

Governance, Regulatory Compliance & Financial System Stability: Reshaping Banking for Changing Times

Bhanu Wijayaratne
Chief Compliance Officer- Hatton National Bank PLC

Introduction

It is not a secret that almost 70% of the Bank assets are financed by depositors whereas the shareholders (equity) have financed only less than 10%. This scenario has made the Banking industry, highly leveraged & fragile. Due to this fragility and associated vulnerabilities the existence of the industry would be heavily dependent on the integrity of Banks and the confidence that the depositors would place on Banks. Confidence of depositors and integrity of banks are complementary and supplementary thus one cannot exist without each other. On the other hand Banks are considered as center points of exchange of money throughout the economy, as the Bankers mobilize deposits from customers, engage in lending, facilitate payments systems and coordinate financial transactions including cash management etc.

Accordingly, it is of paramount importance that bankers carry on their business of banking with utmost trust, with adherence to good behavioural practices in order to win the confidence of customers, as customer confidence is the key to a sound banking system.

Looking at the banking industry from another dimension, it is quite different from any other business whereas the good behaviour of the latter is ensured and controlled to a greater extent by market pressure. In case of banks, regulator has a major role to play in ensuring that banks are well managed and governed properly without solely depending on market pressure and self- discipline to be practiced by Banks. On the other hand, the failure of one bank can trigger a series of failures in other Banks due to the “contagion effect” thus regulators would not allow banks to fail.

As a result there is commonality of interest in creating a well managed banking system by both the Banks and regulators. In order to facilitate a stable financial system one should therefore ensure a well run banking system as banks are crucial in the economy of any country.

This document discusses Governance and Regulatory Compliance and its impact on Financial system stability towards reshaping banking for changing times.

Corporate Governance

Whilst corporate governance is generally known as “the system by which organizations are directed and controlled, the Oxford dictionary defines same as “good order”.

Corporate governance can be referred to as a set of rules that governs the relationship between different stake holders in an organization. It establishes rights and responsibilities of

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

different stakeholders such as the Board of Directors, Corporate management, Shareholders, Customers, Regulators, State, General Public etc., by providing a framework for setting, implementing and monitoring the objectives of the organization. An organization which is committed to practice Corporate Governance should meet the following prerequisites.

- A Board of Directors with required skills, expertise and exposure.
- Sound internal controls and procedures.
- High level of transparency and disclosure.
- Clear cut accountabilities and responsibilities.

The above prerequisites have been agreed upon on the basis that controlling powers should not be carried out by the company owners but the Board of Directors, which stemmed from the concept of distancing the ownership from management of the company for the sake of good governance.

Accordingly, one would see that the Corporate Governance is the process of which the Board of Directors sets procedures & processes that keeps the organization alive, ensuring its “going concern”.

Although governance evolved via self discipline, the recent calamities seen in the financial world have strongly suggested that self regulation alone may not be sufficient, thus statutory and regulatory compulsion was essential.

Among the important aspects of governance, comprehensiveness and clarity of financial disclosure of the organization and provision of a clear picture of organization’s overall risk profile & the important features of risk mitigating processes are key initiatives.

The complexity of the industry of banking has diminished the capacity of stakeholders to monitor as to whether the banks do practice corporate governance in the required manner. As a result banks are subject to stricter regulatory compliance than other firms and entities, with a view to safeguarding the depositors rights from any moral hazard issues, thereby ensuring the stability of the financial system in the country and reducing its systemic risk.

Corporate governance in Sri Lankan banks

As per the Banking Act Direction No.11 of 2007 and several subsequent amendments made to same the Corporate Governance processes which are listed below have been established as a framework that facilitates the conduct of the Banking business in a responsible and an accountable manner so as to promote the safety and soundness of individual banks.

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

1) The Responsibilities of the Board

Board of Directors shall ensure implementation of the following ;

- Approve and oversee the bank's strategic objectives and corporate values
- Approve the overall business strategy of the bank, including overall risk policy and risk management procedures and mechanisms with measurable goals, covering at least a period of 3 years ahead.
- Identify the principal risks and ensure implementation of systems to manage such risks.
- Approve implementation of a policy of communication with all stakeholders of the bank.
- Review the adequacy / integrity of the bank's internal control systems & MIS.
- Identify and designate key management personnel (KMP), as defined in the International Accounting Standards, who are in a position to:
 - (i) significantly influence policy;
 - (ii) direct activities;
 - (iii) exercise control over business activities, operations and risk management;

- Define the areas of authority and responsibilities for the Board of Directors (BOD) and Key Management Personnel(KMPs)
- Ensure that there is appropriate oversight of the bank operations by KMPs
- Periodically assess the
 - (i) the selection, nomination and election of directors and KMPs;
 - (ii) the management of conflicts of interests;
 - (iii) the determination of weaknesses and implementation of changes where necessary

- Ensure that there is a succession plan for KMPs.
- Meet regularly, on need basis, with the KMPs to review policies, establish communication lines and monitor progress
- Understand the regulatory environment and ensure that the bank maintains an effective relationship with regulators
- Exercise due diligence in the hiring and oversight of external auditors
- Appoint Chairman & Chief Executive Officer and define their functions & responsibilities
- Board meetings shall be held at least twelve times a year at approximately monthly intervals
- Arrangements to be in place to enable all directors to give comments on proposals for regular board meetings when they relate to promotion of business and risk management
- Procedures shall ensure that notice of at least 7 days is given of a regular board meeting
- Procedures shall ensure that a director who has not attended at least two-thirds of the meetings in the period of 12 months immediately preceding or has not attended the immediately preceding three consecutive meetings held, shall cease to be a director. Participation through an alternate director shall be acceptable as attendance

- Board shall appoint a company secretary who satisfies the provisions of Section 43 of the Banking Act No. 30 of 1988 and directors shall have access to advice & services of the company secretary and company secretary shall prepare the minutes of board meetings
- If the Board considers that the bank is unable to meet its obligations or is about to become insolvent they shall forthwith inform the Director of Bank Supervision of the situation of the bank
- The board shall ensure that the capital adequacy ratio is maintained as stipulated, and publish a corporate governance report as per this directions in the bank's Annual Report
- Adopt a scheme of self-assessment to be undertaken by each director annually, and maintain records of such assessments

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

2) The Board's composition

- Composition should be of a healthy mix of executive directors and non-executive directors, and some independent directors.
- Directors should be persons who would be able to keep up with changes of industry, and provide continuous contribution and guidance to the board decision-making process
- Relationships between the directors and directors with the KMPs should remain at a level that does not suggest the existence of excessive familiarity, undue influence or duress
- The number of directors on the board shall not be less than 7 and not more than 13.
- The total service of a director other than a director who holds the position of CEO shall not exceed nine years.
- An employee of a bank may be appointed, elected or nominated as a director of the bank (hereinafter referred to as an "Executive Director") provided that the number of executive directors shall not exceed one-third of the total number.
- The board shall have at least three independent non-executive directors or one third of the total number of directors, whichever is higher. This sub-direction shall be applicable from 01 January 2010 onwards. A non-executive director shall not be considered independent if he/she:
 - has direct and indirect shareholdings of more than 1 per cent of the bank;
 - currently has or had during the period of two years immediately preceding his/her appointment as director, any business transactions with the bank as described in Direction 3(7) hereof, exceeding 10 per cent of the regulatory capital of the bank.
 - has been employed by the bank during the two year period immediately preceding the appointment as director;
 - has a close relation who is a director or chief executive officer or a member of key management personnel or a material shareholder of the bank or another bank. For this purpose, a "close relation" shall mean the spouse or a financially dependant child;
 - represents a specific stakeholder of the bank;
 - is an employee or a director or a material shareholder in a company or business organization:
 - which currently has a transaction with the bank exceeding 10 per cent of the regulatory capital of the bank, or
 - in which any of the other directors of the bank are employed or are directors or are material shareholders; or
 - in which any of the other directors of the bank have a transaction as defined in Direction 3(7) of these Directions, exceeding 10 per cent of regulatory capital in the bank;
- In the event an alternate director is appointed to represent an independent director, the person so appointed shall also meet the criteria that applies to the independent director.
- Non-executive directors shall be persons with credible track records and/or have necessary skills and experience to bring an independent judgment to bear on issues of strategy, performance and resources.
- A meeting of the board shall not be duly constituted, although the number of directors required to constitute the quorum at such meeting is present, unless more than half of the number of directors present at such meeting are non-executive directors.
- The independent non-executive directors shall be expressly identified as such in all corporate communications that disclose the names of directors of the bank. The bank shall disclose the composition of the board, by category of directors, including the names of the chairman, executive directors, non-executive directors and independent non-executive directors in the

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

annual corporate governance report.

There shall be a formal, considered and transparent procedure for the appointment of new directors to the board. There shall also be procedures in place for the orderly succession of appointments to the board.

All directors appointed to fill a casual vacancy shall be subject to election by shareholders at the first general meeting after their appointment.

If a director resigns or is removed from office, the board shall: (a) announce the director's resignation or removal and the reasons for such removal or resignation including but not limited to information relating to the relevant director's disagreement with the bank, if any; and (b) issue a statement confirming whether or not there are any matters that need to be brought to the attention of shareholders.

A director or an employee of a bank shall not be appointed, elected or nominated as a director of another bank except where such bank is a subsidiary company or an associate company of the first mentioned bank.

3) Criteria to assess the Fitness and Propriety of Directors

In addition to provisions of Section 42 of the Banking Act, No.30 of 1988, the criteria set out below shall apply to determine the fitness and propriety of a person who serves or wishes to serve as a director of a bank. Non-compliance with any one of the criteria as set out herein shall disqualify a person to be appointed, elected or nominated as a director or to continue as a director.

The age of a person who serves as director shall not exceed 70 years.

A person shall not hold office as a director of more than 20 companies/entities/institutions inclusive of subsidiaries or associate companies of the bank.

4) Management functions delegated by the Board

The directors shall carefully study and clearly understand the delegation arrangements in place.

The board shall not delegate any matters to a board committee, chief executive officer, executive directors or key management personnel, to an extent that such delegation would significantly hinder or reduce the ability of the board as a whole to discharge its functions.

The board shall review the delegation processes in place on a periodic basis to ensure that they remain relevant to the needs of the bank.

5) The Chairman and Chief Executive Officer

The roles of Chairman and CEO shall be separate and shall not be performed by the same individual.

The chairman shall be a non-executive director and preferably an independent director as well. In the case where the chairman is not an independent director, the board shall designate an independent director as the Senior Director with suitably documented terms of reference to ensure a greater independent element. The designation of the Senior Director shall be disclosed in the bank's Annual Report.

The board shall disclose in its corporate governance report, the identity of the chairman and the CEO and the nature of any relationship [including financial, business, family or other material/relevant relationship(s)], if any, between the chairman and the CEO and the

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

relationships among members of the board.

The chairman shall: (a) provide leadership to the board; (b) ensure that the board works effectively and discharges its responsibilities; and (c) ensure that all key and appropriate issues are discussed by the board in a timely manner.

The chairman shall be primarily responsible for drawing up and approving the agenda for each board meeting, taking into account where appropriate, any matters proposed by the other directors for inclusion in the agenda. The chairman may delegate the drawing up of the agenda to the company secretary.

The chairman shall ensure that all directors are properly briefed on issues arising at board meetings and also ensure that directors receive adequate information in a timely manner.

The chairman shall encourage all directors to make a full and active contribution to the board's affairs and take the lead to ensure that the board acts in the best interests of the bank.

The chairman shall facilitate the effective contribution of non-executive directors in particular and ensure constructive relations between executive and non-executive directors.

The chairman, shall not engage in activities involving direct supervision of KMPs or any other executive duties

The chairman shall ensure that appropriate steps are taken to maintain effective communication with shareholders and that the views of shareholders are communicated to the board.

Board appointed Committees

Each bank shall have at least four board committees namely Audit Committee, Human Resources and Remuneration Committee, Nomination Committee and Integrated Risk Management Committee as set out in these Directions. These committee shall report directly to the board. All committees shall appoint a secretary to arrange the meetings and maintain minutes, records, etc., under the supervision of the chairman of the committee.

The board shall present a report of the performance on each committee, on their duties and roles at the annual general meeting.

The following rules shall apply in relation to the Audit Committee:

- The chairman of the committee shall be an independent non-executive director who possesses qualifications and experience in accountancy and/or audit.
- All members of the committee shall be non-executive directors.
- The committee shall make recommendations on matters in connection with:
 - (i) the appointment of the external auditor for audit services
- i) the implementation of the Central Bank guidelines issued to auditors from time to time;
- i) the application of the relevant accounting standards; and
 - (iv) the service period, audit fee and any resignation or dismissal of the auditor; provided that the engagement of the Audit partner shall not exceed five years, and that the particular Audit partner is not re-engaged for the audit before the expiry of three years from the date of the completion of the previous term.

The committee shall review and monitor the external auditor's independence and objectivity

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

and the effectiveness of the audit processes in accordance with applicable standards and best practices.

- The committee shall develop and implement a policy on the engagement of an external auditor to provide non-audit services that are permitted under the relevant statutes, regulations, requirements and guidelines. In doing so, the committee shall ensure that the provision by an external auditor of non-audit services does not impair the external auditor's independence or objectivity. When assessing the external auditor's independence or objectivity in relation to the provision of non-audit services, the committee shall consider:
 - (i) whether the skills and experience of the audit firm make it a suitable provider of the non-audit services;
 - (ii) whether there are safeguards in place to ensure that there is no threat to the objectivity and/or independence in the conduct of the audit resulting from the provision of such services by the external auditor;
 - (iii) whether the nature of the non-audit services, the related fee levels and the fee levels individually and in aggregate relative to the audit firm, pose any threat to the objectivity and/or independence of the external auditor.

- The committee shall, before the audit commences, discuss and finalise with the external auditors the nature and scope of the audit, including:

- (i) an assessment of the bank's compliance with the relevant Directions in relation to corporate governance and the management's internal controls over financial reporting;
- (ii) the preparation of financial statements for external purposes in accordance with relevant accounting principles and reporting obligations;
- (iii) the co-ordination between firms where more than one audit firm is involved.

- The committee shall review the financial information of the bank, in order to monitor the integrity of the financial statements of the bank, its annual report, accounts and quarterly reports prepared for disclosure, and the significant financial reporting judgments contained therein. In reviewing the bank's annual report and accounts and quarterly reports before submission to the board, the committee shall focus particularly on:

- (i) major judgmental areas;
- (ii) any changes in accounting policies and practices;
- (iii) significant adjustments arising from the audit;
- (iv) the going concern assumption;
- (v) the compliance with relevant accounting standards and other legal requirements.

- The committee shall discuss issues, problems and reservations arising from the interim and final audits, and any matters the auditor may wish to discuss including those matters that may need to be discussed in the absence of key management personnel, if necessary.

- The committee shall review the external auditor's management letter and the management's response thereto.

- The committee shall take the following steps with regard to the internal audit function of the bank:

- (i) Review the adequacy of the scope, functions and resources of the internal audit department, and satisfy itself that the department has the necessary authority to carry out its work;

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

- (ii) Review the internal audit programme and results of the internal audit process and, where necessary, ensure that appropriate actions are taken on the recommendations of the internal audit department;
- (iii) Review any appraisal or assessment of the performance of the head and senior staff members of the internal audit department;
- (iv) Recommend any appointment or termination of the head, senior staff members and outsourced service providers to the internal audit function;
- (v) Ensure that the committee is appraised of resignations of senior staff members of the internal audit department including the chief internal auditor and any outsourced service providers, and to provide an opportunity to the resigning senior staff members and outsourced service providers to submit reasons for resigning;
- (vi) Ensure that the internal audit function is independent of the activities it audits and that it is performed with impartiality, proficiency and due professional care;

- The committee shall consider the major findings of internal investigations and management's responses thereto;
- The CFO, the chief internal auditor and a representative of the external auditors may normally attend meetings. Other board members and the CEO may also attend upon invitation. However, at least twice a year, the committee shall meet with the external auditors without the executive directors being present.

- The committee shall have:

- (i) explicit authority to investigate into any matter within its terms of reference;
- (ii) the resources which it needs to do so;
- (iii) full access to information;
- (iv) authority to obtain external professional advice and to invite outsiders with relevant experience to attend, if necessary.

- The committee shall meet regularly, with due notice of issues to be discussed and shall record its conclusions in discharging its duties and responsibilities.
- The board shall disclose in an informative way, (i) details of the activities of the audit committee;
- (ii) the number of audit committee meetings held in the year; and (iii) details of attendance of each individual director at such meetings.
- The secretary of the committee (who may be the company secretary or the head of the internal audit function) shall record and keep detailed minutes of the committee meetings.
- The committee shall review arrangements by which employees of the bank may, in confidence, raise concerns about possible improprieties in financial reporting, internal control or other matters. Accordingly, the committee shall ensure that proper arrangements are in place for the fair and independent investigation of such matters and for appropriate follow-up action and to act as the key representative body for overseeing the bank's relations with the external auditor.

➤ The following rules shall apply in relation to the Human Resources and Remuneration Committee:

- The committee shall determine the remuneration policy (salaries, allowances and other financial payments) relating to directors, Chief Executive Officer (CEO) and key management personnel of the bank.
- The committee shall set goals and targets for the directors, CEO and the key management personnel.

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

- The committee shall evaluate the performance of the CEO and key management personnel against the set targets and goals periodically and determine the basis for revising remuneration, benefits and other payments of performance-based incentives.
- The CEO shall be present at all meetings of the committee, except when matters relating to the CEO are being discussed.

➤ The following rules shall apply in relation to the Nomination Committee:

- The committee shall implement a procedure to select/appoint new directors, CEO and key management personnel.
- The committee shall consider and recommend (or not recommend) the re-election of current directors, taking into account the performance and contribution made by the director concerned towards the overall discharge of the board's responsibilities.
- The committee shall set the criteria such as qualifications, experience and key attributes required for eligibility to be considered for appointment or promotion to the post of CEO and the key management positions.
- The committee shall ensure that directors, CEO and key management personnel are fit and proper persons to hold office as specified in the criteria given in Direction 3(3) and as set out in the Statutes.
- The committee shall consider and recommend from time to time, the requirements of additional/new expertise and the succession arrangements for retiring directors and key management personnel.
- The Committee shall be chaired by an Independent Director and preferably be constituted with a majority of Independent Directors. The CEO may be present at meetings by invitation.

➤ The following rules shall apply in relation to the Integrated Risk Management Committee:

- The committee shall consist of at least three non-executive directors, chief executive officer and key management personnel supervising broad risk categories, *i.e.*, credit, market, liquidity, operational and strategic risks.
- The committee shall work with key management personnel very closely and make decisions on behalf of the board within the framework of the authority and responsibility assigned to the committee. The committee shall assess all risks, *i.e.*, credit, market, liquidity, operational and strategic risks to the bank on a monthly basis through appropriate risk indicators and management information. In the case of subsidiary companies and associate companies, risk management shall be done, both on a bank basis and group basis.
- The committee shall review the adequacy and effectiveness of all management level committees such as the credit committee and the asset-liability committee to address specific risks and to manage those risks within quantitative and qualitative risk limits as specified by the committee.
- The committee shall take prompt corrective action to mitigate the effects of specific risks in the case such risks are at levels beyond the prudent levels decided by the committee on the basis of the bank's policies and regulatory and supervisory requirements.
- The committee shall meet at least quarterly to assess all aspects of risk management including updated business continuity plans.
- The committee shall take appropriate actions against the officers responsible for failure to identify specific risks and take prompt corrective actions as recommended by the committee, and/or as directed by the Director of Bank Supervision.

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

- The committee shall submit a risk assessment report within a week of each meeting to the board seeking the board's views, concurrence and/or specific directions.
- The committee shall establish a compliance function to assess the bank's compliance with laws, regulations, regulatory guidelines, internal controls and approved policies on all areas of business operations. A dedicated compliance officer selected from key management personnel shall carry out the compliance function and report to the committee periodically.

7) Related party transactions

➤ The board shall take the necessary steps to avoid any conflicts of interest that may arise from transacting with any person, and particularly with the following categories of persons who shall be considered as "related parties" for the purposes of this Direction:

- (i) Any of the bank's subsidiary companies;
- (ii) Any of the bank's associate companies;
- (iii) Any of the directors of the bank;
- (iv) Any of the bank's key management personnel;
- (v) A close relation of any of the bank's directors or key management personnel;
- (vi) A shareholder owning a material interest in the bank;
- (vii) A concern in which any of the bank's directors or a close relation of any of the bank's directors or any of its material shareholders has a substantial interest.

➤ The type of transactions with related parties covered by this Direction shall include the following:

- (i) The grant of any type of accommodation, as defined in the Monetary Board's Directions on maximum amount of accommodation,
- (ii) The creation of any liabilities of the bank in the form of deposits, borrowings and investments,
- (iii) The provision of any services of a financial or non-financial nature provided to the bank or received from the bank,
- (iv) The creation or maintenance of reporting lines and information flows between the bank and any related parties which may lead to the sharing of potentially proprietary, confidential or otherwise sensitive information that may give benefits to such related parties.

➤ The board shall ensure that the bank does not engage in transactions with related parties as defined above, in a manner that would grant such parties "more favourable treatment" than that accorded to other constituents of the bank carrying on the same business. In this context, "more favourable treatment" shall mean and include treatment, including the:

a) Granting of "total net accommodation" to related parties, exceeding a prudent percentage of the bank's regulatory capital, as determined by the board. For purposes of this sub-direction:

- (i) "Accommodation" shall mean accommodation as defined in the Banking Act Directions, No.7 of 2007 on Maximum Amount of Accommodation.
- (ii) The "total net accommodation" shall be computed by deducting from the total accommodation, the cash collateral and investments made by such related parties in

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

the bank's share capital and debt instruments with a maturity of 5 years or more.

b) Charging of a lower rate of interest than the bank's best lending rate or paying more than the bank's deposit rate for a comparable transaction with an unrelated comparable counterparty;

c) Providing of preferential treatment, such as favourable terms, covering trade losses and/or waiving fees/commissions, that extend beyond the terms granted in the normal course of business undertaken with unrelated parties;

d) Providing services to or receiving services from a related-party without an evaluation procedure;

e) Maintaining reporting lines and information flows that may lead to sharing potentially proprietary, confidential or otherwise sensitive information with related parties, except as required for the performance of legitimate duties and functions.

➤ A bank shall not grant any accommodation to any of its directors or to a close relation of such director unless such accommodation is sanctioned at a meeting of its board of directors, with not less than two-thirds of the number of directors other than the director concerned, voting in favour of such accommodation. This accommodation shall be secured by such security as may from time to time be determined by the Monetary Board as well.

(i) Where any accommodation has been granted by a bank to a person or a close relation of a person or to any concern in which the person has a substantial interest, and such person is subsequently appointed as a director of the bank, steps shall be taken by the bank to obtain the necessary security as may be approved for that purpose by the Monetary Board, within one year from the date of appointment of the person as a director.

(ii) Where such security is not provided by the period as provided in as per a) above, the bank shall take steps to recover any amount due on account of any accommodation, together with interest, if any, within the period specified at the time of the grant of accommodation or at the expiry of a period of eighteen months from the date of appointment of such director, whichever is earlier.

(iii) Any director who fails to comply with the above sub-directions shall be deemed to have vacated the office of director and the bank shall disclose such fact to the public.

(iv) This sub-direction, however, shall not apply to a director who at the time of the grant of the accommodation was an employee of the bank and the accommodation was granted under a scheme applicable to all employees of such bank.

➤ A bank shall not grant any accommodation or "more favourable treatment" relating to the waiver of fees and/or commissions to any employee or a close relation of such employee or to any concern in which the employee or close relation has a substantial interest other than on the basis of a scheme applicable to the employees of such bank or when secured by security as may be approved by the Monetary Board in respect of accommodation granted.

➤ No accommodation granted by a bank, nor any part of such accommodation, nor any interest due thereon shall be remitted without the prior approval of the Monetary Board and any remission without such approval shall be void and of no effect.

8) Disclosures

➤ The board shall ensure that:

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

- (a) annual audited financial statements and quarterly financial statements are prepared and published in accordance with the formats prescribed by the supervisory and regulatory authorities and applicable accounting standards, and that
- (b) such statements are published in the newspapers in an abridged form, in Sinhala, Tamil and English.
- The board shall ensure that the following minimum disclosures are made in the Annual Report:
- (i) A statement to the effect that the annual audited financial statements have been prepared in line with applicable accounting standards and regulatory requirements, inclusive of specific disclosures.
- (ii) A report by the board on the bank's internal control mechanism that confirms that the financial reporting system has been designed to provide reasonable assurance regarding the reliability of financial reporting, and that the preparation of financial statements for external purposes has been done in accordance with relevant accounting principles and regulatory requirements.
- (iii) The external auditor's certification on the effectiveness of the internal control mechanism referred to in Direction (b) above, in respect of any statements prepared or published after 31 December 2008 or an assurance report issued by external auditors under SLSAE 3050.
- (iv) Details of directors, including names, fitness and propriety, transactions with the bank and the total of fees/remuneration paid by the bank.
- (v) Total net accommodation as defined under point (7) granted to each category of related parties. The net accommodation granted to each category of related parties shall also be disclosed as a percentage of the bank's regulatory capital.
- (vi) The aggregate values of remuneration paid by the bank to its key management personnel and the aggregate values of the transactions of the bank with its key management personnel, set out by broad categories such as remuneration paid, accommodation granted and deposits or investments made in the bank.
- (vii) The external auditor's certification of the compliance with these Directions in the annual corporate governance reports published after 01 January 2010.
- (viii) Or a confirmation published by the Board in banks annual corporate governance report that all findings of the factual findings reports of auditors issued under Sri Lanka related services practice statement 4750 have been incorporated in the annual corporate governance report provided that auditors confirm same to the Director Bank Supervision.

Corporate governance initiatives taken by Institute of Chartered Accountants of Sri Lanka

The Institute of Chartered Accountants of Sri Lanka too has formulated and published the following codes of best practices pertains to the area of corporate governance in Sri Lanka.

- The Code of Best practices on matters relating to financial aspects of Corporate Governance.
- The Code of Best practices on audit committees.
- The Code of Best practices on Corporate Governance
- Rules on Corporate Governance for listed companies
- Code of best practices, jointly with Securities Exchange Commission

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

Regulatory compliance

Compliance in general terms relates to adherence to laws and regulations and internal policies and procedures. However in practice it has a broad scope, which covers areas such as observance, application of standards, managing conflict of interest etc. Since of late Compliance has extended it's scope to cover areas such as Anti Money Laundering, Combating of Financing of Terrorism and Tax Laws in connection with financial services. In other word, compliance function protects the organization against unlawful and socially unfriendly behaviours and strengthens the ethical consciousness. It is the responsibility of the Board of Directors (BOD) of financial institutions to ensure that the organization formulates a compliance policy which needs to be approved by the BOD. This initiative by the BOD is to ensure overseeing the organizations strategic objectives and setting up of a compliance culture in meeting such strategic objectives. Similarly the BOD should ensure that financial institutions are equipped with adequate policies & procedures that enable effective supervision & control on all business operations.

In addition to internal controls, word “compliance” has relevance to regulatory and supervisory structures enabling external regulators and supervisors to ensure that financial institutions adhere to rules, regulations and directions set out by them.

Compliance function is not only costly time consuming but also an onerous endeavor. Therefore, the Compliance function can be effectively implemented only if it stems from the Board level which should have the support and blessings of the top management. The compliance functions can therefore be termed as execution of business processes designed to manage risks involved and to benchmark against pre-established tolerance levels applicable to the industry.

Financial system stability

Financial system stability means the resilience of the financial system to internal and external shocks that may arise from any economic, financial, political or any other factor. In order to maintain financial system stability one should preserve the soundness of financial institutions, ensure robustness of financial markets and financial infrastructure and also smooth and effective intermediation processes.

Central Bank of Sri Lanka is charged with the duty of securing the “Financial System Stability” of the country together with Economic and Price stability.

In order to ensure financial system stability CBSL is empowered under various enactments including :

- Monetary Law Act

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

- Banking Act
- Finance Business Act

Accordingly, the CBSL is empowered to issue directions to financial institutions with a view to protecting the public against any mismanagement causing bank failures and thereby losing public confidence.

Why governance and compliance is important for financial system stability

The key functionalities of a bank such as accepting deposits, making withdrawals, engaging in payment channels, facilitates the real economy to function smoothly. On the other hand, the real economy to do well it is a necessity that the payment system of the country and the financial institutions function effectively.

Similarly, banks and the financial markets are integrated into the real economy, as a result instability of even one institution could create spillover effects which can lead to systemic risks due to the heavy contagion effect found in the industry of banking.

Also the financial system stability is of paramount importance to improve the sovereign ratings of the country. A strong sovereign / credit rating would facilitate mobilizing of funds from international markets and investors at low interest rates with longer tenures. Such funds mobilized would certainly pave the way to accelerated growth in the economy.

Accordingly it is needless to say that the governance and compliance initiatives would have a definite impact on the financial system stability.

The failures experienced recently in Sri Lankan financial systems

When screening the history of the financial business in Sri Lanka, one would find that 13 registered finance companies have failed out of which two companies were revived with new investments whilst eleven companies were liquidated.

In early 2000, a Bank failed and it was only in 2007, that the deposits of the said bank were transferred to a new savings bank.

In 2009, 08 Non Bank Financial Institutions (NBFIs) faced liquidity problems mainly due to the collapse of a related corporate entity in a particular group. However, such NBFIs were gradually revived under re-structuring arrangements supervised by CBSL.

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

In 2013, a NBFIs faced liquidity crisis due to mismanagement and misappropriation of funds by certain directors of the said company. Although, CBSL commenced the process of restructuring, same has been interrupted as a result of a stay order.

New initiatives planned /taken to reshape banking for changing times

Capital adequacy

As per the initiatives of CBSL, the financial sector will be duly encouraged and supported to fall in line with CBSLs forward looking policies designed to align with potential world-wide policies and to get adjusted to volatilities that may occur due to any possible financial distress or failures.

Adequate capital and other reinforcements will be put in place to prepare the Sri Lankan financial sector specially the Banks, to withstand vicious business cycles and vulnerable business climates. CBSL would play the role of a pragmatic systemic risk mitigator who should encourage innovations to ensure overall goal of financial system stability.

As the Banks and NBFIs represent nearly 64% of the asset base of the Sri Lankan financial system, CBSL has recognized the need for certain structural changes to ensure that Banks and NBFIs are well positioned in the envisaged projected growth in the Sri Lankan economy. Accordingly regulatory regimes needs to be further strengthened whilst encouraging diversification of sources of funding and business operations.

Accordingly capital of the banks and NBFIs need to be further strengthened to ensure that sufficient buffers are built in during smooth sailing periods to strengthen resilience of the financial sector.

In the given scenario CBSL is promoting and encouraging banking and the NBFIs sectors to concentrate on consolidation through mergers and absorption of businesses.

The following initiatives have already been declared by CBSL towards strengthening of the capital of banking industry.

- Increasing minimum capital requirement for existing banks by 1st January 2016.
 - Licensed Commercial Banks – minimum Rs. 10 Bn.
 - Licensed Specialized Banks – minimum Rs. 5 Bn.

- Migrate to the advanced approach under the Basel II Capital Adequacy Framework by implementation of standardized approach for calculating capital charge for operational risk under pillar I.
- Adopt Basel III capital standards.
 - Increasing quality and quantity of capital of banks.

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

- Introduction of a capital conservation buffer with the intention of creating capital buffers in good times that can be used to absorb shocks in periods of stress.
- Introduction of a counter cyclical buffer to reduce pro-cyclicality to prevent excessive credit growth.

Integrated risk management

The risk management framework for banks also have been established by way of Banking Act Direction No. 7 of 2011 on Integrated Risk Management Framework for Licensed Banks. The key features of same are as follows:

- All Licensed Banks should have a documented Integrated Risk Management framework (IRM) approved by the Board of Directors and same should be reviewed annually.
- IRM document should cover following areas:
 - Potential risks
 - Possible sources of such risks
 - Mechanism of management information
 - Reporting/monitoring of such risks
 - Measures taken to control/mitigate risks
 - Relevant officers/committees responsible for such controls
- The Board of Directors should assess the integrated risk profile of the Bank and its management through IRM at least quarterly to ensure implementation of IRM
- In the event of any material lapses in IRM, the officers responsible will be reassessed by Director Bank Supervision Department- CBSL on the fitness and propriety of such officers.
- Clear guidelines have been issued on stress testing framework.

Prevention on money laundering and terrorist financing

- A risk based approach is being introduced in meeting AML/CFT Anti Money Laundering (AML) and Combating Financing of Terrorism (CFT) regulations, keeping in line with the revised recommendations of Financial Action Task Force. (FATF).
- A National Risk Assessment on AML/CFT is being conducted in order to win global confidence which is of paramount importance in attracting genuine foreign investors and foreign direct investments (FDIs).

It is important to mention that promoting and allowing tainted money into the economy would not only compromise the financial stability of the country but also the sovereignty of the nation and the territorial integrity of the country.

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.

Other initiatives

- A regulatory framework has been introduced for valuation of immovable property of licensed banks.
- The appropriate changes have been incorporated into the existing regulatory framework keeping in line with new accounting standards by introducing new offline surveillance reporting system.
- Introduction of an early warning system to identify emerging risk.
- Expedite the investigating processes on unauthorized finance businesses.
- Impose penalties and disqualify from holding office for Key Management Personnel when there are continued non-compliance of CBSL Directions.
- Lottery Schemes have been prohibited.
- Accuracy of disclosure of interest rates, fees, charges etc. including provision of Key Fact Documents (KFDs) which should carry all material facts pertaining to products and services of banks.
- All new products and services to be introduced by banks are to be cleared for meeting required regulatory requirements.
- Implementation of the customer charter.
- Issuance of the guidelines on outsourcing of business operations.
- More focused attention be given by Banks to customer complaints in order to address grievances in an efficient and timely manner with an overall ultimatum of consumer protection.

Conclusion

There is no dispute that the Banks carry broader responsibilities which go beyond their shareholders and employees, due to the simple reason that the banks function as trustees of public deposits. If the responsibilities entrusted on the banks are to be effectively discharged, it is very important that the persons who are manning the business of banking, possess right skills, knowledge and expertise in their respective command areas. Accordingly, the Directors who are appointed to the respective Boards and the Key Management Personnel (KMPs) of banks should update their knowledge and skills on a regular basis and live up to the expectations placed on them in meeting regulatory compliance to ensure that the banks are well managed to facilitate a stable financial system, especially in changing times where the banking industry is being reshaped to take up increasing challenges.

Disclaimer:

Articles and the opinions expressed herein do not necessarily represent the view of the Co. / organization or any employee / member thereof or of any particular editor.