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**INSOLVENCY PROCEDURE RELATING TO BANKING INSTITUTIONS IN
SRI LANKA**

by
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Insolvency Procedure relating to Banking Institutions in Sri Lanka:

Some points for consideration :

We have experienced our very first bank failure in Sri Lanka and that too of a small specialized bank (not a commercial bank) with no systemic effect.

The Banking Act provides for the cancellation of a licence of a licensed bank and the steps that may be taken after such cancellation. This is ,prima facie , what the Section appears to provide for. However, it may also provide for such resolution to take effect before the cancellation of the licence. The Banking Act has been amended to make this absolutely clear that intervention by the regulator can be even before the licence is cancelled.

The Section provides for the Regulator himself (i.e. the Director of Bank Supervision) or for his appointee to rehabilitate the bank.

From our experience of our first bank failure the question that looms large is –

What is the right time to intervene in a weak bank without precipitating the very failure we are trying to avert through rehabilitation, as a result of market reaction to regulatory intervention.

Will intervention send the wrong signals and cause a run on the Bank? This is only natural as at the first sign of trouble there will be a flight to safety and the Bank will collapse when it could very well have been rehabilitated.

Question 2 – Why is it necessary to suspend banking business?

In this case irregular accounting practices were resorted to to mislead the regulator. Even though the Bank was liquid and able to meet its liabilities, it was doing so with new deposits or through the market at very high risk premiums . Even a freeze on deposits imposed was of no avail as deposits were being mobilized in the guise of investment instruments which the public were not aware of. Todate investors in these so called “money market bills” (as opposed to deposits) believe that they are depositors and not creditors. This distinction is important as in liquidation, creditors do not rank pari passu with depositors and therefore stand to lose.

Question 3 – When you have intervened as a regulator through a freeze on deposits or in some other manner should the public be informed?

This matter came up in this case because of spurious deposit mobilizing schemes which were rampant at that time and the Central Bank had to make public announcement of the financial institutions that were registered with the Central Bank and which were licensed to accept public deposits. The name of the failed bank too was published as, subject to the freeze, it could accept deposits to the extent that the limit was not exceeded. Two weeks after the list of such institutions were published, the Bank’s business was suspended and a liquidation decision was subsequently taken. The fact that the name of this Bank was published notwithstanding it being subject to intervention was challenged. If, indeed, the name of this Bank did not appear on the list published, it would have had adverse reactions from its depositors to its detriment.

Question 4 – How does suspension compare with administration?

It is not the same as the term administration is commonly understood. Even after suspension the Bank continues to be under the control and management of the Board of Directors even though their powers are thwarted by the measures taken by the regulator to prevent them from carrying on banking business. Its assets are frozen and only rudimentary payments are enabled and that too with the consent of the regulator. The role of the regulator in the circumstances is that of a quasi administrator. During the period of suspension the “as is” condition of the Bank is assessed by the regulator and may be with the help of the auditors, and a decision is taken on the measures needed to be taken to rehabilitate the Bank or merge it with a stronger bank etc.

Question 5 – Should the final decision of the regulator be permitted to be challenged in a court of law?

This is the insurmountable challenge we face today over this failed bank where, for the second time, the decision of the Monetary Board, taken bona fide, has been challenged in Court, staying the hand of the regulator to liquidate the Bank and deal with its assets.

This is tantamount to the powers of the regulator over financial institutions under its purview, being usurped by the Court. The Court ordered that the decision to liquidate and cancel the licence be quashed and that the regulator should examine any available options for the recapitalisation of the bank as a going concern. When it was represented that all options had been examined and that the liquidation decision was the last resort, the options available were required to be examined further. The approach and attitude of the court exemplifies a crucial aspect of administration of banks and resolution of weak banks in that judicial intervention could frustrate the efforts of the Regulator to effect an orderly exit of a weak bank.

Question 6 – What are the implications for financial stability in a scenario where weak banks are not permitted to exit in a clean and swift manner as a result of the ignorance of the judiciary to adjudicate on matters relating to banking and finance, especially in view of the fiduciary responsibility of Bank Management which is a feature unique to Bank Management alone.

Question 7 – Is the curtailment of judicial intervention in this instance beneficial to financial stability and what are the constitutional safeguards available to give effect to this policy stance. What is the experience of other jurisdictions. This has been our first bank failure and the moral hazard of regulation was paramount in the expectations of the public that the regulation and supervision of banks by the Central Bank ensured the safety of their deposits regardless of the market signals evident that certain institutions were more risky than others.

Question 8 – What is the alternative to a scenario where it is not only a decision of the Monetary Board to liquidate a bank that can be challenged in a certiorari action, but even a decision of the Monetary Board to appoint a receiver, administrator etc. can be challenged in the same way. We see the answer in educating the judiciary on the policy objectives of regulation and supervision of the banking system and the adverse repercussions of judgements which do not take cognizance of these objectives could have to financial system stability.

What is the result of judicial intervention in regulatory decisions? The meager assets available to depositors in liquidation are dissipated and run down, fast losing their value; employees are able to claim their wages at the expense of depositors funds and the delay in implementation of the liquidation process is detrimental to the interests of depositors and creditors. It is almost 2 years since the first suspension of this bank and a steady depletion of the cash assets available to depositors has resulted through payment of salaries, expenses etc. This is not taking into consideration the considerable pressure on the regulatory and legal resources of the Central Bank as a result.

Finally, it is my considered view that the decision of the regulator should be final on how it proposes to deal with a failed bank. This is based on the principle that it is the prerogative of those who are responsible for the entry of a bank to be responsible for its exit through the cancellation of the banking licence issued to such institution.