Sunil Mendis: Financial system stability and Basel II - the way forward

Inaugural address by the Chief Guest Mr Sunil Mendis, Governor of the Central Bank of Sri Lanka, at the 17th Anniversary Convention of the Association of Professional Bankers, Colombo, Sri Lanka, 28 August 2005.

*   *   *

Ladies and Gentlemen

It is an honour for me to be invited to give the keynote address at this forum of eminent bankers in Sri Lanka and distinguished persons from the international banking arena. I am happy to see our friends from the Reserve Bank of India and from the Basel Committee who will no doubt make this convention very lively for discussion on a subject which concerns us all.

As Central Bankers we have a common interest in ensuring financial stability which impacts upon the macroeconomic performance. Further, as monetary policy transmission takes place through the financial institutions for the achievement of its target of economic and price stability, the Central Bank has the responsibility for ensuring that the financial system as a whole is sound. It should be strong enough to withstand internal and external shocks. We must ensure that our payments and settlements system is protected from the risk of failure at any cost since it is the conduit through which our economic business and commercial activity is facilitated. The causes and consequences of the recent Asian financial crises are still vivid in our minds and we from our part, as professional bankers, must endeavor to ensure that they are not repeated.

The Central Banks can use both preventive measures and corrective action to maintain financial stability. A constant and continuous monitoring of risks is a preventive measure. Crisis resolution is a corrective action. A strong regulatory regime would ensure the former and a financial safety net is an essential component of the latter. The two supplement each other. The cooperation of all parties concerned in both these actions is of paramount importance in maintaining financial system stability.

In Sri Lanka, as in most emerging economies, we have a bank dominated financial system. Therefore, ensuring banking soundness will inevitably lead to financial system soundness. The recent initiatives taken in this regard are significant – we have enhanced capital requirements to reflect the increased leverage in the industry. Even regulatory capital is at a comfortable margin above the international norm but is still only 10% of risk assets which is the absolute minimum should these risks materialize. Therefore, increasing the minimum capital requirements would provide a healthy platform for growth and expansion of banking business. However, capital is the last line of defence. The more immediate needs are good corporate governance and good risk management which will steer the banking system towards good financial health.

A sound corporate governance regime would seek to promote the highest standards of professional behaviour and integrity. Policies should be implemented to prohibit any behaviour or relationship that diminishes its quality. This is very often evident in conflicts of interest, connected lending, which is not on an arms length, and preferential treatment to related parties. The independence of directors too is crucial where directors should have the ability to exercise objective judgement, regardless of board structures or ownership structures.

Well established corporate governance committees such as the Board Audit Committee which oversees the bank's internal auditors, with objectivity and independence, should comprise of non-executive members of the Board who have the requisite knowledge that is commensurate with the complex nature of the banking institution.

Independent, competent and qualified auditors is an essential pre-requisite of good corporate governance which would achieve a number of important objectives. It would ensure timely identification of risks and the publication of financial statements which accurately represent the financial position and performance of the bank. Auditors should understand their duty to the bank and its stakeholders to exercise due professional care in the conduct of audits. In this connection, we have, in the recent past, strengthened the relationship of auditors with the regulator and the company to benefit from each others' capabilities, expertise and knowledge.

Basel II has attempted to capture all these critical aspects into the new accord. A bank's own assessment of its capital needs, coupled with the regulator's assessment of the adequacy of capital, which would encompass all other aspects of its operations, apart from credit, would ensure adequate capital to insulate the bank against its risk exposure. After all, managing risk is fast becoming the single most important issue for the regulators as well as for the institutions that are regulated. Therefore, Basel II is good news and we can only benefit mutually from its adoption. A roadmap is therefore already drawn up and we hope we can all commence our journey down this road to reach our goal of a safe and sound banking system resulting in financial stability which is what we all aspire.

As you are all aware, our banking community is in the process of adopting the standardized approach within Basel II by 2007. However, the major challenge faced by the banks in the next few years, are the IT, skills development and training that are required to implement the more advanced approach which relies heavily on quantitative techniques. It is imperative, therefore, that banks start getting ready for this eventuality sooner, than later.

Basel II should not be looked at as an exercise in compliance but as an impetus to more efficient risk management across the banking sector. Its benefits would be seen in the ability of the financial system, to promote sustainable economic growth which would be beneficial to the banks, the central bank and to the consumers of banking business. It would naturally require commitment of substantial capital and human resources from both the banks and the regulators. We should all work together, therefore, to achieve these goals. This should not only be the objective of the Central Bank as we are all guardians of financial stability – I trust this conference will provide an adequate forum for open discussion. Thank you.