70% of economic activity comes from people's buying. In Germany, consumption still accounts for 60% of the economy. It is Western consumption that has been the driving force in the world economic growth during the last 30 years. Therefore, for the world economy to expand, Western societies need to keep consuming more and more. However, consuming more means they need to find more money to spend or the costs of what they buy need to come down.

The pattern of spending in the Western world over the past 30 years centered on the borrowing mania that led to the financial crisis in 2007. The loans were mostly provided by Bank Credit Cards and Finance Companies. Bankers were delighted to lend not just to make profits but because politicians, economists and regulators were encouraging them. There was an understanding that without more borrowing there would be less consumption and factories would not be able to expand. That perception encouraged banks to lend without restraints and allowed people to borrow more than what they should.**(Greame Maxton 2011).**

In the US and much of Europe, consumers and bank debts are larger than the economies. Banks around the world remain crippled by millions of worthless loans. Even after 2007, with the emergence of the financial crisis, governments also took more loans than what they should in order to bail out the banks.

The tale of the financial and economic woe could be identified as the result of three reasons, namely,

* Consumer debt in the US and Europe
* The financial institutions' weakness in regulating, supervising and irresponsible lending
* The Government debt especially in the West and Japan.

The global financial crisis is now seven years old. The West still faces the biggest debt bubble in history and it will have implications for decades. The effect of the great crash in 1929 followed by the world economic crisis lasted for a number of decades. Similarly, the bursting of the stock market bubble in 1989 in Japan has had an impact that has run for years. Many argue that the 2007 bubble was larger than those of both 1929 in the US and that of Japan in 1989. Therefore, one has to think about a possible prolonged crisis around the world**(ibid).**

As we see, the bulk of the pain of the financial crisis was felt in the US and now spread to Europe as a debt crisis. But there are some countries in Asia which escaped much of the economic crisis and ensured financial system stability, Australia has been one of the countries that was able to face the crisis with least problems. The main reasons associated with financial system stability in these countries are that they have adopted correct policy actions early, taking into account the emerging risks. Sri Lanka has been one of the countries that maintains a robust financial system. Against this background, it is the right time todiscuss as to how the recent consolidation effort has been influential in strengthening financial system stability in Sri Lanka.

The Role of the Financial System in Economic Development

Historically, economists and politicians alike have emphasized the importance of the financial system for the rise of capitalism, industrialization, and economic development. Adam Smith in 1776 pointed to the role of money in lowering transaction costs, thus permitting greater specialization, and fostering technological innovation. Joseph Schumpeter argued in 1911 that financial intermediaries play a pivotal role in economic development because they choose which firms should use society's savings. On the other hand, development economists for many decades have ignored the financial system and focused on other policy areas. Lucas (1988) described the role of finance in the growth process as overstated, and Robinson (1952) argued that financial development primarily follows economic growth. Following the seminal works by Goldsmith (1969), McKinnon (1973), and Shaw & Maxell Fry (1973), however, a large and still active theoretical and empirical literature has related financial development to economic growth.Looking at the literature one can realize that the history of the financial systems is full of boom and drawback cycles, bank failures, and systemic risk and currency crises. Just as there is comprehensive literature on the impact of finance on growth, there is an equally important Process. Empirical studies have found that a positive impact of financial deepening on economic growth is statistically and economically significant (**Justin David 2014).**

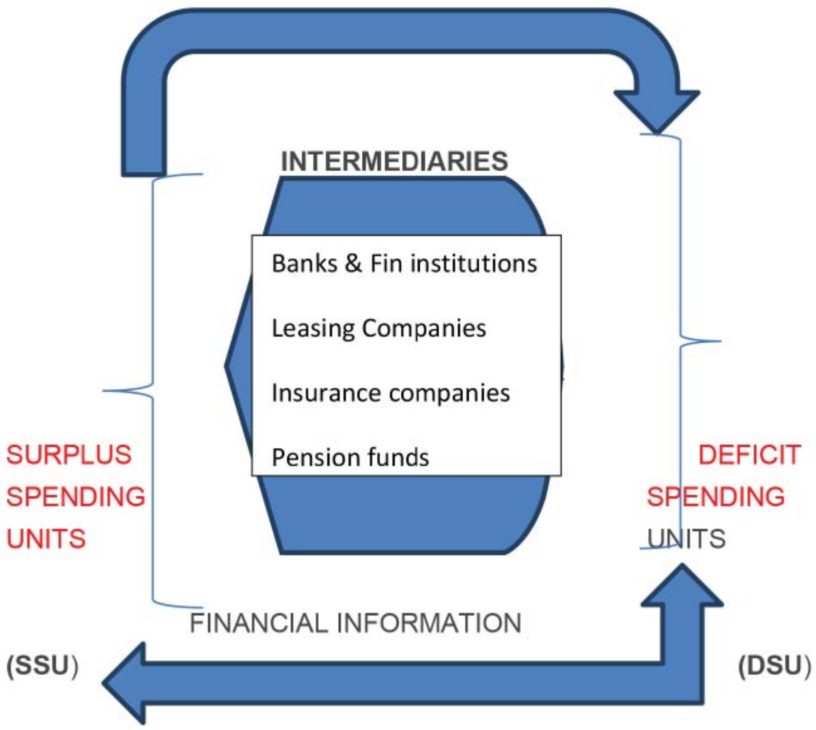
More recently, studies have related the development of the financial sector to other real sector outcomes, including the pattern of countries' trade balance and changes in income distribution and poverty levels. Given the importance of finance for growth, its inherent risks, and the large socioeconomic costs of banking crises, it is not surprising that the financial sector is often at the top of the policy agenda. However, the importance of access to credit as an entry barrier into the real sector and the relative ease with which owners and creditors of financial institutions can be expropriated also make financial sector policies an important tool in the political process.

What is a financial system?

A financial system could be defined as a system which enables the transfer of money between those who have (investors) and those who need money (borrowers).The system can exist at country level, internationally or at regional level. In a financial system the involved parties could be basically Surplus Spending Units (SSU) and Deficit Spending Units (DSU) with financial intermediaries. The term "system" in "Financial System" indicates a group of complex and closely linked institutions, agents, procedures, markets, transactions, claims and liabilities within an economy.

More precisely the Financial System could be understood by looking at the following chart.

Chart 1 FINANCIAL SYSTEM



As shown in Chart 1, one may understand the two sides of a financial system:Left side indicates the Surplus Spending Units(SSU) i.e. Household sector-those who have surplus money to invest, and the right side shows the Deficit Spending Units (DSU) i.e. borrowers. Financial intermediaries come into the middle and they play a bigger role transferring the money between SSU and DSU. In a practical sense, in any economy where financial needs are concerned, there SSUs (may be households) and DSUs (may be corporate sector). When there is surplus money one can invest/lend this money to earn a return. On the other hand when an individual or institution is in a state of need for money he can borrow by paying a fee for that transaction. The arrow shows that SSUs will invest their surplus money in the corporate sector and the corporate sector will have to pay a fee for the sum they borrowed. To perform these transactions there are intermediaries in the system. Intermediaries are basically commercial banks, investment banks, the stock market, Unit trusts, and finance companies.

Major Components of a Financial System

A Financial system usually comprisesa set of closely inter-connected entities such as financial institutions, financial markets, instruments, services, and infrastructures. The functionalities of these components are described in the following section in order to understand the role of the financial system in an economy.

Five Basic Components of a Financial System

* Financial Institutions
* Financial Markets
* Financial Instruments (Assets or Securities)
* Financial Services
* infrastructure

Financial institutions facilitate smooth working of the financial system by making SSUs (investors) and DSUs (borrowers) meet. They basically mobilize the savings of investors either directly or indirectly through financial markets and provide financial accessibility for need sectors. For this purposes, financial institutions use different **financial instruments**. At the same time, in this process financial institutions become the service providers of different types **of financial services.**

They offer services to organizations looking for advice on different problems including restructuring for diversification strategies. They also offer a complete array of services to the organizations who want to raise funds from the markets and take care of financial assets, for example, deposits, securities, loans, etc.

Financial Markets

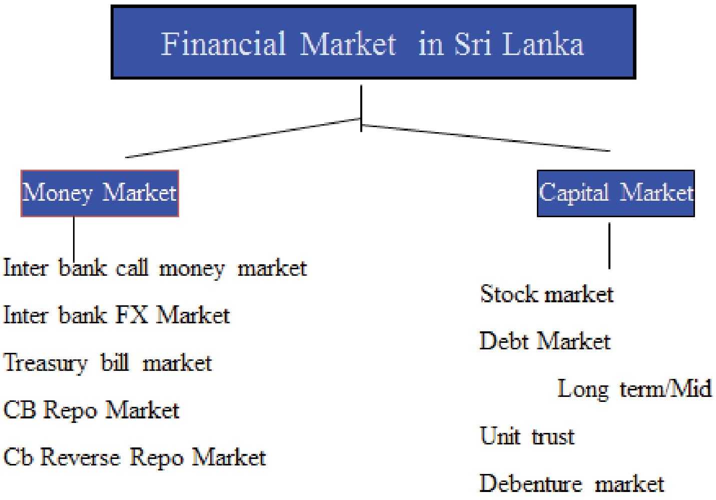
A financial market can be defined as "a place, arrangement or mechanism, where financial instruments are created, exchanged or traded". In other words, it is the place where financial assets are created or transferred. Essentially, financial markets operate according to the same principle and mechanism as every other market. The product traded in a financial market is money or funds. The price for the product 'money' is interest rate (plus additional fees).

This financial market can be seen from the point of supply and demand: the suppliers of monetary capital are basically household and other depositors who do not consume all their income at a certain point in time, and instead save a certain portion for the future. This is why they are called Savers or Surplus Spending Units. The demand for funds/money, on the other side, comes from companies or individuals facing the basic problem of requiring more money than what they have. At the same time, they are prepared to pay a fee/price for borrowing money, because they expect the benefit they can receive with the borrowed funds to be greater than the cost of borrowing. As explained earlier,they are called Deficit Spending Units.

A financial market also can be divided into, and identified as two major sub markets; namely Money market and Capital market.

As indicated in Chart 2, Sri Lanka's Financial market can be split into two categories as Money market and Capital market: whilst the Money market handles short-term financial assets (less than a year) the Capital market takes care of those financial assets that have a maturity period of more than one year. Chart 2 below indicates two categories.

Chart 2 Financial Market



The key functions of Financial markets are:

a) Assisting in the creation and allocation of credit and liquidity.
b) Serving as intermediaries for mobilization of savings
c) Helping to achieve a balanced economic growth
d) Offering financial convenience.

With regard to the Financial market, two types of markets namely Primary and Secondary markets exist.While the Primary market handles new issue of securities, in contrast,the Secondary market takes care of securities that are presently available in the Stock Market.The commodity traded in this market is basically financial instruments which fall into the category of financial assets and financial liabilities. Then the participants (or players) of the financial market should be Surplus units, Deficit Units and especially financial institutions as mentioned earlier.Financial markets facilitate trade between buyers and sellers of financial instruments. This interaction between the buyers and sellers of financial assets generates prices (e.g. stock prices, interest rates, exchange rates, etc.). The interaction of many buyers and sellers in the financial market provides marketability and liquidity for financial assets. At the same time, financial markets provide the facility for such holders to transfer their risk to a willing party by way of selling their stake (i.e. stock holdings) in the market. By aggregating Information, financial markets act as collectors and aggregators of information about financial asset values, their changes, trends, relevant news and announcements, and the flow of funds from lenders to borrowers. Such additional information will yield a better decision i.e. a better allocation of funds.

Financial markets catch the attention of investors and make it possible for companies to finance their operations and attain growth. Money markets make it possible for businesses to gain access to funds on short term basis while capital markets allow businesses to gain long-term funding to assist expansion. Without financial markets, borrowers would have problems finding lenders. Intermediaries like banks assist in this procedure. Banks take deposits from investors and lend money from the pool of deposited money to people who need loans. Banks commonly provide money in the form of loans.

Financial Instruments

Financial instruments are defined, as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity". Generally speaking, the products which are traded in a financial market are financial assets, securities or other type of financial instruments. There is a wide range of securities in the market since the needs of investors and credit seekers are different. They indicate a claim on the settlement of the principal down the road or payment of a regular amount by means of interest or dividend. Equity shares, debentures, bonds, etc. are some examples of Financial Instruments.

Financial Services

Financial services consist of services provided by Asset Management and Liability Management Companies. They help to get the necessary funds and also make sure that they are efficiently deployed. They assist in determining the financing combination and extend their professional services upto the stage of servicing of lenders.They help with borrowing, selling and purchasing of securities, lending and investing, making and allowing payments and settlements and taking care of risk exposures in financial markets. These range from leasing companies, pension funds, merchant bankers, portfolio managers, bill discounting, to acceptance houses.

Moreover,the financial services sector offers a number of professional services such as credit rating, venture capital financing, mutual funds, merchant banking, depository services, book building, etc. Financial institutions and financial markets help in the working of the financial system by means of financial instruments. To be able to carry out the jobs given, they need several services of a financial nature.

Current status of Financial system in Sri Lanka

As regards Sri Lanka, the financial system can be broadly divided into two, namely Formal and Informal sectors. Similarly, the existing financial system in Sri Lanka exhibits several elements of diversification in terms of institutions, products/services and processes. During the past few decades, the financial system of Sri Lanka has expanded considerably as the banking system spread out with the opening of bank branches all over the country. Although the financial sector liberalization took place in the late 1970s and early 1980s there was skepticism about the effectiveness of such liberalization towards economic growth and efficiency. However, over the past few decades, state commercial banks (SCBs) have played a major role, by having a large network of branches as well as a higher percentage of savings and lending. The financial sector's contribution to Gross Domestic Product (GDP) increased from 1.2% in 1970 to 7.6% in 1997. Over the past 10 years, the industry's contribution to GDP has increased significantly from 7.7% in 2007 to 10% in 2013. Moreover, the past two years (2010 and 2011) have shown significant growth momentums (8% and 8.3% respectively), bringing the highest contribution to GDP from the service sector. With those achievements, the per capita income has increased from US$ 1,000 in 2005 to US$ 3,280 in 2013.

This tremendous growth in per capita income associated with high growth rates and stability has influenced the increase of the asset base and related activities in the Banking and Finance industry.

Over the past few years there has been stability in the financial system in spite of the uncertainties that arose as a result of the developments in the global market. This was mainly attributable to the actions taken to strengthen the regulatory and supervisory mechanism and adoption of risk management practices. The total assets of the financial sector rose as a result of increased investments.

During the past five years there has been a continuous expansion in the Banking & Finance industry business. The total assets of the banking and major financial institutions have recorded an average growth of 15 percent over the past four years while showing a 16.5 percent growth in the year 2013 in comparison to 2012. Meanwhile, the number of bank branches and other outlets have increased over the year showing the increased demand for financial services.

In terms of banking density, the number of branches per 100,000 people have recorded an increase over the past four years to ten branches per 100,000 in 2008 to 11.8 branches in 2013. These developments have given rise to offering more services in the banking industry thereby increasing the number of persons employed in the Banking sector from 46,014 in 2010 to nearly 50,000 in 2013. As a result of expanding economic activities and growth in business potentials, financial intermediaries in the country have opened up branches and retail outlets to cater to the increasing demand. The continuous changes in macroeconomic variables such as rise in per capita income, increased income generating activities and reduction in the poverty level in the country in recent years, have been instrumental in increasing the demand for more financial accessibility.

Table 1: Key Financial Indicators in the Banking System

Annual Growth %	2007	2008	2009	2010	2011	2012	2013
Assets	16.9	7.7	11.7	17.8	18.3	19.9	16.5
Deposits	16.5	7.9	18.8	15.9	18.7	18.0	15.0
Loans & advances	18.9	6.6	-2.3	23.7	31.3	21.0	8.8
Ratios %							
Capital adequacy	14.1	14.5	16.1	16.2	15.2	16.0	16.3
NPL (net)	2.4	3.4	5.0	3.0	2.1	2.2	3.8
Statu liquid assest	30.4	31.3	39.2	36.6	32.4	31.3	37.7
ROA (After tax)	1.1	1.1	1.0	1.7	1.8	na	na
ROE(After tax)	14.0	13.4	11.8	22.2	19.8	na	na

SOURCE: Annual Reports 2009 2010 2013 CBSL

The selected indicators in Table 1 show that the Banking and Finance industry in Sri Lanka is on the rise over the past few years. Financial inclusion has been the other contributory factor forthe recent growth in the banking business. Especially, restoration of economic activities and the distribution mechanism in the North and East have paved the way for both Financial Intermediaries and general public to restart their day to day business with expectations for the future.

In the recent years, Banking sector activities have been diversified from mere deposit collection and lending to offering of a number of banking products to attract customers. Deposit mobilization and disbursement of loans for various purposes have shown a significant increase during the past few years. This changing environment,together with expansionary activities in the Banking & Financial industry may well provide many opportunities to banking and financial institutions to expand their scope of activities in time to come.

In an overall sense, all the selected indicators show that there is a need for improving the competencies of existing employees as well as others who aspire to join the banking sector so that the Banking & Financial sector can deliver better results to the economy and the general public.

The performance of the Banking and Financial industry in the country in terms of accepted financial Indicators has improved significantly. The profitability of the banking sector continuously increased and it has further reinforced the level of capital. The total assets of banks and major financial institutions have recorded an average growth of 15% over the past five years while showing an 18% growth in the year 2013. Similarly, deposits in the banking system have marked a steady growth throughout the period from 2007 to 2013. Looking at the trend in credit growth one could realize that loans and advances during the last year was on a moderate level.

These moderate credit expansions and the share in investment activities need to be discussed after taking into account the heavy investment in the public sector over the past few years. However this moderate credit growth could be attributed mainly to the lagged effect of the tight monetary policy stance maintained during the year 2012 and the flimsy recovery of the global economy and the consequent reduction of credit flow towards international trade related activities. However the Central Bank of Sri Lanka has taken adequate measures to ensure a rational credit flow and thereby induce right investment growth in the country.

The non - banking financial institutions, which include licensed Finance Companies(LFC) and Specialized Leasing Companies (SLC) represent nearly seven percent of Sri Lanka's financial system. This sector has expanded in 2013, despite the moderation in the sector's accommodation growth. The total asset base of LFCs and SLCs grew by 20 percent in 2013 when compared with the 22 percent increase in 2012. Reflecting a similar trend, total deposits of LFCs & SLCs grew by 33 percent in 2013 compared to a 37 percent growth in 2012. However, the drastic fall in the Gold price in the market and high lending rates offered by the LFCs and SLCs have led to an increase in the NPL in the sector.

The Rationale Behind Financial Sector Consolidation

The concept of consolidation of financial institutions has been one of the most notable features of the Financial landscape of both developed and developing countries in the recent past.In advanced economies such as USA and Central European and Latin American countries market driven consolidation processes are being carried out to enhance the competitiveness , particularly in a global context. It is generally perceived that consolidation in financial Institutions is required when there is near a crisis or to get away from an existing crisis. However, emerging global economic & political environment and complexities in the financial markets have given rise to the need for middle income countries to be vigilant and to ensure stability .

In effect, the primary motive of financial sector consolidation is :

* To achieve cost savings and revenue enhancement
* To improve information technology through globalization of financial markets and to increase stakeholder pressure for financial consolidation.
* Banks and financial institutions to be more competitive by achieving economies of scale
* Companies to enhance shareholders' value and achieve synergies through consolidation
* To mitigate the possible risk in the financial market
* To raise Capita/ funds internationally when there is such a need,and
* To maintain overall stability in the country's financial system.

Some country experiences of financial consolidation

It is widely accepted that a resilient financial system would ensure financial systems stability thereby supporting the economic stability. Past experiences in certain countries have manifested that consolidation provides better opportunities to banks and financial institutions to carry out their business keeping the required compliance and guidelines laid down by the regulator from time to time. For example Malaysia, after the Asian Financial crisis in 1997 adopted a merger program by reducing the number of NBFI from 39 in 1997 to eight in the year 2000. Subsequently, Finance Companies were merged with commercial banks. The overall confidence and stability in Malaysian financial sector was partly associated with the consolidation process. Singapore and Thailand can be considered as other success stories of the consolidation exercise. Singapore consolidated six banking groups into three groups thereby strengthening the banks' capabilities, building efficient management teams and enhancing operational effectiveness. Moreover, after the Asian Financial crisis, countries such as Thailand, South Korea, Philippines and Indonesia launched their restructuring process including consolidation of banks and finance companies**(C.J.P Siriwardana 2014).**

This initiatives have been instrumental in strengthening the financial system in those countries and to keep a buffer against recent global financial crisis.. However, looking at Sri Lanka's financial system one cannot say that there is a crisis or instability in the financial sector. Rather, the banking and financial sector has been instrumental in the high level of growth in the real sector.

In the past, Sri Lanka 's financial system has undergone difficulties due to a number of reasons. Non compliance by small financial institutions with corporate governance principles, capital and liquidity requirements, were some of the reasons that have caused a crisis and resulted unfavorably on the stability of the financial system of the country.

As revealed by the Central Bank Governor "......consolidation of the banking and non-banking sectors is not an ad-hoc arrangement but is part of an overall strategy and is being done at the most suitable time for the country". The Governor has further elaborated, "that the Banks and Non-Banking Financial Institutions (NBFIs) needed some improvement for a long time but the time was not right.It is not something that you can do every day, there has to be a time and a place. Year 2014 seemed to be the ideal period of time for us to introduce a new improvement into our economy, through financial sector consolidation...". Governor has further explained that financial sector consolidation is similar to various economic and policy measures taken by the Central Bank over the last few years such as to curb currency depreciation, manage debt, maintain a flexible Rupee, and for IMF programmes, etc.(**Ajith Nivard Cabraal 2nd May 2014)**

This new environment has given rise to players in the Banking and Finance industry to think differently and to be equipped with the most updated knowledge to run their organization to the satisfaction of the stakeholders.

Against this background the CBSL has taken necessary action to strengthen the stability in the country. As revealed by the CBSL Annual Report 2014 '... in early 2014 the Central bank unveiled the Master Plan for consolidation in the financial sector which was formulated with the aim of building a strong, dynamic and internationally competitive financial sector, with cross- border linkage and significant overseas presence. Foreign financial institutions are also expected to play greater role in economic activity in years ahead**.' (CBSL AR 2014).**

The financial sector consolidation announced in the Budget speech and the Task, initiated by the CBSL has now completed three phases successfully from January to September 2014. (**CJ P Siriwardana CBSL 64th Anniversary oration Sept 2014**). The outcomes seem to be very promising .

Conclusion

As stated at the outset, Sri Lanka has a robust banking and financial sector with a strong asset base and customer base scattered across the island. Throughout the past few decades the financial system has performed well and catered to the household sector as well as business sector to carry out their functions smoothly. However, there were some instances that the country had to face challenges as a result of the Global financial crisis. The consolidation process announced by the regulator has resulted in strengthening the stability in the country. It is pertinent to mention that certain Latin American countries such as Argentina, Venezuela etc. had to bring about consolidation at a time when they had no choice but to do so, since they were under stress. The CBSL Governor states that "... As far as Sri Lanka is concerned, it is not under any stress now and it's a good time for the country to introduce these changes so that it can position the financial sector for the future. We need to resolve them today when they are at a much lower level. If we don't address those now, we'll have to address it at the time when it becomes bigger in 2020" (**Ajith Nivard Cabraal 2nd May 2014**).

As of mid-September 2014, eight banks and twenty nine LFCs have confirmed their merger and acquisition transactions under the consolidation programme. Consolidation of the banking and non-banking sectors is not an ad-hoc arrangement but is part of an overall strategy and is being done at the most suitable time for the country as CBSL Governor stated.Since the consolidation programme is still in progress it is too early to conclude that the consolidation process has provided expected results. However,this consolidation will be another move that has been focused on the stability in the financial system in particular, and high growth as far as our country's development is concerned, in general.

References

AjithNivardCabraal (2May2014)WWW.Daily Mirror.lk/business /economics/economics 4655.
Annual Reports , Central Bank of Sri Lanka, 2010,2012 , 2013
Greame Maxton , (2011) End of progress : how modern economies have failed us, Willey 2011
IMF Summary report, (2001) Consolidation in the Financial sector , www. imf/org/ external/Np /g10/2001/eag/pd
James Haley, (27 May 2014) www.Cigionline.org/new/age of uncertainity
Joseph Fried (2012) , Who really drove the economy into ditch ? New York NY Algora publishing,
Justin David (11.April 2014) ,Global financial crisis what cause it and how world responded, www.Constra .com.au/gl
C J P Siriwardana (2014) CBSL, 64th Anniversary Oration, 24th Sept 2014. CBSL publication