

# Responsibility, Immunity and Liability: Are Financial Supervisors Liable for Depositors' Losses?

## A Sri Lankan Case Study

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### Abstract

*A stable financial system is a fundamental need for economic growth and prosperity. Hence, an efficient and continuous financial supervisory function is underscored by legal, economic and political rationale where prevention of bank runs reigns as the prime motive. The liquidity crisis faced by some financial institutions in Sri Lanka in 2008 resulted in the Central Bank of Sri Lanka being sued by depositors/investors of such institutions for alleged negligence. This situation is not alien in financial markets world over, as in times of crisis supervisory actions and responses are often criticised and questioned. Hence, supervisors, who are expected to work without fear or favour, perform their balancing act under a cloud of legal risk. In this background, the responsibilities and powers of the Central Bank of Sri Lanka is analysed to verify whether the supervisory role of the Central Bank conforms to the Basel Core principles. Immunity and accountability of the Central Bank of Sri Lanka is discussed in general as a preface to discussing the recent legal action faced by the financial sector supervisor of Sri Lanka, their implications and lessons to be learnt. With a plethora of new laws and regulations being borne out of crisis, the supervisors may be exposing themselves to a higher degree of legal risk apart from creating new liabilities. This paper recommends new provisions to be considered to be adopted into the financial sector laws in Sri Lanka.*

**Keywords:** Regulator, Supervision, Lender of Last Resort

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## 1. Introduction

At times of crisis, financial supervision is under spotlight. Goodhart states that ‘a supervisor is only noticed when either he/she angers the regulated by some restrictive or intrusive action, or when supervision “fails” in the sense that a financial institution collapses or a customer gets ripped-off.’(Goodhart 21)

Supervision is broadly defined as monitoring and enforcement of rules laid down by the regulators.(Lastra 84) Lastra defines supervision as a seamless process that flows through the life cycle of a financial entity, from the entry of an institution into the market to crisis management (Lastra 85).

The primary role of the financial sector supervisor is to preserve financial stability. Unlike price stability which could be measured by facts or figures,(Gadancz et al. 365) financial system stability cannot be easily measured and has no single definition.(Schinasi 3) Schinasi defines financial stability as ‘a condition in which an economy’s mechanisms for pricing, allocating, and managing financial risks ... are functioning well enough to contribute to the performance of the economy’ (10). Allen and Wood define financial stability as ‘a state of affairs in which an episode of financial instability is unlikely to occur, so that fear of financial instability is not a material factor in economic decisions taken by households or businesses’ (Allen and Wood).

The financial crisis that crippled the world in 2007-09 had the legislators, the policy makers, the supervisors, the market analysts and such other stakeholders of the financial sector including the depositors and the general public questioning the effectiveness of supervision in the background of its expected functions, roles, goals and responsibilities.(The Group of Thirty 18) While there is no one perfect method of financial supervision that can cure any instability and prevent all crises, the crisis saw more than one finger being pointed at the financial supervisors for failures and lapses on their part, which have allegedly fanned and fuelled the crisis to reach beyond territorial limits and cause wide havoc around the world (Bernanke).

The Sri Lankan financial markets were not directly affected by the events of the global financial turmoil. However, the crash of an unregulated financial institution, which was a member of a large financial conglomerate resulted in panic among depositors, causing a liquidity crisis in several non-bank financial institutions. The crisis that ensued required an executive response. A ‘Stimulus Package’ was endorsed by the Cabinet of Ministers to stabilise the crisis hit finance companies in the short run.<sup>2</sup> The legislative responses have

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<sup>2</sup> Central Bank of Sri Lanka, ‘*Press Release: Central Bank Begins Implementation of Stimulus Package*’

been equally spontaneous. The liquidity crisis laid bare the weaknesses of the regulatory and supervisory system, and the enforceability of the law to effectively curb financial instability. Hence, the Finance Companies Act, No. 78 of 1988 was overhauled and the Finance Business Act, No. 42 of 2011 was enacted with 'more teeth' to the supervisor.

The most dramatic development consequent to the liquidity crisis came from the corner of depositors. Some depositors of some financial institutions, both regulated and unregulated, took the Central Bank of Sri Lanka (CBSL) to courts over alleged negligence, mala fide actions and derogation of duties and responsibilities.<sup>3</sup> Even though the CBSL enjoys immunity under the Monetary Law Act, No 49 of 1950,<sup>4</sup> courts in Sri Lanka have not interpreted the provisions of the law as granting iron-clad immunity to the supervisor. In some cases, the Supreme Court of Sri Lanka, which is the apex court in the country, has required the CBSL to be involved in repayment processes of unregulated shadow banking institutions all the while broadly and generally interpreting the provisions of the Finance Companies Act.<sup>5</sup> The judicial responses to depositor action has raised questions about financial supervisor's independence, accountability, immunity and the ability to carry out its functions without fear or favour. It has also given rise to a public discussion about the legal liability of the financial supervisor to third party losses.<sup>6</sup>

This paper aims to analyse whether the prudential supervisor could be held liable for depositors' losses, with emphasis on Sri Lanka.

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*and Intervenes to Stabilise Registered Finance Companies of the Ceylinco Group?* (CBSL, 6 March 2009 <[www.cbsl.gov.lk/pics\\_n\\_docs/latest\\_news/press\\_20090306e.doc](http://www.cbsl.gov.lk/pics_n_docs/latest_news/press_20090306e.doc)>

<sup>3</sup> SC/FR/449/08 Buddhika Lakmal Wijesekara vs The Monetary Board et al; SC/FR/262/2009 Susil Gunadasa Illangasinghe et al vs The Monetary Board et al; SC/FR/317/2009 E M De Soysa et al vs The Monetary Board et al

<sup>4</sup> s 47

<sup>5</sup> Central Bank of Sri Lanka, 'Current Status of The Finance & Guarantee Company Ltd., Finance & Guarantee Property Developers (Pvt) Ltd. and F&G Real Estate Co. Ltd'(Central Bank of Sri Lanka, 7 December 2009 <[http://www.cbsl.gov.lk/pics\\_n\\_docs/latest\\_news/press\\_20091207ea.pdf](http://www.cbsl.gov.lk/pics_n_docs/latest_news/press_20091207ea.pdf)>; Central Bank 'Ceylinco Shriram Capital Management Services Company (Pvt) Limited, Ceylinco Capital Investment Company (Pvt) Limited, Ceylinco Consolidated (Pvt) Limited and CLC Asset Management (Pvt) Limited'(Central Bank of Sri Lanka, 9 July 2009)

<[http://www.cbsl.gov.lk/pics\\_n\\_docs/02\\_prs/\\_docs/notices/publicnotice\\_20090710e.pdf](http://www.cbsl.gov.lk/pics_n_docs/02_prs/_docs/notices/publicnotice_20090710e.pdf)>; Central Bank 'The Golden Key Credit Card Company Limited'(Central Bank of Sri Lanka, 28 April 2009) <[http://www.cbsl.gov.lk/pics\\_n\\_docs/02\\_prs/\\_docs/notices/notice\\_02052009e.pdf](http://www.cbsl.gov.lk/pics_n_docs/02_prs/_docs/notices/notice_02052009e.pdf)>

<sup>6</sup> Ajith Cabraal, 'Failure of deposit taking institutions: Causes, Legal remedies and Solutions' (Bar Association of Sri Lanka, Colombo, 30 June 2009)

<[http://www.cbsl.gov.lk/pics\\_n\\_docs/02\\_prs/\\_docs/speeches/g\\_speech\\_20090630e.pdf](http://www.cbsl.gov.lk/pics_n_docs/02_prs/_docs/speeches/g_speech_20090630e.pdf)>

The paper is divided into three parts. Firstly, the rationale for financial supervision would be discussed. Secondly, the powers conferred on the CBSL as the financial supervisor would be analysed against the Basel Core Principles.(Supervision) The balance between immunity and accountability would be discussed in general and several cases instituted by depositors against the CBSL would be analysed to ascertain the judicial thoughts on the role and the function of the CBSL.

The outcome of the study is to be able to make recommendations that would be useful for future amendments to laws of Sri Lanka in order to address legal risks.

## **2. The Role of Supervision**

The peculiar features of banks and other deposit taking institutions, in particular asset-liability mismatch, risky asset portfolio, low capitalization and access to tax-payer funded safety nets at times of crisis, make the industry more susceptible to risks and hazards. Unlike an institution that carries on its activities funded by its shareholders, the banks and other deposit taking institutions are funded primarily by public deposits. This peculiar feature of banking paves the way for public scrutiny of its business, regulations and strict supervision due to the inordinate effects of its failure on many stakeholders including the general public. The multiplicity of markets, instruments, infrastructure, regulators, supervisors and institutions makes the financial sector multidimensional and complex. Multiple stakeholders bring in multiple expectations, which when coupled with numerous goals make financial supervision an extremely tricky task. Each stakeholder expects a different outcome from supervision, hence supervisors are called upon to perform a balancing act.

Regulation could be defined as rule setting where supervision is the monitoring process. Regulation and supervision are complementary in its functions and in many jurisdictions, including Sri Lanka, both tasks are performed by a single entity.

### **2.1 Legal rationale for financial supervision**

The failure of a deposit taking institution is expected to result in greater hardships for the public than that of a comparable non-deposit taking institution (Great Britain. Treasury 6). Hence, one of the main arguments for regulation and supervision of deposit taking institutions is depositor protection, which is inherently linked to prevention of bank runs. Not all depositors are sophisticated and possess financial literacy, hence the supervisor is called upon to monitor the health of deposit taking institutions according to the prudential rules and thereby ensure safety of funds of the depositor. Whilst there can be no guarantee of a zero per cent failure and institutions may fail and be allowed to fail as a disciplinary

measure, due to its inordinate impact on the everyday lives of ordinary citizens, supervisory authorities are expected to minimise the probability of failure of financial institutions. Prevention of runs can be identified as a fundamental factor common to legal, economic and political rationale for financial supervision, which would be discussed at a later stage.

Banking assets are mostly illiquid in nature, comprising loans and long term investments, securities, reserves and physical assets. The liabilities are liquid and comprise mainly of deposits that are payable on demand. Managing the maturities of assets and liabilities is one of the primary tasks of a bank and any wide mismatch therein would result in illiquidity of the bank and may even lead to insolvency within a short period of time. Cabral argues that large banks seek to enhance their profits by widening the gap between their assets and liabilities (Cabral). Even though this practice may yield profits in the short run, the bank may face a liquidity shock at any given stressful situation. This practice also leads to adverse selection and moral hazard due to availability of publicly funded safety nets to too big to fail banks whereby the management is not afraid of taking risks in the expectation of bailout funds from the Government.

Financial institutions are subject to systemic risk. Systemic risk is defined by Lastra as the 'risk that financial difficulties at one or more bank spill over to a large number of other banks or the financial system as a whole' (138-139). The shock of failure that cripples the financial system temporarily may within a very short time frame result in a wide-scale bank run and ultimately, if not contained swiftly and appropriately by the supervisor, cause the failure of the entire financial system. Systemic risk is expected to be identified, gauged and mitigated by the financial supervisor. The failure of the Financial Supervisory Authority (FSA) to identify the build-up of systemic risk within the UK financial sector was categorised by HM Treasury as a key failure that led to the crisis in 2007 whereby 'the regulators and supervisors failed to provide the robust scrutiny and challenge that banks and other financial institutions needed to ensure that risks building up on their balance sheets were manageable – not only at the level of individual firms, but across the system as a whole' (Great Britain. Treasury., *A New Approach to Financial Regulation : The Blueprint for Reform* 5).

While stringent financial regulation and supervision are called for due to the prevalence of the systemic risk, some scholars resist regulation and supervision on the basis of free market policies. Alan Greenspan, five times the Chairman of the Federal Reserve, who has remained vociferous about anti-regulation, has reportedly admitted that prior to the crisis he had relied on the premise that regulation is no better than market forces (Andrews). However, without regulation and supervision, the externalities caused by systemic risk may not be mitigated or internalized, which therefore could result in economic inefficiencies as seen in the crisis. Schwarcz argues that systemic risk should be regulated to maximize economic efficiency to prevent a tragedy of the commons, 'an event in which the benefits of exploiting finite capital resources accrue to individual market participants, each of which is motivated to maximize

use of the resource, whereas the costs of the exploitation are distributed among an even wider class of persons, in this case ordinary people who are harmed by unemployment and poverty'(Schwarcz 205-206).

The legal rationale for regulation and supervision rests on the premise that sound regulation coupled with strong enforcement powers would minimise bank failures, mitigate systemic risks and promote financial system stability.

## **2.2 Economic rationale for financial supervision**

The economic role of a bank is to convert illiquid assets into liquid liabilities (Diamond and Dybvig 401-402). Banks promote capital formation, access to finance and liquidity for individuals and enterprises hence contributing towards the economic performance of a country.

The main economic rationale for supervision stems from the peculiarity of banks at their failure. Unlike other businesses, the prices of banking products do not encapsulate the losses that are borne by society at their failure. Hence bank failures result in negative externalities and social costs (Atsem). The failure of several banks at the same time causing systemic collapse results in widely felt externalities that impose massive costs on society (Wagner). Bank failures result in job losses for employees and denial of access to bank accounts for daily transactions to the depositors, causing great distress. Further, the 2007-09 crisis resulted in systemically important banks and some non-banks in several countries being bailed out with public funds, burdening the public with the cost of bank rescues. Hence, sound financial supervision is needed in order to minimise negative externalities in the form of social costs at a bank failure, which are hitherto not borne by any party to banking transactions (Llewellyn).

The nature of banking itself gives rise to failure. Bank balance sheets are saddled with risky assets that are not easily tradable or convertible into liquid assets at times of crises. By amassing risky assets of similar nature and driven by similar opportunities and profit margins that result in poor diversification of both asset and liability portfolios, bank balance sheets appear to be more and more similar each day. Goodhart quoting Wagner states that poor diversification of assets and liabilities by financial institutions makes them more vulnerable to failure under the same shock (C. Goodhart). Due to the similarity of institutions, the failure could become contagious and develop into a systemic crisis. Therefore, one of the requirements of regulation and supervision is to arrest concentration of risk by avoiding poor diversification of assets and liabilities of financial institutions.

Goodhart argues that ordinary individuals have no time or expertise to continuously calculate riskiness and assess reputation of financial institutions (Lastra 74). One can also add

financial products to the said statement as the subprime crisis in the US in 2007 was primarily blamed on the widely conceived misjudgement of escalating housing values where persons who were unable to take a mortgage under market rates bought houses under subprime rates in the hope of selling such properties in a few years' time for a higher price and settling the debts – an expectation that proved to be fatally wrong. An ordinary depositor or a creditor of a financial institution does not have the financial literacy or the foresight to a level where risks and rewards of complex financial instruments could be identified and losses could be mitigated. While credit rating agencies and external audit reports published by auditors are available to consumers to make informed decisions, such agencies are recruited and paid by the financial institutions themselves, which gives rise to agency issues and biased opinions that does not support depositors' interests. Therefore, one of the main expectations of a financial supervisor would be to monitor the health of the institutions on established standards, take steps in the event of an institution failing to meet the required standards and preserve depositors' interests. The economic rationale for supervision and regulation of financial markets does not require replacement of competition with regulation and supervision. Llewellyn argues that regulation and competition are not in conflict. Supervision, which is the monitoring of enforcement of regulation can also be said to not be in conflict with market competition.

### **2.3 Political or public policy rationale for financial supervision**

One of the key motives for banking supervision is to prevent bank runs, i.e. panic withdrawal by depositors fearing an imminent failure of a bank, which has the potential to develop into a self-fulfilling prophecy. Hence, deposit taking institutions have access to several safety nets. The most fundamental safety nets are deposit insurance schemes and lender of last resort facilities from the Central Bank, both involving significant costs to the state. Even when there is no explicit deposit insurance scheme in place, the implicit guarantee of deposits by the government works as a safety net for the banks (MacDonald 11). Therefore, depositor protection has become a political fact of life. This causes moral hazard issues as the availability of safety nets promotes excessive risk taking by banks, whereby firstly, they become too big to fail, secondly, having the insurance of a government rescue they continue to seek higher profits in the short term taking excessive risks (Atsem). However, a detailed discussion of this vicious cycle of moral hazards falls outside the scope of this paper.

The role of effective financial supervision and the importance of preserving the financial system stability have been underscored during the time of the crisis. Many financial institutions failed and had to be bailed out with tax payer money, hurting the government coffers of many countries and ailing the economy of the world. In the United Kingdom, the banking bailout bill peaked at £ 955Bn (National Audit Office 6). In the United States, the Troubled Asset Relief Programme was funded up to USD 700Bn (Ericson M, He E). In

Europe, the bailing out process is on-going and appears to be far from over. The fiscal costs at crisis include not only bailout funding but also the costs of recapitalisation of banks and the reimbursement of insured depositors. Arguing that major financial instability or crisis can also bring about significant fiscal instability, Eschenbach and Schuknecht state that fiscal costs measured by fiscal debt could be as high as 50% of GDP of a country (Felix Eschenbach and Schuknecht 6). Basing their research on 124 systemic banking crises over the period of 1970 to 2007, Laeven and Valencia argue that fiscal costs, net of recoveries, associated with banking crises could range from 13.3% to a shocking 55.1% of the GDP (Laeven and Valencia 24). During the 2007-09 crises, the amount of financial support given to banks on a global basis has been approximately \$7 trillion or 12% of global GDP (Huertas). Generally associated with too big to fail or too interconnected to fail concepts, large banks and banking conglomerates have been the primary recipients of rescue packages by governments, giving rise to unrest and social discontent worldwide.

The market confidence and financial inclusiveness are also strong political tools. Access to finance empowers society by including individuals, small and medium enterprises and an ‘un-bankable’ strata of the society in the web of financial intermediation. Widely practiced through microfinance, it is one of the key social and development goals of developing economies (World Bank ix). With no continuous and reliable funding sources at hand, many industries and entrepreneurs rely on their own savings, loans from informal credit sources such as money lenders and ad hoc grants which prevent them from achieving optimal levels of production. Most developing countries thus encourage credit to rural and SME sectors with a view to achieving provincial and sectorial growth. Access to finance paves the way for new entrants to the market, expansion of businesses that would create more job opportunities and improve production, therefore profits, which would all contribute towards the economic growth of the country. Governments that practice ‘pro poor growth’ policies need to improve access to finance as a prerequisite alongside with prevention of market failure (OECD 11). However, one of the key issues with regard to priority sector lending is credit/counterparty risk. Often associated with sectors with high non-performing assets or low profitability, the fundamental task for the financial supervisor would be to balance the risks of lending with policy goals of the government. Hence, independence of the financial supervisor is an essential component to strike a balance between public policy goals and the financial system stability.

The Basel Core Principles for effective bank supervision lists financial supervisors’ independence and accountability as key principles for effective supervision. Lastra (49) includes functional and operational guarantees as a composite element of independence of a central bank which may well be applied in the case of a financial supervisory agency. This requires to be guaranteed by way of a law that safeguards independence. The decisional independence of the supervisory agency would depend on its decision making power

guaranteed by law as well as on the people who are appointed to carry out the duties and functions of the agency. The ability to take independent decisions without seeking pre or post assent of the political order would afford room for the supervisor to issue directions, rules and regulations to the financial industry, taking a balanced approach to mitigate exposure to risks and accumulation of low yielding assets.

Lastra (47), in her discussions on central banking independence, stresses the need to have appointment and dismissal procedures for board members, term of office of Governor and relationship between the Central Bank and the Treasury or the Minister of Finance as some of the key provisions to be included in a law to guarantee the independent function of the central bank. These provisions could be generally applicable to guarantee independence of any other agency such as the financial supervisory agency.

It is therefore evident that for reasons that are diverse and perhaps self-serving, supervision of the financial system is called for by legal, economic and political quarters woven together by the pressing need to avoid failures and prevent bank runs. It recognises the important role played by financial supervisors in the market and also rests heavy responsibilities on the supervisors that need effective execution. While the market players may urge for less regulation and supervision and more self-regulation and discipline, subject to general standards set by regulators and supervisors, the expectations of the public are levelled at a higher interventionist hard-knuckled control oriented supervision. This is especially true for deposit taking institutions that rely heavily on retail funding where individual depositors expect a greater deal of trust and confidence to part with their hard earned money.

### **3. Supervision of deposit taking institutions in Sri Lanka**

The Central Bank of Sri Lanka (CBSL) is the apex financial institution in Sri Lanka. It has been established in 1950 under the Monetary Law Act, No 58 of 1950 (MLA)<sup>7</sup> as 'the authority responsible for the administration and regulation of the monetary and banking system of Ceylon' entrusted with the objectives of monetary policy, exchange rate policy, promoting and maintaining a high level of production, employment and real income in Sri Lanka and encouraging and promoting the full development of the productive resources of Sri Lanka.<sup>8</sup> Mr John Exter, the Founder Governor of the CBSL who also drafted the MLA, in his recommendations to establish a central bank had stated that the 'establishment of the Central Bank should greatly strengthen the banking system. Through its power to examine

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<sup>7</sup> It was established as the Central Bank of Ceylon and was renamed as the 'Central Bank of Sri Lanka' in 1985.

<sup>8</sup> Monetary Law Act No 58 of 1949, s 5

and supervise the operations of the commercial banks, it can prevent them from engaging in unsound banking practices and thus protect Ceylon depositors against bank failures’ (Exter 8). In 2002, the MLA was revised and the objective of preserving the stability of the financial system was added.<sup>9</sup>

The main deposit taking institutions that are authorised by the CBSL are the licensed commercial banks, the licensed specialised banks (hereinafter collectively referred to as ‘banks’) and the licensed finance companies (finance companies). The banks and finance companies are the predominant holders of the deposit liabilities in the financial system (Central Bank of Sri Lanka 178). The co-operative societies established under the Co-operative Societies Law No. 5 of 1972 and other micro finance institutions too accept deposits. The supervision of banks is entrusted to the Bank Supervision Department of the CBSL. The Department of Supervision of Non-Bank Financial Institutions supervises licensed finance companies and registered finance leasing establishments (Central Bank of Sri Lanka, Objectives, Functions & Organization).

The laws applicable to banks in Sri Lanka are mainly the Banking Act No 30 of 1988, the Foreign Exchange Act No. 12 of 2017, the Companies Act No. 7 of 2007, the Finance Leasing Act No. 56 of 2000 and the Financial Transactions Reporting Act No. 6 of 2006.<sup>10</sup> For finance companies all the laws mentioned above apply except the Banking Act which is replaced by the Finance Business Act No. 42 of 2011.

The statutory duties, responsibilities and powers entrusted to the CBSL to carry out its functions would be critically examined hereunder. Subject to criticism (Delis and Staikouras 511-512) of being vague, the Core Principles for Effective Bank Supervision -(BCPs) issued by the Basel Committee on Banking Supervision act as a benchmark for establishing key components of financial supervisory systems (IMF 25).

### **3.1 Licensing**

Banking is founded on trust and confidence, hence preserving the integrity of the system by making it impenetrable by fraudulent, incompetent and financially unsound persons is a key requirement of supervision. According to Lastra, licensing is the screening stage that prevents unsuitable persons from entering the financial sector (R. Lastra 110). While licensing is an integral part of financial supervision, some scholars argue that licensing coupled with supervision *stricto sensu* would create a bubble of complacency for depositors where a false sense of security would exist (Cartwright 298, 301).

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<sup>9</sup> Monetary Law (Amendment) Act No. 32 of 2002, s 2

<sup>10</sup> All laws are available in the electronic form at [http://www.lawnet.lk/list\\_page.php?id=3](http://www.lawnet.lk/list_page.php?id=3).

The Monetary Board, with the approval of the Minister of Finance, is empowered to license commercial banks (LCBs) and specialised banks (LSBs) in terms of Sections 2 and 76A of the Banking Act. The finance companies are licensed under Section 5 of the Finance Business Act.<sup>11</sup> For both banks and finance companies provisional approval may be granted prior to issuing a license.<sup>12</sup>

The main exemption to licensing is contained in Section 31 of the Banking (Amendment) Act No. 33 of 1995 whereby, inter alia, a building society incorporated under the National Housing Act (Chapter 401) or a non-profit organisation that accepts deposits only from its registered members under the prior written approval of the Monetary Board are exempt from the requirement to obtain a license to accept deposits.

According to the BCPs, a financial supervisory agency should clearly define the permissible activities of licensed banks. Barth et al argue that due to conflicts of interest, increased risk taking due to availability of safety nets and the formation of large financial conglomerates that are too big to supervise, restrictions should be placed on permissible activities of banks (Barth et al. 3-4). Schedules 2 and 4 of the Banking Act set out the permissible activities for banks in Sri Lanka that include accepting deposits and granting loans and advances; dealing with securities; and engaging in hire-purchase services, factoring and leasing. The banks in Sri Lanka are not permitted to engage in insurance activities and real estate investment, development, and management. The Sri Lankan practice in this regard is in line with most low or middle income economies in the world.

As per the BCPs, the supervisor must restrict the use of the word 'bank' in the name of institutions.<sup>13</sup> The restriction is expected to prevent the general public from being 'misled by unlicensed, unsupervised institutions implying otherwise by the use of "bank" in their titles'. Section 16 of the Banking Act of Sri Lanka mandates the use of, as part of the name of a licensed bank, any of the words "bank", "banker" or "banking", or any of its derivatives, transliterations, or their equivalent in any other language and prohibits the use of such words in the name or the description of any other institution except with the prior written approval of the Monetary Board. However, the effectiveness of this prohibition is undermined by the exceptions in subsection (3) of section 16 of the Banking Act which extends to, *inter alia*, subsidiaries of banks that could use the word 'bank' in their names even though they are not licensed banks. Even when the equity investment in the subsidiary is sold by the bank, there are no provisions in the Banking Act to remove the word 'Bank' from its name. Therefore, in order to mitigate the confusions that may arise, the CBSL has been conducting extensive public awareness programmes to educate the public of the licensed deposit taking

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<sup>11</sup> Finance Business Act, No 42 of 2011

<sup>12</sup> Banking Act, s 3(4); Finance Business Act, s 5 (3) (b)

<sup>13</sup> Principle 2

institutions. In Sri Lanka, finance companies are licensed by the Monetary Board under Section 2 of the Finance Business Act and the usage of the word ‘finance’ in the name of companies has been restricted to licensed finance companies<sup>14</sup>

As per the BCPs, clear and objective criteria promote transparency of the licensing process and also make it resistant to political influence and interference (See Principles 15 and 16). In Sri Lanka, the Monetary Board is required to satisfy itself as to the suitability of the applicant having regard to the interests of the national economy, including the banking needs. According to the evaluation criteria published by the Monetary Board, an applicant should satisfy the Board in particular on the history of the company; the financial status, experience and suitability of the directors and key officers; the adequacy of the capital and the ability to comply with the provisions of the law.

In summary, licensing procedure in Sri Lanka appears to be sound and comprehensive, and also, conform to the requirements of the BCPs.

### **3.2 Supervision *Stricto Sensu***

Lastra refers to supervision *stricto sensu* (prudential supervision) as the ‘monitoring of the safety and soundness of a financial institution during its healthy life’ (R. Lastra 110). Prudential supervision includes onsite and offsite supervision, spot examinations and continuous supervision by way of reporting requirements (Basel Committee 2). The CBSL has adopted the risk based supervision (RBS) approach, which focuses on identification and management of risks and the assessment of adequacy of resources to mitigate risks as opposed to relying on historical data to carry out point-in-time assessments. Minimum capital, liquidity, classification of loans and advances and provisioning, fit and propriety of directors and key management officers, deposit insurance and single borrower limits are some of the areas on which directions have been issued by the Monetary Board. Compliance with directions is mandatory.

Supervisors conduct on-site examinations by visiting the premises of financial institutions to gather information and peruse records. The conduct of on-site examinations and spot examinations of banks is sanctioned under sections 41 and 76L of the Banking Act and Sections 29, 29A and 29B of the Monetary Law Act. The purpose of the on-site examination is to ascertain whether a bank is in sound financial conditions and whether its business has been carried on in accordance with the provisions of the law. In the process, all books and records including minutes of meetings of the board of directors, accounts, vouchers, title deeds and other documents and records relating to the business of the bank would be

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<sup>14</sup> Finance Business Act, s 10 (2)

perused on sample basis according to the internationally accepted CAMEL model (Capital Adequacy, Asset Quality, Management, Earnings and Liquidity).

The licensed finance companies are examined in terms of Section 24 of the Finance Business Act. The on-site examination of the finance companies has been strengthened by extending the powers of the supervisors to obtain search warrants in instances where resistance is anticipated. To address any shortcomings or noncompliance revealed at an on-site examination, corrective action is recommended by the CBSL. The on-site examination reports are submitted to the Monetary Board. On-site supervision enables the supervisor to independently verify the veracity of the information provided by the financial institution and also the quality and reliability of the internal control mechanism as at a particular time.<sup>15</sup> The effectiveness of an on-site examination lies also in its frequency. A study (Plank et al. 26) suggests that there is a positive correlation between the frequency of on-site audits and banking discipline. Delis and Staikouras (513) argue that intensifying the frequency of examinations beyond a certain threshold may constrain bank risk. The Banks and finance companies in Sri Lanka are subject to on-site supervision at least once in every two years.<sup>16</sup> The Standard & Poor's Ratings Services (Standard and Poors') has expressed its concerns over the low frequency of on-site examinations as 'not being sufficient' to assist the supervisors in an early detection of accumulating risks. The CBSL, however, has refuted the claim on the basis that where risks have been flagged at regular onsite examinations, such banks have been supervised more closely with follow up/spot examinations on a regular basis.

Off-site or continuous supervision is an important monitoring mechanism. The CBSL, as a part of continuous supervision requires the financial institutions to provide a continuous flow of information at given intervals to identify risks, stresses, non-compliances and the corporate affairs of such entities. The data returns from banks and finance companies are fed into the two electronic surveillance systems maintained at the Bank Supervision and Non-Bank Supervision Departments of the CBSL. Each system flags potential threats and weaknesses across the industry, which facilitates the identification, management and mitigation of systemic risk. Spot examinations are carried out to further investigate the issues flagged by the surveillance system.

The CBSL has published a list of qualified auditors to carry out external audits of banks in terms of the Banking Act. The banks and finance companies are required to submit audited financial statements to the CBSL and also publish the same in newspapers in Sinhala, Tamil and English languages.

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<sup>15</sup> Delis and Staikouras (n 81) 513

<sup>16</sup> Ibid

The supervisory role of the CBSL has been under intense public pressure since the collapse of an unregulated deposit taking institution in 2008. One of the sovereign rating agencies, Standards and Poor's, in its 2012 Country Assessment has commented that finance companies have been 'weakly' supervised and that the banking regulations in Sri Lanka are 'somewhat weaker than international standards'. However, Delis and Staikouras (511, 519) argue that "letter-of-law evaluations supplemented by the opinions of experts" on the basis of "vague" BCPs is a flawed methodology. Hence, the true assessment of the fragility of the Sri Lankan financial system is debatable.

### **3.3 Sanctioning**

The enforceability of regulations is the true test of effective supervision (Bhattacharya and Daouk 75, 79). The CBSL is empowered to take a wide array of actions to enforce the provisions of the Banking Act and the Finance Business Act, which includes the powers to issue orders, initiate action in a court of law and also, to suspend or cancel a license.

In terms of the Banking Act, where the Director of Bank Supervision (DBS) is satisfied that a licensed commercial bank (LCB) has carried on its affairs in a manner that causes loss to depositors or other creditors or has failed to comply with the provisions of the Banking Act, the DBS may issue cease and desist orders or direct the bank to take steps to comply with the Act or correct the conditions resulting from failure. Similar provisions are also applicable for licensed specialised banks (LSBs).

The Finance Business Act which was enacted in 2011, carries extensive sanctions. In the case of finance companies, on a report submitted by the Director of the Department of Supervision of Non-Bank Financial Institutions (D/SNBFI) that a licensed finance company has carried on its affairs in a manner that causes loss to depositors or has failed to comply with the provisions of the Finance Business Act, the Monetary Board may impose a penalty; issue a cease and desist order, publish the name of the finance company as a finance company regarding which the Board has serious supervisory concerns; appoint a manager; appoint a Central Bank officer as a representative; remove any director, manager or employee of the finance company; and also reorganise the share capital of the finance company. Violation of the provisions of the Finance Business Act constitutes an offence, which, on conviction after a trial before a Magistrate, is given a penalty not exceeding three year imprisonment, a fine not exceeding three million rupees or both can be imposed as specified in the Act.

The exercise of sanctioning powers of the CBSL is subject to secrecy and not disclosed to the public. However, in 2007, the Monetary Board issued corporate governance directions to banks that contained a direction as follows:

‘A statement of the regulatory and supervisory concerns on lapses in the bank’s risk management, or non-compliance with these Directions that have been pointed out by the Director of Bank Supervision, if so directed by the Monetary Board to be disclosed to the public, together with the measures taken by the bank to address such concerns’<sup>17</sup> (Emphasis added).

A similar direction has been issued to finance companies in 2008<sup>18</sup>.

However, no directions have been issued so far by the Monetary Board directing banks or finance companies to disclose lapses/noncompliance with the law. Hence, it appears that the possibility of being ‘directed to disclose’ is expected to act as a deterrent more than being a sanction.

The CBSL has been alleged to be inefficient in some areas in carrying out its regulatory and supervisory duties including administering sanctions to licensed institutions, which in turn has exposed it to public, legislative and judicial scrutiny. During the period 2000-2011, No director or key management official of a bank or finance company has been prosecuted under the Banking Act, the Finance Companies Act (now repealed) or the Finance Business Act by the CBSL. Even though legislative changes have given more powers to the supervisor to initiate action against noncompliance or unlawful conduct, no action has been filed by the CBSL against any director or officer of a regulated institution. Further, consequent to the collapse of 13 finance companies in the early 1990s, the Finance Companies Act has been amended in 1991 introducing provisions for recovery of assets that are misappropriated or improperly utilised by any director or officer of a finance company<sup>19</sup>. The timing and the contents of the amendment indicate that the new provisions have been introduced swiftly to be made use of under the crisis situation that prevailed at the time. However, no action has been taken by the CBSL under the said amendment. The failure of 13 finance companies and the actions taken by the CBSL to prevent the failures have been criticised by the Parliamentary Committee on Public Enterprises and subsequently, a Presidential Commission of Inquiry had been appointed to examine, inter-alia, the findings of the report of the Public Enterprises of the Parliament of Sri Lanka and the individual conduct by the relevant officials of the CBSL, who were in charge of the regulation and supervision of banking and non-banking financial sectors during the period 1991 to 2005. The findings have been reported on 15 December 2008 to H.E. the President (“The Report of the

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<sup>17</sup> Corporate Governance for Licensed Commercial Banks in Sri Lanka, No. 11 of 2007, Direction 3(8)(ii)(i); Corporate Governance for Licensed Specialised Banks in Sri Lanka, No. 12 of 2007, Direction 3(8)(ii)(i)

<sup>18</sup> The Finance Companies (Corporate Governance) Direction, No. 3 of 2008 direction 10(2)(i)

<sup>19</sup> The Finance Companies (Amendment) Act No 23 of 1991, s 5

Presidential Commission of Inquiry into Matters Relating to Failed Finance Companies”) however, the report has not been published.

On a positive note, during the liquidity crisis in 2008-9, the Monetary Board has broadly interpreted the powers contained in the Finance Companies Act and has taken measures outside the scope of the Finance Companies Act in order to preserve the system stability. The measures taken include the removal of the board of directors, issue of new shares and appointment of managing agents to the finance companies in liquidity stress without following the statutory procedure of suspension of license, which in any event would only exacerbate the crisis.<sup>20</sup> The public had been made aware of the measures adopted by the CBSL through regular press notices.<sup>21</sup>

The CBSL was under heavy public criticism for failing to administer sanctions against illegal deposit taking institutions. Under the Finance Companies Act No. 78 of 1988 (now repealed) which was the fundamental statute to supervise non-bank deposit taking institutions from 1988 to 2011, adequate provisions were not available to restrain illegal deposit taking institutions and no definition for the term ‘deposit’ existed. The conduct of finance business without authority was an offence that required proof of accepting money as deposits and lending and investments of the same. The lacuna had resulted in several unscrupulous companies being set up as ‘finance companies’ accepting deposits from the public and solely using the said funds for consumption purposes without making any investments or granting loans (Fuard). In 2008, the Monetary Board has determined that 6 persons/companies have carried on unauthorised finance business. However, the CBSL did not institute legal action against all of the said persons, which seriously undermines the enforceability of sanctions in the law and the effectiveness of supervision of the CBSL. The law has since been strengthened by granting more power and more flexibility to the supervisor.

### **3.4 Crisis Management**

In the crisis management stage, damage mitigating mechanisms are set in motion. While some crisis management mechanisms induce moral hazard, a discussion of same is outside the scope of this Paper.

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<sup>20</sup> Central Bank of Sri Lanka, ‘Press Release: Central Bank Begins Implementation of Stimulus Package and Intervenes to Stabilise Registered Finance Companies of the Ceylinco Group’ (CBSL, 6 March 2009) <[www.cbsl.gov.lk/pics\\_n\\_docs/latest\\_news/press\\_20090306e.doc](http://www.cbsl.gov.lk/pics_n_docs/latest_news/press_20090306e.doc)>

<sup>21</sup> N 16

### **3.4.1 The Lender of Last Resort (LOLR) function of the Central Bank**

Deposit taking institutions are exposed to and inalienable from liquidity risk owing to their function of transforming liquid liabilities to illiquid assets (Davis) whereby solvent institutions could be illiquid and insolvent within a short period of time. The notion that it is 'generally possible to distinguish illiquidity from insolvency' has been discarded by Goodhart as a myth (C. A. E. Goodhart 339, 343). Therefore, one of the crucial functions of a central bank would be to provide lender of last resort facilities in the wake of illiquidity.

In Sri Lanka, the CBSL performs dual functions of conducting the monetary policy and supervising the financial system. Basing their findings on 104 bank failures in 24 countries, Goodhart and Schoenmaker assert that there is no requirement to separate the functions of monetary policy and financial stability (Goodhart and Schoenmaker 539, 556). Therefore, it can be stated that the dual role played by the CBSL does not hinder its ability to exercise the LOLR function.

The CBSL is empowered under Section 86 of the Monetary Law Act to grant lender of last resort assistance to banks. Further, under the Finance Companies Act, No 78 of 1988, it was empowered to grant direct loans or refinance loans to finance companies in distress. The CBSL has not exercised the LOLR function for the last 10 years, which may be attributable to bad experience of non-recovery in full of the loans granted during the financial crisis in early 1990s, where the CBSL had granted a sum of Rs. 2.7Bn to 13 failed finance companies as refinance and direct loans (Gnanadass). Consequently, being embroiled in long winding up processes, the recoverability of the said loans has been minimal. The Committee on Public Enterprises (COPE) has in its Second Report found that "the CBSL has failed, neglected and acted in a lethargic manner in relation to the recovery of a sum of Rs. 7000 million which had been granted to bankrupt financial companies". The criticism levelled against the CBSL for failure to recover the loans granted in 1990s may have made it once bitten twice shy to grant loans to finance companies during the liquidity crisis during 2007-8.

### **3.4.2 Availability of a Deposit Insurance Scheme**

The CBSL has implemented the Sri Lanka Deposit Insurance Scheme (SLDIS) in terms of the Monetary Law Act with effect from October 1, 2010. All banks and finance companies have been required to obtain its membership. In an event of cancellation or suspension of a license of a bank or a finance company, each depositor would be entitled to a payment of not exceeding Rs. 600,000. The deposits of member banks and finance companies, Government of Sri Lanka, shareholders, directors, key management personnel, other related parties, abandoned property and dormant accounts have been excluded from the scheme. The SLDIS is a pre-contributed DIS where the initial capital has been borne by the CBSL and a premium is required to be paid by members on a monthly or quarterly basis.

Consequent to suspension and/or cancellation of license of a few finance companies, the effectiveness of SLDIS is currently being tested.

### **3.4.3 Resolution mechanism**

The Monetary Law Act, the Banking Act and the Finance Business Act provide for the winding up of banks and finance companies. However, the winding up of deposit institutions have proved to be lengthy and caused inordinate hardships to depositors. For example the winding up order for Mercantile Credit Limited had been issued in 2005 by the District Court of Colombo whereas the company was bankrupt in 1990.

The CBSL has thus, in the absence of similar provisions in the law, prepared a resolution plan for banks and finance companies which allow the CBSL to intervene and stabilise an institution prior to its failure (Ratnasiri 185), which includes deposit insurance, purchase and assumption, bridge banking, open-bank assistance. The traditional resolution methods of restructuring, mergers and acquisition and finally, liquidation have also been included in the resolution plan of the CBSL. To set the resolution plan in motion, several quantitative and qualitative trigger points have been identified including continuous decline in deposits, capital adequacy, cash balances or the liquid assets ratio or increase in the non-performing loans ratio.

In 2008, the Monetary Board invoked the provisions of Section 30 of the Monetary Law Act to contain the issues at a Systemically Important Bank in Sri Lanka, the Seylan Bank PLC. Being a member of a financial conglomerate with (as in 2008) 6 finance companies, 2 leasing companies and 2 banks, a run on Seylan Bank instigated by the failure of an unregulated deposit taking institution within the group was threatening the stability of the wider financial system. The CBSL having prepared for a crisis, had set in motion the resolution plan and replaced the board of directors, appointed a managing agent and called for liquidity injections from a state bank without disrupting the banking services of the bank. The Bank was open for business on the following day. The swift action of the CBSL had been commended by the Standard and Poor's Rating (Standard and Poor's).

While resolution of licensed deposit taking institutions have been addressed by law and through policy measures by the CBSL, resolution of unregulated deposit taking institutions have only led to long drawn court cases with no result either for the depositors or for the regulators. In terms of the Finance Companies Act (repealed in 2011), the options available to the CBSL were to require the institution to obtain registration, repay the depositors or wind up the institution, From 1988 to 2011, the CBSL has not commenced winding up proceedings of any unauthorised deposit taking institution. The Finance Business Act has given the CBSL more flexibility in this regard.

## 4. Legal liability for depositor losses – a myth or a reality?

### 4.1 Immunity from suit vs Accountability?

Immunity has roots in independence. Dempegiotis quoting Friedman states that an independent central bank is generally regarded as the 'most efficient' institutional framework to attain monetary as well as financial system stability (Dempegiotis 131). Hence immunity may promote efficiency of central banks. The first principle of the Basel Core Principles (BCPs) states that the financial supervisors should be operationally independent but remain accountable for the discharge of its duties. It further states that the supervisors should have legal protection when exercising their duties under the statutes.

Dempegiotis (131) defines accountability as 'an obligation' of which, execution would be measured on 'specific criteria' and which ex-post requires 'justification' of actions and assumption of responsibility for failure. Lastra and Shams categorises accountability of central banks under 'Public accountability' (Lastra and Heba Abstract). Immunity accorded to public officials when executing public duties have been frowned upon on the basis of want of democracy and rule of law in the process. The financial supervisors have not been 'elected' by the people to govern the financial sector. They are viewed as a group of 'white-collared gentlemen' who form a bureaucratic government that enjoys legal, operational and decisional freedom (Dempegiotis). The financial supervisors world over are hence subject to accountability to the three organs of the Government, the Executive, the Legislature and the Judiciary to curb exercising unfettered discretion in matters that concern the public at large.

The CBSL enjoys operational independence from the Government. However, the inclusion of the Secretary to the Ministry of Finance as a member of the Monetary Board had been critiqued by the IMF on the basis that it undermines the operational independence of the CBSL (Caruana and Burton).

The legal protection accorded to financial supervisors is largely to avoid the psychological factors of fear or favour being interferential in the execution of its duties. In a study undertaken by the World Bank Group on 20 jurisdictions, it has been observed that the fear psychosis enlarges with the amount of stress in the system (Washington et al.). Further, it has been observed that most jurisdictions accord statutory protection for supervisors in the circumstances where the supervisor (employee) has carried out the function in good faith within the scope of his employment.

The financial supervisors in many jurisdictions have been subject to legal action by depositors but none so famously as in the series of cases instituted by the Three Rivers District Council against the Bank of England (BOE), involving the collapse of the Bank of Credit and Commerce International (BCCI), claiming that the BOE had breached its

obligations under the First Banking Co-ordination Directive and that it had been guilty of misfeasance in public office. The case, of which the details are now well known (Arora 487), was the first case of its kind faced by the BOE in its three-centuries-long existence. While the case was adjourned by the liquidators of the BCCI in 2005, the academic interests have been reignited by the collapse of the Northern Rock Bank (NR) in September 2007 (Gray 37). However, due to the nationalisation of the NR (“TIMELINE-Northern Rock Nationalised”), depositors’ interests have been safeguarded hence there appears to be no likelihood of a case being instituted against the FSA on the same grounds.

With great power comes great responsibility, and also accountability. The nexus between the financial power concentrated in regulators (and also in some financial institutions as seen during the LIBOR scandal in the UK (Peston) and public accountability should be strengthened. However, this Dissertation would be limited to a discussion on the accountability of the financial sector supervisor and its legal liability, as a detailed dissection of immunity, responsibility and accountability would fall outside the ambit of this essay.

Proctor argues on the basis of the judgments in *Davis v Radcliffe* (WLR) and *Yuen Kun-Yeu v Attorney General of Hong Kong* (AC) that depositors cannot sue the regulator for the tort of breach of statutory care, neither for losses from negligent supervision (Proctor 23). He points out that the Common Law courts have held continuously that the financial regulatory function is for the protection of markets and depositors as a whole and falls short of private duty of care (71).

The officers of CBSL are accorded legal protection under Section 47 of the Monetary Law Act whereby except on grounds of misconduct or wilful default, no member of the Monetary Board or officer or servant of the CBSL shall be liable for any damage or loss suffered by the bank. In terms of the Finance Business Act prior sanction of the Attorney-General is mandatory to institute prosecution. However, the law has not excluded legal scrutiny of any act done, order made or decision given by the CBSL as no immunity from suit has been accorded.

## **4.2 Case Studies**

In the wake of the liquidity crisis in 2007, the depositors of several unregulated entities and one licensed finance company instituted action against the CBSL alleging, inter-alia, negligence and bad faith in carrying on its duties as the financial supervisor. The following is an analysis of the final/interim orders given by the courts and the implications of same on the CBSL.

#### **4.2.1 Failure of the Sakwithi House Construction (Pvt) Limited**

A company named 'Sakwithi House Constructions (Private) Limited' owned and managed by a person named Sakwithi Ranasinghe a.k.a. Chandana Weerakumara Ranasinghe had been investigated by the CBSL under section 11 of the Finance Companies Act to ascertain whether such person is carrying on finance business illegally. Ranasinghe had placed advertisements in print and electronic media over several years soliciting funds from the public which had prompted the CBSL to commence its investigation. Ranasinghe, in an apparent attempt to distance himself from the application of the Finance Companies Act had issued documents titled 'letter of employment in Sakwithi House Construction Limited (Sakwithi House)' in lieu of certificates of deposit (Faurd). During the investigations by the CBSL, Ranasinghe had allegedly fled the country in September 2008 defaulting approximately Rs. 900 million of 5000 depositors (Fuard).

Consequently, on 25 September 2008, the CBSL published notices informing the public that 'Sakwithi House Constructions (Private) Limited' is not a registered finance company and is not authorized to carry on finance business by accepting money from the public as deposits or in any other form.<sup>22</sup>

A Fundamental Rights Application was filed in the Supreme Court of Sri Lanka by one of the depositors seeking compensation from the CBSL alleging negligence on the part of the CBSL for failing to protect the public from the illegal scheme operated by Ranasinghe by acting in a timely manner (Ramanayake). The case was in limine dismissed by the Supreme Court on the basis that there are no grounds on which Petitioner's fundamental rights have been violated by the CBSL.

It therefore appears that the court had been reluctant to interpret as certificates of deposits any document which does not carry the word 'deposit' and to adduce liability to the CBSL in an event when a person has made deposits with a company that by the plain reading of its name does not denote in any way to be a bank.

#### **4.2.2 Failure of the Golden Key Credit Card Company Private Limited**

The Golden Key Credit Card Co. Limited (GKCL), a member of the Ceylinco Group a diverse conglomerate in Sri Lanka, had been issuing credit cards to the public on accepting 'security deposits' in cash. The company had been offering rates of return in the range of 24% to 30% p.a. on the said 'security deposits' and had held about Rs. 26 Bn on behalf of about 10,000 depositors.

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<sup>22</sup> CBSL, 'Conduct of Finance Business by Unauthorised Persons' (CBSL, 25 September 2008)  
<[http://www.cbsl.gov.lk/pics\\_n\\_docs/02\\_prs/\\_docs/notices/notices%20to\\_public\\_20080925e.pdf](http://www.cbsl.gov.lk/pics_n_docs/02_prs/_docs/notices/notices%20to_public_20080925e.pdf)>

The business of the company had been investigated by the CBSL in 2006 and due to the nature of the company being similar to issuing payment cards, a decision had been taken to regularise the company in terms of a regulation to be issued with regard to payment cards.<sup>23</sup>

Consequent to the failure of the Sakwithi House in September 2008, the depositors of the GKCL have been demanding the return of the funds on an immediate basis. On 27 December 2008, the CBSL had issued a press release assuring the depositors of regulated institutions of the safety of their investment<sup>s.24</sup> GKCL failed in December 2008.

A Fundamental Rights Application was filed in the Supreme Court of Sri Lanka by a group of depositors seeking compensation from the CBSL alleging negligence on the part of the CBSL for failing to protect the public from the illegal scheme operated by the GKCL (Selvanayagam, S).

The Supreme Court, for the first time in the history of the CBSL, directed the CBSL on 23.03.2009 and 30.03.2009 to determine that the GKCL had been carrying on finance business without authority and to take action under section 11 of the Finance Companies Act. The court further directed the CBSL, inter- alia, to obtain a Declaration of Assets and Liabilities from directors and key officers of the GKCL and suspend such person's bank accounts and obtain details of the balances.

The Court appointed a Committee of Chartered Accountants (CCA) on 18 May 2009 to prepare a list of the depositors and formulate a scheme of payment (Selvanayagam, S). The Secretariat of the CCA was established in the CBSL (Weerarathne). The CCA had taken steps to repay the depositors by disposing the assets of the company on a staggered basis.<sup>25</sup> Thereafter, a Task Force was approved of by the Supreme Court to identify assets of the company, sell the same and make payments to the depositors, whereas at April 2014, Rs. 2.036 Bn has been repaid to the depositors.<sup>26</sup> As a final settlement of the said case, on 04.08.2015, a methodology has been filed of record in the Supreme Court, whereby the Treasury would advance funds upto Rs 8.5Bn to repay the security deposit holders of the GKCCCL. Accordingly, security deposit holders with deposits worth Rs. 2 million or less will be compensated in less than a month while depositors with upto Rs. 10 million rupees

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<sup>23</sup> Gerald Ranasinghe vs The Monetary Board and 16 others (2009) SCFR 192/2009

<sup>24</sup> Bank Supervision Department, 'CBSL on Golden Key Issue' (CBSL, 27 December 2008) <[http://www.cbsl.gov.lk/htm/english/02\\_prs/p\\_1.asp?yr=2008](http://www.cbsl.gov.lk/htm/english/02_prs/p_1.asp?yr=2008)>

<sup>25</sup> Similar measures have been adopted by the Supreme Court in Susil Gunadasa Illangasinghe et al vs The Monetary Board and 21 others which relates to the failure of Ceylinco Shriram Capital Management Services Limited, and E DE Soyya vs The Monetary Board and 34 others which relates to the failure of F&G Real Estate Company (Private) Limited. Both institutions have engaged in unauthorised solicitation of deposits.

<sup>26</sup> <http://www.ft.lk/2014/07/26/golden-key-announces-completion-of-phase-3/>

will be compensated within two months and depositors who have deposits greater than Rs. 10 Million, within a year.

In another development, due to the delay in settling the said liabilities within the time periods set out in the modalities, a Contempt of Court action has been filed by the security deposit holders of GKCCCL against the Monetary Board of the Central Bank and the Minister of Finance (“Golden Key Depositors’ Complaint – Contempt Case against CB: SC Re-Fixes for 17 January | FT Online”). The said case is ongoing as at the date of this paper.

#### **4.2.3 Liquidity crisis at Industrial Finance Limited (IFL)**

IFL, a licensed finance company had been severely affected by the liquidity crisis in 2007 where it was unable to repay the deposits on demand. It is alleged that the liquidity crisis had been the result of a transfer of deposits to IFL from an unauthorised deposit taking institution, without transferring assets to the equivalent value.<sup>27</sup> In order to contain the crisis, the CBSL appointed the People’s Leasing Company Limited as the Managing Agent of IFL with effect from 16 December 2009 (Wijedasa) and consequently removed the board of directors of the company. The CBSL by directions issued on 12 July 2010 has required IFL to, *inter alia*, convert the deposit liabilities transferred from the unauthorised entity into preference shares. A Writ Application was filed by a Depositors Association in 2010 praying for a writ of certiorari, quashing the direction of the CBSL to convert deposits into shares.

This was the first case filed by depositors of a licensed finance company against the CBSL. In an unprecedented move, the Court of Appeal granted leave to proceed. On 19.07.2012, the Petitioner moved the court to withdraw the application and it has been pro forma dismissed by the Court without costs.<sup>28</sup>

#### **4.2.4 General analysis**

It appears that the Supreme Court of Sri Lanka has taken an active role in granting relief to depositors and has obtained the assistance of the CBSL to establish a repayment mechanism for the depositors of failed financial institutions irrespective of the illegal nature of the business carried on by such institutions. The unusual and unprecedented measures adopted by the Supreme Court reveals a lacuna in the Sri Lankan financial systems where there is no asset management mechanism in place to restructure or dispose of assets of distressed

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<sup>27</sup> *Industrial Finance Depositors Society Limited vs The Monetary Board and 3 others* (2010) CA Writ Application No 865/2010, paragraph 11

<sup>28</sup> Similarly, a case instituted by the depositors of Central Investment and Finance Ltd has been dismissed by the Court of Appeal. <http://www.sundaytimes.lk/140622/business-times/appeal-court-dismisses-case-by-cifl-depositors-opposing-central-bank-recovery-plan-104036.html>

companies. In the circumstances, the Court has relied upon the supervisor of the financial system to provide assistance to formulate a repayment mechanism.

The Supreme Court has issued orders on the CBSL to make determinations under Section 11 of the Finance Companies Act with regard to companies carrying on unauthorised finance business. These orders appear to negate the decisional independence of the Monetary Board, where it is the sole authority in Sri Lanka to determine whether a person is carrying on finance business. The Court, however, being consistent with judgments of foreign courts, had not determined that the CBSL should compensate the depositors.

The effectiveness of the supervisory powers of the CBSL has been challenged before the Court of Appeal in the Industrial Finance Company Case where the Court has granted leave to proceed. The granting of leave to proceed itself is indicative of the fact that the Court is willing to make judgment on the capabilities and bona fides of the CBSL in executing its functions. This case however was dismissed by the Courts after 2 years of hearing on the application of the Petitioner.

In conclusion, the case studies indicate that the Courts in Sri Lanka have not determined that the financial supervisor is liable for depositors' losses. However, it appears that the Sri Lankan financial sector lacks an agency to revive or restructure failed financial institutions and such lacuna has been de facto filled by the Supreme Court of Sri Lanka through the CBSL and a Committee of Chartered Accountants, which comprises civilians with no statutory powers.

## **5. Conclusions and Recommendations**

A stable and a well-developed financial system is key to economic development. In order to preserve financial stability, to safeguard the reputation of the financial markets and to protect the interests of the depositors, an effective financial supervisor is a vital need, promoted by legal, political and economic quarters.

In Sri Lanka, the Monetary Law Act has conferred on the Central Bank of Sri Lanka (CBSL), the responsibility of maintaining the financial system stability. Analysing the Sri Lankan laws pertaining to banks and finance companies, it is clear that the statutes have provided for a supervisory structure in line with the Basel Core Principles (BCPs). Its licensing procedure and supervision *stricto sensu* is in compliance with the standard expected from the BCPs and follows the rationale of supervision.

However, it is observed that in the areas of exercising sanctions the CBSL has shown weaknesses which may expose the CBSL to supervisory failures. Cartwright quoting

Galbraith states that 'Regulatory bodies, like the people who comprise them, have a marked life-cycle. In youth they are vigorous, aggressive, evangelistic, and even intolerant. Later, they mellow, and in old age — after a matter of ten or fifteen years, they become, with some exceptions, either an arm of the industry they are regulating or senile' (Cartwright 298, 301). It is up to the CBSL to assume its powers and execute all aspects of supervision with equal efficiency and vigour. In the case of licensed finance companies the new law has conferred more power and flexibility to the CBSL, which if not exercised, the CBSL would run the risk of being subject to Writs of Mandamus compelling it to perform its duties. The crisis management measures adopted by the CBSL have proven to be practical and successful in the instance of the rescue of the Seylan Bank, a systemically important bank in Sri Lanka that was rescued amidst a liquidity crisis that affected the entire financial sector. Hence, the powers granted by laws to the CBSL can be stated as being adequate to execute its supervisory functions.

It was observed that the CBSL enjoys operational independence but also is accountable to the executive, legislature and the judiciary. However, in terms of the Monetary Law Act, the supervisors do not have immunity from suit hence the decisions and actions taken by the officers of the CBSL can be subjected to judicial review. The recent cases instituted against the CBSL by some depositors of both licensed and non-licensed deposit taking institutions were studied in the backdrop of the adequacy of supervision. The Supreme Court has not decided, quite rightly so, that the CBSL should repay the depositors of failed deposit taking institutions. However, the Court has involved the CBSL in the mechanism established by the Court to repay the depositors. The involvement of the CBSL in the repayment process falls outside the scope of its objectives and gives rise to conflict of interests where it is required to be a member of a team to resolve a failed financial institution at the same time being the financial sector supervisor for licensed banks and finance companies.

The analysis of the determinations of the Supreme Court and actions taken by the CBSL reveals several lacunas in the Sri Lankan financial sector, namely the lack of an institution to restructure failed financial institutions, non-availability of a statutory special resolution regime and an exclusive fast tracked liquidation process for financial institutions. The case study revealed that the financial supervisor is involved in the court processes not as a punishment for lax supervision or as an indication of the liability of the CBSL to repay the depositors but to fill the lacuna in the financial system.

In the circumstances, it is recommended that an orderly liquidation mechanism be established in Sri Lanka by a statute that is empowered to liquidate a failed financial institution more effectively than the civil courts. It would be both time and cost efficient and the depositors and other creditors would receive a higher repayment in terms of time value of money. The entity should be independent from the CBSL and should not involve itself in any supervisory activities.

Further, in respect of licensed banks and finance companies which are systemically important, an effective resolution regime is recommended to be established with statutory powers in order to avoid systemic disruptions and losses at instances of instability or failure. The Financial Stability Board has published a report (Key Attributes of Effective Resolution Regimes for Financial Institutions) which can be *mutatis mutandis* adopted to suit the financial system of Sri Lanka.

In conclusion, it can be stated that the judicial review of the functions of the CBSL and involvement of the CBSL in the repayment of deposits indicate the lacunas in the financial landscape of Sri Lanka, which is the absence of a statutory special resolution regime, an orderly liquidation mechanism and an institution to restructure assets of failed financial institutions. Therefore, in order to preserve the independence of the CBSL and to allow its effective execution of statutory duties, the Legislature and policy makers should consider the establishment of a statutory special resolution regime, an orderly liquidation mechanism and an asset restructuring mechanism in Sri Lanka.

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