

Ranee Jayamaha: Promoting credit culture and expediting the process of debt recovery

Speech by Dr Ranee Jayamaha, Deputy Governor of the Central Bank of Sri Lanka, at a workshop on proposed law on restructuring of sick industries and other legal issues at the Centre for Banking Studies, Rajagiriya, 1 February 2005.

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Honourable Mr K C Kamalabayson, Attorney General, Mr Sumant Batra the Guest Speaker from India, distinguish guests, Ladies and Gentlemen.

I am happy to be associated with this Workshop aimed at deliberating on vital issues relating to the proposed law on Restructuring of Sick Industries, and other legal and financial system issues on debt recovery by financial institutions.

As you are aware, the two core objectives of the Central Bank are: to secure economic and price stability and financial system stability with a view to encouraging and promoting the development of productive resources of the Country. Debt recovery is one of the core elements of financial system stability and it depends on the performance of economic sectors, the industrial sector being one of the important areas. This is why the Central Bank has been interested in promoting credit culture and expediting the process of debt recovery.

In recognition of this, in the year 1990, the Central Bank was associated in the enactment of a package of fourteen Debt Recovery Related laws. One of these laws has enabled the extension to private commercial banks, the parate execution powers ie a Roman Dutch Law principle to sell movable and immovable property secured to a bank as collateral to recover debt without recourse to courts of law. Prior to the enactment of this law, the powers of parate execution were available only to financial institutions established by statutes passed in Parliament. I am informed that a bill prepared to amend this law to further widen and strengthen the powers of parate execution granted to financial institutions could not be passed in Parliament due to constitutional issues. The right to obtain injunctions against the execution of parate has thwarted the objectives of this law and this has resulted in banks being reluctant to lend to high risk borrowers even against security. With injunctions brought by the defaulters against the rights of exercise of parate execution by banks, the cost of recovery of bad debt has become phenomenal.

Against this background, banks and financial institutions are reluctant to deal with industries that have become unviable irrespective of the reason that has led to it. Consequently, the sick and unviable industries are left alone without any outside financial or other assistance.

The exercise of parate execution powers has been debated and questioned in various fora over the years and now, a need has arisen to examine whether there are other alternative routes to debt recovery. It has also become necessary to evaluate whether the exercise of parate powers by commercial banks has achieved its objectives. According to banks and financial institutions, the very threat of parate action and publicity prompt defaulters to pay the debt. After fourteen years of the application of the debt recovery laws, it is therefore, fitting that an objective assessment be made to the recovery of debts through this legislation.

The moderate development in the Sri Lankan economy in the past decade, saw a heavy demand for credit and the expansion of loan portfolios of banks. As banking is known to be a risky business, the monies placed on trust by depositors have to be prudently invested, but with a firm commitment to return funds to depositors when they call for it. In the circumstances, banks are duty bound to ensure the safety and soundness of their institutions by prudently deploying funds they mobilize. Loan defaults and non-performing advances are quite common in our part of the world. They have contributed to the maintenance of high interest spreads which in turn translate into high lending rates as banks tend to cover the cost of carrying large volumes of non-performing loans in their balance sheets. The cost of non-performing advances is therefore a charge on profits by way of provision to be made for these losses. Banks lose out on interest income that is rightfully theirs. Effectively therefore, the good borrowers pay the price for defaulting borrowers.

I am aware that banks have their own methodologies to evaluate risks when granting loans and advances and recently, they have been adopting modern methods of credit risk mitigating techniques based on the Basle Principles. To begin with, the lack of adequate knowledge of the industry, poor credit assessment skills and ineffective follow-up and supervision of loans are the key to non-recovery of debt. A banker who lends only against collateral without looking at the viability of the project is obviously imprudent. Sometimes, banks are not familiar with the industry to which a loan is granted - it is imperative that they are conversant with yields, markets and prices to be able to assess the viability of the project. In others, follow-up and monitoring is virtually non-existent. The close monitoring of a project during the gestation period or grace will often leads project to fruition and in turn will bring in repayment according to the repayment plan. These areas call for special attention by banks and financial institutions.

The banks try to mitigate these lapses by the use of modern technology and intensive evaluation processes in granting loans and advances. Even these attempts can be beaten by unexpected eventualities and by willful defaulters. While credit discipline and culture are of paramount importance for financial institutions' viability and the stability of the financial system as a whole, we need to strike a balance between the system viability and revival of enterprises/industries, in a manner that they can be going concerns and repay their debts.

More recently, wide publicity has been given to Chapter 11 of the United States Bankruptcy Code which allows a debtor to continue its operations under a re-organization plan. Similarly, the Indian government initiative in the form of Sick Industrial Companies (Special Provisions) Act was passed with the objective of ensuring timely detection of sick and potentially sick industrial companies, to expedite the revival of potentially viable units and closure of nonviable units is noteworthy. We are informed that India is also re-examining the provisions of this law.

The prevailing labour laws and parate execution powers make it difficult for financially troubled enterprises to restructure and continue business operations. The exercise of parate execution powers lead only to closure of enterprises, although the law provides for restructuring. The purchase of the mortgaged properties by the bank at the auction sale through the exercise of rights of parate execution has resulted in another undesirable phenomena, that is the accumulation of foreclosed assets on the balance sheets of banks.

Undoubtedly, the closure of enterprises results in great cost to the economy by way of loss of output, loss of employment, defaults to creditors and low return to entrepreneurs. It is therefore, vital to have a sound procedure in place to assist ailing enterprises to overcome their problems, provided the enterprises are commercially viable and the problems are of a temporary nature. In this context, it is opportune time for Sri Lanka to consider the need for the enactment of a law comparable to the applicable laws in other countries and the preparation of guidelines for industrial restructuring in Sri Lanka.

Recognising the need, the Central Bank has set up a committee to review the laws for recovery of loans applicable to banking institutions. The committee comprises representatives of all relevant sectors and it is working towards arriving at a consensus on debt recovery proposals. In the meantime, the Business Recovery and Insolvency Practitioners Association of Sri Lanka (BRIPASL) has had a series of discussions and formulated draft legislation for the revival of sick industries. I appreciate the co-ordination between the two committees and their efforts in arranging this important workshop.

I understand that the Keynote Speaker today, Mr. Sumant Batra from India who has acquired wide knowledge on restructuring of sick industries in India would elaborate his experience on corporate turn-around and insolvency, and respond to similar proposals that would be made at this workshop.

I am confident that the eminent speakers from various fields who are present at this forum, would provide an opportunity to the distinguished participants to share and rationalize ideas, thus ensuring the formulation of sound principles to be incorporated in the draft legislation on the restructuring of sick industries. A comprehensive law on this aspect would help enterprises to become viable in the medium to long term while enabling the banks to recover the debt and be viable financial institutions. I hope today's deliberations would guide the relevant committees and those who are associated in policy formulation to take this important initiative forward.

Thank you.