Ranee Jayamaha: Glimpse of current financial regulations

Inaugural speech by Dr Ranee Jayamaha, Deputy Governor of the Central Bank of Sri Lanka, at the Client Seminar on International Trade, organized by HNB (Hatton National Bank), Colombo, 13 November 2006.

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Mr Theagarajah, officials of HNB, Mr Richard Lightbound from Wachovia Bank, distinguished participants, ladies and gentlemen. Thank you for the invitation extended to me to be present at the client seminar on Trends in International Trade. Let me congratulate HNB for taking the corporate social responsibility seriously and arranging a forum to exchange stakeholder views on an important subject.

Generally, regulations are not liked by anybody. Same goes with the financial community in Sri Lanka. However, the common factor is that even regulators do not like to rule by regulation. For a better appreciation of the past and present financial regulatory environment, let me first set out the key elements underlying financial regulations. In summary: (a) regulations are mainly a reaction to an action by the financial community, although there may be instances in which regulations are brought in on hindsight with a forward-looking approach, but they are a few; (b) there is a clear difference between the objectives of regulators and market participants; (c) regulations are not necessarily a one-way street. They are not there only to tighten markets. Many instances can be quoted where regulations have been relaxed depending on the circumstances and environment; (d) regulators should be proactive and work towards the development of markets rather than impeding their growth; and (f) the institutions and markets that are subjected to regulations should not try to find loopholes to circumvent regulations. Unless there is a conscious decision by the shareholders, the Director Boards, the senior management and officials of financial institutions, regulations by themselves do not bring in decided results.

Let me first deal with the world financial regulatory environment with a brief background of attempts made to stabilise financial systems.

Over the last 2 decades or so, the financial sector witnessed a radical reform process. The focus of the reforms was on deregulation and liberalization of the financial sector. The volume and value of transactions have increased many times, the speed with which transactions are initiated and completed has accelerated; new markets have opened up; there has been a significant expansion in the range of financial instruments; financial firms have grown bigger and bigger and international businesses have become increasingly concentrated in the hands of a relatively small number of mega financial institutions/firms with balance sheets, approaching in some cases exceeding trillion dollars.

The driving forces behind these developments are well known. First, the world economy has grown substantially over the last two decades and financial activity has increased faster than the world GDP. Second, there has been a significant liberalization of financial markets and the environment for international capital flows. Third, technology has advanced enormously in terms of both the capacity as well as sophistication. Countries have benefited immensely from these developments and, as a result, wide choices are available to savers & investors, borrowers & lenders together with greater flexibility & efficiency in the allocation of capital. Many institutions have sprung up in both money and capital markets. Similarly, the financial world has become more complicated with closer inter-connectedness within and between individual firms, institutions and markets.

In the meantime, the regulatory authorities have begun to focus on the achievement of specific objectives and found that they have to react to action by the financial markets by putting breaks to halt the rapid expansion, which would otherwise threaten the stability objectives. So, they brought in financial regulations to deal with the situations. Unabated by the tightening of financial regulation, financial markets continued to grow rapidly and ended up in crises and the world has learnt many lessons from financial crises. The outcome of the Mexican crisis in 1994, the Russian crisis from 1992 to 1995 and the Asian crisis from 1997 to 1998 was the further tightening of financial regulations and introduction of new ones. They were more reactionary and intrusive after the Enron and World Com failures in the USA. The Sarbanes Oxley regulations, which are considered somewhat draconian have come to stay, but may be with modifications. Similarly, after the BCCI and Bearings crisis, the Bank of England introduced a series of financial regulations and also handed over its supervisory functions of financial institutions to the Financial Services Authority set up in 1998, with the primary objective of regulating financial markets in a meaningful manner.

How has Sri Lanka fared?

Sri Lanka's financial sector is not insulated completely from global changes and their impacts. The financial authorities in Sri Lanka also faced the challenge of maintaining the overall financial system stability while trying to ensure that financial markets and intermediaries operate prudently and competitively. So they brought in necessary regulations. Over the last few decades, Sri Lanka also reduced the level of statutory pre-emptions, dismantled the complex structure of administered interest rates, laid down capital adequacy requirements, introduced prudential norms and liberalized entry norms for domestic and foreign banks. Most of these measures have the backing of specific legislation, under which the Central Bank has issued financial regulations. So, financial regulations are not a one-way street to tighten conditions but also to open up and promote competitiveness.

Financial regulations are like traffic lights which stop financial intermediaries from going at the same speed in terms of mobilizing funds, borrowing, lending, introducing innovative products, taking risks and engaging in speculative activities. When they have to stop at the traffic lights, financial intermediaries not only in Sri Lanka but also elsewhere, complain that they are over-regulated. Although this is a general statement, there may be some truth in it. We, as responsible regulatory authority, recon that over-regulation can kill the initiatives of the financial intermediaries, suppress innovations and market developments. There is, therefore, a clear responsibility for the financial regulators to ensure that financial intermediaries and markets are not over-regulated. It is also understood that regulation should be proactive and supervision should be risk-based and not compliance-based. While these underlying themes are recognized as important elements in financial regulations, it is also significant to note that regulators are compelled to bring in new regulations when market participants are non-compliant, non-cooperative and for not being prudent. This is where market discipline is important in avoiding new regulations. The non-compliance by one important financial intermediary will also lead to all other institutions being subject to regulations to avoid discrimination. In this respect we are democratic and fair.

Sri Lanka's financial regulatory environment

There are 3 main financial regulators in Sri Lanka. They are the Central Bank of Sri Lanka, the Securities and Exchange Commission (SEC) and the Insurance Board of Sri Lanka (IBSL). The Registrar of Companies which registers banking and financial institutions is also seen as a regulator but not as a supervisory body. The Central Bank as the apex regulatory authority regulates and supervises about 70% of the financial sector. The IBSL regulates and supervises around 11% of financial institutions, mainly the insurance companies and SEC accounts for about 4% of the system, basically the capital market institutions. The balance financial intermediaries are regulated by various authorities while some are not regulated at all.

Banking companies in Sri Lanka come under several jurisdictions, but the Banking Act is the centrepiece for financial regulations. It sets out all necessary regulatory provisions for capital requirements, shareholder limits, credit operations, provisioning requirements, consolidation, acquisition and mergers, suspension, winding up of banking companies, etc. Sri Lanka's banking sector is currently operating on Basel I, but getting ready to implement Basel II Capital Adequacy Ratios from early 2008. Basel II is basically risk mitigation in banking operations and, it allows supervisors and regulators to encourage or require banks to build up capital buffers in good times. Financial regulations have thus been set taking into consideration the cyclical situation which banking firms face in home and host countries.

In addition to the provisions in the Banking Act, the Monetary Law Act which governs the operations of the Central Bank, also provide for regulation of banking companies. However, in recent times, through various amendments, most of the provisions of the Monetary Law Act have been incorporated in the Banking Act. Their stock market operations come under the purview of the SEC Act. In addition to the banks, the Central Bank regulates the finance companies under Finance Companies Act and the leasing companies under the Leasing Act. The primary dealers who deal in the government securities market irrespective of whether they are banks or not, are under the supervision of the Central Bank.

The SEC regulates the investment companies, merchant banks, venture capital companies, unit trusts and the rating agencies. Under the provisions of the Act, the SEC issues financial regulations to ensure that companies listed in the Stock Exchange operate in an orderly manner preserving the stability of the capital markets and, as a whole, the financial system.

The registered insurance companies, the insurance broking companies and ancillary service providers are regulated by the IBSL to safeguard public interest. The insurance policies consist of long-term savings of the public and, therefore, the sustainability of insurance companies is important for long-term savers.

All financial institutions operating in Sri Lanka are required to comply with the recently enacted Money Laundering Legislation, Countering the Terrorist Financing Legislation and the Financial Transaction Reporting Act. Relevant regulations will be issued shortly. The recently introduced Payments and Settlements Act provides wide powers to the Central Bank to regulate the national payments system.

Despite these legislation and financial regulations, there are many operations by the financial intermediaries which cannot be captured by one or more financial regulation. One such category is financial conglomerates, which engage in banking and finance, insurance and stock market transactions. They still have a leeway to take advantage over others. Regulating these conglomerates is a real challenge. There is a limit to impose rules on all aspects of operations which will lead to over-regulation and that should be avoided. Improved understanding of potential risks may bring in better results. We have to find a middle way in regulation. Market participants should also be given adequate information to protect themselves from any problems related to new products, markets, or institutions and how to mitigate risks. This is a task for policy makers and regulators. More importantly, in finding a middle path, regulators also have to trust markets and institutions, but ensure that the innovations do not result in undue stress to the financial system. A more practical way to regulate financial conglomerates is the closer coordination among regulatory authorities. Another area that is difficult to be brought under regulation is the derivative trading by financial institutions. Fortunately, this trade has not expanded yet in Sri Lanka, but we may have to be mindful of their emergence, sometime in the future.

The essence of financial regulations, therefore, is to encourage financial intermediaries to identify and manage risks without causing instability in their own institutions which can have riffle effects on the entire financial system which is heavily dependant on public confidence. A systemically important financial intermediary can cause serious threats to the wider financial system. Financial regulator helps to build that public confidence through regulation and supervision. That’s why regulators try to promote financial intermediaries to hedge against possible risks and prevent over exposure. In keeping with the world trends, the Central Bank as well as the other regulatory authorities will try to be proactive and avoid over-regulation, but at the same time take necessary steps to ensure system-wide stability.

Let me sum up. Financial regulations are necessary given the complexity of financial transactions that are taking place here in Sri Lanka and elsewhere. They are not liked by anybody but regulations should be viewed as brakes or traffic lights. Regulations by themselves are not meaningful, unless the financial community makes a concerted effort to observe what is good for the wider financial system. Regulators should be flexible to relax regulations, where possible, and allow markets to grow. For example, very recently, the government decided to allow foreigners to invest in Sri Lanka Treasury Bonds through TIERA accounts. That is a further relaxation of capital controls. If financial markets use this opportunity in an objective manner, we can expect further relaxations. Regulators and policy makers should find a middle way to understand the way innovative products work.

My message to this august audience is that under the present regulatory regime, Sri Lanka’s financial system is resilient and it is capable of absorbing shocks from within or outside. We should be happy to note that like the Sri Lankan economy, the financial system has also displayed its resilience under trying circumstances in the recent past. We hope it will continue to be so in the future. From a regulatory point of view, we will continue to support markets and financial intermediaries to maintain the required robustness of the financial system.

Thank y ou.