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The Application of Corporate Governance Principles in the Banking Sector in Sri Lanka – An Overview

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Abstract

All economies in the world are propelled by banks and the banking industry. Since the end of the war, Sri Lanka's development has been accelerated and banks play a prominent role in the economy as they finance growth and development. Corporate Governance (CG) is seen as a particularly important regime for banks, due to their engagement with public funds, the public's confidence and trust is of paramount importance to a bank's stability. It is crucial that laws and regulations provide a versatile framework for good governance of the banking sector. This study critically examined the state of CG development and its underlying implications in the banking sector. Primarily, the relevant provisions of the Companies Act, Banking Act and the Monetary Law in Sri Lanka were evaluated, in addition to the other relevant laws, in order to ascertain whether they provide an adequate framework to ensure proper CG of banks. The Central Bank of Sri Lanka (CBSL) has improved its capacity over the years to supervise, enforce and maintain financial stability. It ensures the safety and stability of banks at all times and has taken steps to implement risk management, BASEL II, for tight CG of banking. A mandatory code of CG has been issued by the CBSL, requiring all banks to fully comply with the rules on or before the 31st of January 2009. This study also explores the scope, extent, impact and the effectiveness of the supervisory and regulatory role of the CBSL and identifies the challenges faced by it when addressing the CG issues in the banking industry.

Keywords: Banking Industry, Central Bank, Corporate Collapses, Corporate Governance

1. Introduction

A Bank, as the apex financial body and the dominant financial intermediary in a country is essential for all economies in the world. A sound and effective banking system helps develop a country's economy to a greater extent and consequently, allows a country to function smoothly without hassle. The banking system, which is the backbone of an economy, plays a significant role in economic development. As the main depository for the economy, savings banks are important sources of finance for businesses. No growth can be achieved unless savings are efficiently channelled into investment.

Banks are in a unique position that enables them to solicit funds from the public. As a result, there exists an intimate relationship between a bank and its customer, which in essence, is a relationship of trust and confidence. This relationship places a fiduciary responsibility on banks to safeguard depositors' funds. Customers have faith in the banking system that their liabilities on deposits will be repaid and financial requirements will be met. Customers' trust and

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confidence is of paramount importance for the survival and stability of a bank. The nature of the business is such that at least 80% of the banking assets are financed by depositor's funds and only a very low percentage in the range of 5%-10% will be by equity (Moonesinghe, 2005). Thus, banks should be compelled to follow good behavioural practices and safeguard the interests of people who have trusted them and made their savings available by way of deposits for conducting their businesses (Wijewardena, 2009).

2. Statement of Problem

Weak or inadequate CG in the banking sector can contribute to financial instability and expose banks and financial institutions to greater risks. Further, it will also reduce investor confidence in the stability of the banking industry, which may cause investors to divert their funds to other modes of investment. Therefore, introducing a degree of mandatory observance of CG principles for banks and financial institutions is of vital importance in creating a new culture of trust and confidence. CG assures that banking transactions are conducted taking into consideration the aspects of responsibility and accountability. Therefore, in return, the conviction is that, this will assure the safety and soundness of individual banks, resulting in the stability of the banking sector as a whole.

3. Research Objective

This paper examines the CG rules applicable in the banking sector of Sri Lanka in order to determine whether such rules provide the investing public with adequate protection and confidence. It examines the relevant provisions in the Banking Act, No. 30 of 1988 ('Banking Act'), the Monetary Law Act, No.58 of 1949 ('Monetary Law') and the Companies Act, No. 7 of 2007 ('Companies Act') in order to ascertain the reforms related to CG in Sri Lanka, their prominent characteristics and whether they provide an adequate CG framework for licensed commercial banks. In this context, this study focuses on examining their implications on the corporate sector.

4. Research Methodology

This is a qualitative research; mainly, carried out by reference to secondary data. Reference was made to large collection of publications on the subject, including scholarly journals, text books, legislation, academic writings, newspaper articles and the worldwide web as a source for collecting secondary data.

5. Literature Review

John Exeter, in the Report on the Establishment of the Central Bank for Ceylon which was authored in 1949, identified the banking system as an economic activity in a country which stabilizes the public welfare to a higher degree. It also creates unique changes to a country's economic backdrop. A sound banking system is critical to a healthy, well-functioning economy of a country. Hence, the supervision of banks helps safeguard the public against mismanagement, bank failures and the public loss of confidence in the banking system. Efficient supervision aids the protection of depositors and stakeholders against possible losses and enables the members of the banks to manage their financial services more intelligently (Exter, 1949). In such a context, the proper functioning and stability of the banking sector is essential to maintain the stability of the financial system and the entire economy of the country. Moonesinghe articulated, "money is the core of every capitalist economy and a coterie of well compensated people in the financial services industry become entrusted with the custody of the whole of a society's bank deposits, investments and in certain instances, even their gold. Thus, what is profound here is that the corporate responsibility is one of trust – called fiduciary responsibility – where public deposits are placed in trust with bank management, so much so that the primary responsibility of bank management is to their depositors and not to their shareholders" (Moonesinghe, 2005). The study demonstrates that it is crucial that laws and regulations provide a framework for CG in the banking sector. Shleifer and Vishney described that CG is the way in which suppliers of finance to corporations assure themselves of getting

a return on their investment and a set of mechanisms which ensures that potential providers of external capital receive a fair return on their investment, because the ownership of firms is separated from their control (Shleifer and Vishney, 1997). Maw and Michael opined that CG as a subject, as an objective or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy (Maw and Michael, 1994). Dinc found that CG plays an extra vital role when it comes to its application in the banking sector; as the sector provides funds mobilization and financial intermediaries across individuals and larger corporate entities. According to him bank plays roles as "Primary bank for its shareholders", as "cross shareholders" while also provides a fundamental contribution to the governance and financing of larger companies in an economic sphere (Dinc, 2006). Researchers confirmed that the importance of CG rules for the development of the banking sector in Sri Lanka. It is accepted that CG variables have strong explaining power of financial efficiency of Sri Lankan commercial banks. Thus, it can be seen that the role of CG practices in enhancing the extent of the level of efficiency in Sri Lankan commercial banks are vital (Sivaraja, *et al.,* 2018).

6. What is a Bank?

The term 'bank' carries a variety of meanings and there is no definitive interpretation. The perceptive definition of a 'bank' differs based on the nature of a bank's activities. Section 16 of the Banking Act declares that no company other than a Licensed Commercial Bank or a Licensed Specialized Bank shall use the word 'bank, banker, banking' or part or parts of words, any derivate, its translation or equivalent to any language except with the approval of the Monetary Board.

'The main difference between a Licensed Commercial Bank and a Licensed Specialised Bank is that the former is permitted to accept demand deposits from the public (operate current accounts for customers) and is an authorised dealer in foreign exchange, which entitles it to engage in a wide-range of foreign exchange transactions' (Regulation and Supervision of banks, CBSL). On the other hand, Licensed Specialised Banks are permitted to limited engagements in foreign exchange with, the approval of the Central Bank. The banking sector in Sri Lanka at present comprises of around twenty-six licensed commercial banks, which consists of thirteen state banks and thirteen foreign banks. The number of licensed specialized banks adds up to six. In addition, there are about sixteen regional rural development banks which are operating in the country. Section 2 of the Bills of Exchange Ordinance No. 25 of 1927 of Sri Lanka, defined the term 'banks' as "a body of persons whether incorporated or not who carry on the business of banking". Section 86 of the Banking Act has codified its interpretation of "banking business" as:

"The business of receiving funds from the public through the acceptance of money deposits payable upon demand by cheque, draft, order or otherwise and the use of such funds either in whole or in part for advances, investments or any other operation either authorized by law or by customary banking practices".

7. Banking Company

The Banking Act deals with the licensing of persons carrying out banking business and the Companies Act prescribes that they should be limited liability companies complying with the provisions of the Act. The term 'banking company' is not defined in Sri Lankan law. According to the definition of 'a company' given by the Sections 2(6) and 86 of the Banking Act, a banking company is a company that has been incorporated under the Companies Act. All licensed commercial banks are companies which are duly incorporated as public limited companies under the Companies Act. A public limited company becomes a banking company when a license is issued to it by the Monetary Board to do banking business. Furthermore, licensed commercial banks are subject to the Companies Act and the Banking Act, which permits the Central Bank to impose directives on licensed banks to ensure the stability of the banking system with the focus of preventing a banking crisis.

8. Why is Confidence so Important in Banking

In Sri Lanka, As In Most Economies, Banks Dominate The Financial System. Thus, given the Unique Nature of the Business and the Key Roles Played by banks in the economy, it is important to conduct banking in a safe manner. Banking is a monetary business and this includes fund raising through deposits and debt securities, lending and investing funds thus acquired and facilitation of domestic and international payment through provision of services. The course of business of the bank is contingent on public confidence in banks and the loss of confidence can disrupt the financial system, which in turn would affect the economy.

The Former Governor of the CBSL, Cabraal provides that there are certain distinguishing features between the banking sector and the financial sector. 'A company generates its funds through the sale of shares, whilst a bank depends on public investments through deposits. A significant development on the capital front of the institution creates numerous responsibilities towards the operational resilience, as the public funds need to be safeguarded in a special way. Banks act as financial intermediaries by allocating funds from savers to borrowers in an efficient manner. Through facilitation and processing of payments domestically and internationally by means of their products, banks become agents of the payments system. Banks play a vital role in maintaining financial stability by gaining public trust and confidence, which is critical to a healthy, well-functioning company. The loss of public confidence will lead to a systemic banking crisis' (Cabraal, 2004).

Immediately following the major corporate collapses, most developed countries introduced new rules regarding the governance of companies to ensure transparency and accountability in their management. Such corporate frauds and collapses occurred worldwide during the recent past, significantly shaking investor confidence. These incidents were vivid examples of the risks posed by CG breakdowns. They also questioned the effectiveness of the CG regimes prevalent in such countries during that time. In these circumstances, the topic of 'CG', which has gained widespread acceptance as a mechanism to uplift the standards of governance in companies and enhance investor confidence, was brought into the limelight.

The notion of CG originated in the United Kingdom (UK) and the United States of America (USA). The fear amongst the shareholders that corporate managers will misappropriate their funds fuelled the rapid spread of this concept. Hence, it was believed that active shareholder participation in the governance of companies would increase transparency, accountability, and its capacity to create wealth. Corporate governance is considered to have significant implications for the growth prospects of an economy, because proper corporate governance practices reduce risks for investors, attract investment capital and improve performance of companies (Spanos, 2005).

9. What is Corporate Governance

There is no one, specific, universally accepted definition for the term 'Corporate Governance'. It is an internationally debated inter-disciplinary concept with many characteristics. CG comprises of the set of laws, processes, policies, customs and institutions which have a say in the nature in which the business of an institution is conducted by the management through principles such as transparency, accountability and integrity.

The Organization for Economic Co-operation and Development (OECD) principles define CG as follows:

"CG is the system by which companies are directed and controlled. It involves a set of relationships between the company's management, its board, its shareholders and other stakeholders. CG also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance."

It is evident from the OECD definition that CG is the method via which the numerous stakeholders of a company represent themselves and interact with each other with a view of long-term wealth creation, whilst

being a good corporate citizen. CG is now identified and acknowledged as an essential and critical element of financial stability, necessary to generate trust and confidence in banks - particularly where financial failures, fraud and dubious business practices have had a negative effect on investor confidence.

10. Why Good Governance Practices are Needed

Good CG plays a vital role in underpinning the integrity and efficiency of financial markets (OECD). The promotion of good governance practices amongst companies will enhance investor confidence and attract investors capable of contributing capital for the further development of such companies. On the contrary, poor CG systems would result in corrupt/fraudulent business practices, financial distress, erosion of competitiveness and depletion of corporate assets/resources, which in turn will drive away investors and ultimately hinder the economic development of the country. Hence, good CG is a tool for bringing in socio-economic discipline to businesses.

The spate of corporate scandals and failures around the world in the 1980's and early 1990's led the conviction of the necessity for changes in the way, especially public listed companies, were governed by the regulators and investors. In each of the companies which collapsed, it became apparent that there were considerable lapses be it accounting or in financial reporting and lack of adequate risk management and internal control. Upon investigating the reasons behind the failures of these companies, some recurrent themes emerged, such as investors not being kept informed of what was happening, misleading financial statements as a result of "creative accounting", etc.

11. Evolution of Corporate Governance in Sri Lanka

Sri Lanka experienced a calamity of banks and finance company failures when Pramuka collapsed in October, 2002, followed by the fall of Golden Key Credit Card Company Limited (GKCCC) in 2008 and the collapses of unregulated deposit taking institutions such as "Sakwithi" and "Daduwan". Such financial collapses resulted in damaging the public trust and confidence in finance companies as a whole. Though these failures did not lead to a general collapse of the entire financial system, it caused a severe adverse effect and 'triggered a financial tsunami'. In the first few weeks, most deposit taking institutions, mainly finance companies, suffered due to the loss of public confidence (Weerasooriya, 2010). The causes of these failures can be attributed to failures such as the abuse of power and resources, irregularities in lending and handling depositors' money, inadequacies in the level of CG, inadequate internal controls and risk management, irregularities in financial reporting, lack of transparency etc. Seylan Bank PLC is one other local example where the depositors ran over their deposits. Fortunately, the CBSL, as a responsible regulator, intervened and implemented necessary measures. In the wake of such scandals being exposed, the CG rules meant for listed companies in Sri Lanka were revised, and new codes of conduct for such companies were introduced. This was done with the objective of safeguarding the investors as well as to restore and maintain public confidence in the entire financial system. Similarly, as a response to these failures, the need to focus on good behavioural practices of CG for banks and financial institutions arose in order to prevent the repetition of such devastations as well as to build and maintain trust and confidence in the overall financial stability of the country. Recognizing that the collapsing of a bank creates a negative impact on a country's economy while reflecting the uncertainty of the country's financial sector, the regulatory bodies sought to take various measures, as a result of which, the CG in the banking sector became an important subject of discussion.

In Sri Lanka, main reforms of CG were introduced during the period ranging from 1997 to 2008. Whilst Sri Lanka has enjoyed a relatively calm and safe environment in the past, it attempted to improve CG through the adoption of voluntary codes in the belief that it will greatly contribute in safeguarding the interests of the depositors. Based on the recommendations contained in the Cadbury Committee Report, CG initiatives were first introduced in Sri Lanka by the Institute of Chartered Accountants of Sri Lanka

(ICASL), which formulated and published a voluntary Code of Best Practice on matters relating to financial aspects of CG in 1997, which was made applicable to all listed companies. Subsequently, ICASL published the Code of Best Practice on Audit Committees in 2002 and thereafter, in collaboration with the Securities and Exchange Commission of Sri Lanka (SEC), published the Code of Best Practice on CG in 2003. This was published with the objective of ensuring that Sri Lanka kept abreast with the CG developments taking place in other jurisdictions. Compared to the previous codes issued by ICASL, the 2003 Code was comprehensive and included a number of principles to enable the proper functioning of a corporate board. Thereafter in 2004, the SEC issued guidelines on audit and audit committees for the initial voluntary compliance by listed companies with a view of subsequently making it mandatory. However, these guidelines did not attain mandatory status as expected.

During the year 2005, ICASL and SEC along with the Colombo Stock Exchange (CSE) commenced to reform the 2003 Code to strengthen the CG framework in the secondary market of Sri Lanka. A draft code of CG was formulated in 2006 by a select committee considering CG codes in several jurisdictions, including UK, New York-USA, Singapore and Malaysia, with a view to formulate rules which accounted for the realities of the Sri Lankan situation. The SEC issued a press notice in January 2007 stating that the amended 2006 Code will be implemented shortly after effecting certain minor amendments. During the interim, certain rules contained in the draft 2006 Code were incorporated to the Listing Rules of the CSE which was to be effective from 1st April 2007 and these rules were declared compulsory for all listed companies in Sri Lanka effective from 1st April 2008. The SEC and the ICASL once again revised the Code of Best Practice in the year 2013. The 2013 version of the Code of Best Practice is akin to the UK CG Code and sets out in detail the CG standards that must be adhered to. Nevertheless, the Code of Best Practice is a purely voluntary code and, in the writer's opinion and experience, it will not serve any meaningful purpose and will merely be window dressing if it is not made mandatory. However, in comparison with other jurisdictions, the mandatory rules are minimal and relate to Board Composition, Audit Committees, Nominating Committees and Remunerations Committees. In addition to the above Code and Listing Rules, certain companies have developed and established their own codes of CG.

With the expectation to further enhance the level of good CG practices within the banking sector, mandatory code of CG for Licensed Commercial Banks in Sri Lanka was issued in April 2008 by CBSL, the watchdog of the financial system. It commenced on 1st January 2008 and all banks were required to fully comply with the rules by or before January 2009. The directions consist of two main parts: Principles which are to be used as guidance in interpretation and rules which are to be strictly complied with. Being a comprehensive code of CG, it sets out principles and rules such as, responsibilities of the board; composition of the board; criteria to assess the fitness and propriety of directors; management functions delegated by the board, chairman and the CEO; board appointed committees and their role; related party transactions and disclosures. Special transitional provisions have been made for some of the more contentious provisions. Further, by the Banking Act, Direction No. 11 of 2007, CG Directions were issued by the Central Bank of Sri Lanka to Licensed Commercial Banks to manage the multitude of risks that arose in their operations, to secure financial system stability and improve CG practices.

Further, the Code of Best Practice 2017 issued by ICASL strengthening the CG of Sri Lanka has also introduced some key changes such as board composition, board meetings and role of the board and audit committee charter and as new areas, related party transaction committee, requirement for reporting on cyber security and requirement for environment, society and governance. This is another voluntary Code and all the banks were entreated to adhere to the same in order to assure the integrity and stability of the financial system Nevertheless one cannot ascertain for sure compliance of the same as requested by banks, as the financial institutes enjoyed considerable freedom in implementing these practices. Such discretionary behaviour leads to variations between companies.

Thus, given the important role of financial institutions in the national economy, introduction of a mandatory code in Sri Lanka encompassing principles and rules was a timely measure equally desirable and commendable. Given the role of dominant financial intermediaries undertaken by banks, the code is a reminder and emphasised that, they in return have broader responsibilities. Hence, by strengthening the banking system, the public will be encouraged to make greater use of banks, as depositaries for their savings.

12. Regulation of Banks by the CBSL

The Banking Industry is regulated by the CBSL and it is conferred with regulatory and supervisory powers to govern the licensed banks mainly by two legislative enactments, the Monetary Law Act and the Banking Act. New laws enacted lately by the Parliament such as, Payment and Settlement Systems Act No. 28 of 2005, Financial Transactions Reporting Act No. 6 of 2005 and Prevention of Money Laundering Act No. 5 of 2006 grant additional powers to the Central Bank. The CBSL discharges the role of maintaining a stable financial system, through mechanisms such as, establishing the required legal framework and by ensuring that the financial institutions operate within such regulatory frameworks; ensuring that the key categories of financial institutions are regulated and supervised; that conditions are optimized in key financial markets, the stability is maintained; payments and settlement systems overseeing and acting in the capacity of the lender of last resort by continuous monitoring of the entire financial system.

The Bank Supervision Department of the CBSL carries out the regulatory and supervisory function relating to banks licensed by the Monetary Board and these functions can be categorized under four main areas: Monetary, developmental, supervisory and agency. The Bank Supervision Department of the CBSL is empowered by the ss. 10(c) and 46(1) of the Monetary Act to monitor the financial status of licensed commercial banks and licensed specialized banks. Periodic information provided by banks is utilized for this purpose. Under this supervisory function of periodic examination of commercial banks as well as other banking institutions, as determined by the Monetary Board, it is required to ensure that they are efficiently managed and that the depositors' interests are safeguarded.

13. The Importance of the Regulation and Supervision of the Banking Industry

The banking sector is the most prominent feature in the functioning of a financial system and therefore the stable, efficient and effective performance of the banking sector is extremely crucial. The banking system contributes to the economy of the country by facilitating the discharge of the functions of money in many ways. It provides a medium of exchange through operating a wide range of payment instruments, like current accounts, payment cards and fund transfer systems both locally and internationally. Banks perform the function of money as a differed payment system through the business of financial intermediation in accepting deposits in the form of current, savings and fixed deposit accounts; lending money to the public as long term and short term loans and overdrafts and operating deferred payments instruments such as letters of credit and credit cards. Banks also serve as a liquid store of wealth or savings by providing a wide range of financial assets principally encompassing deposits and investments. Therefore, banks perform the functions of money through their business and operational activities. They also provide a major source of money circulation through bank deposits which are maintained by the general public, based on their trust and confidence in the financial soundness of the particular individual bank and the banking system as a collective.

Forms of regulatory and supervisory measures implemented by the Supervision Department of the CBSL could be categorized into four main topics: Prudential regulation, monetary regulation, systemic regulation and consumer protection. Supervision of banking institutions by the CBSL is carried out through the main methods of examinations and problem resolutions. Banks have to undergo statutory examinations at least once in two years. Examinations include on-site examination and off-

site surveillance, which is based on the internationally recognised CAMEL (Capital Adequacy, Asset Quality, Management, Earnings and Liquidity) model. On-site examination is a new approach that has been adopted by the Supervision Department which concentrates on aspects such as identifying and managing banking risks and assessing whether resources to mitigate such risks are adequate. Off-site surveillance is the examination of information received periodically from the banks in the form of annual reports, statements and returns relating to their performance and financial status intending to reveal warnings at the earliest of potential problems, which can be addressed by implementing early remedial action on a regular basis. With regard to the on-site examinations, periodical visits are made by CBSL examiners to banks to collect data and information through the physical examination of bank's books and accounts to assess the financial condition of the banks.

Problem resolution includes supervisory interventions on banks at the discretion of the Monetary Board or the Director of Bank Supervision of the CBSL. Though categorized under different headings, all these types of regulatory and supervisory measures work together to ensure the solvency of banking institutions, which will in turn help to maintain the public confidence in the entire banking system.

In order to improve the safety and stability of the banking system and to achieve the financial system soundness, which is one of its principal objectives, the CBSL also declared the new directions regarding the maintenance of capital adequacy by banks, under the BASEL 11 with the objective of risk mitigation in the management of banks. The BASEL committee on Bank Supervision identified governance requirements in the areas of Board of Directors, Compensation, Senior Management, Risk Management Framework, Internal Audit Function, Disclosures and Role of Supervisors as the crucial components for the creating of strong governance framework in the banks (BASEL Committee, 2015).

14. Directors and their Role in the Governance of Banking Companies

The board of directors of a company is of primary importance to its decision-making and governance process, as the board is ultimately responsible for the proper governance of their companies. Similarly, the board of directors and the management of banks will have to assume a greater role because most decisions about the business, such as the strategic direction and operational policies, are taken by them as the shareholders have no power to meddle with the operation of the business unless through the variety of rights conferred to the shareholders under the Companies Act. Good CG exists when the board is capable of acting independently, participates in shaping banking strategies to ensure the stability of the bank and the safety of its depositors' funds.

As stated above, the board of directors of a bank play a pivotal role in bank governance. Directors of a bank possess a greater fiduciary responsibility than directors of a normal company. Banks need to be able to attract and to retain experienced and conscientious directors, whose loyalty and care ultimately determine the success of the financial institution. To accomplish such trust and confidence every bank and financial institutions participating in the financial system should introduce high profile internal management and accountability structures. This should be the cornerstone upon which the CG framework of the bank and financial institutions is established (Moonesinghe, 2005).

The principles of CG require 'promoting corporate fairness, transparency and accountability' (Wolfensohn, 1999) in order to prevent one stakeholder group from misappropriating the cash flows and assets of another stakeholder group. Therefore, the directors of a company are required to use their best efforts for the company to be managed well and improved on a regular basis. The board of directors of a bank should ideally assume the overarching responsibility and take accountability to ensure the proper management of the affairs of the bank, as well as the safety and stability of the bank. As the board is in charge of strategy and risk management, they are also required to identify the principal risks and ensure that necessary strategy is implemented in order to handle such risks in a prudent manner. Given its responsibility to balance various interests at the same time, the board is straddled with task of assuring its obligations to other stakeholders are taken in to consideration and addressed by

implementing a clear communications policy between the bank and all relevant stakeholders, including depositors, creditors and shareholders. They shall also ensure that the aspirations and the rights of all the stakeholders get articulated through their actions.

As mentioned earlier, the 2008 and 2013 codes of CG extensively spell out the responsibilities of the board, directors, management and many more areas. It has included many responsibilities on the board and thus the board and the management would be under greater scrutiny and checks and balances. Few of these responsibilities include: Assuring that a sound business strategy is formulated and implemented; making certain that effective systems are implemented to ensure the integrity of information, internal controls, continuation of business and managing risks; implementing sustainable business development strategies; ensuring that laws, regulations and ethical standards are complied with; etc. The directors are also expected to meet regularly with the principal persons in the management to review policies and monitor progress in order to achieve corporate objectives.

As companies accepting public deposits, banks are mandatorily required by legal provisions to disclose the particulars of their directors. The Company Secretary is tasked with acquiring a declaration of all related party interests. This is meant to prevent a director from abusing his position and prevent conflict of interest, self-dealing, insider trading, providing preferential treatment to related parties, etc. Not only a conflict but also the appearance of a conflict of interest should be avoided. If a director has any interest in a matter of the company, which is ascertained to be important by the board, the matter should be dealt with and voted upon at a board meeting where independent non-executive directors are present.

The amendment to the Section 42 of the Banking Act of 2005 brought in the test to determine whether a director is fit and proper. It requires the approval of the CBSL prior to being appointed to the board of a bank. Although the shareholders of banks are primarily responsible for the appointment of competent and experienced people with high integrity and capabilities to manage the bank, the CBSL holds the power to disqualify the appointment and election of directors or the Chief Executive Officer of a bank if they are not fit and proper individuals. In the event of failure to comply with directives, the Monetary Board also can remove directors and impose sanctions. Thus, it is evident that even if all the shareholders wish for a particular individual to be appointed as a director, the CBSL holds the right of denying such a person a seat on the board.

The directors and officers of banks are obliged to ensure that the 'fit and proper' attributes of bank management are complied with (Moonesinghe, 2005). This responsibility includes implementing appropriate policies and business objectives for the benefit of the investors which would also nurture the confidence and trust of the public. It is important that the bank management understands that the sole goal and objective of regulators is the stability of the bank for the depositors and for the financial system.

The CG rules have measures to assess and ensure that the directors are independent in the context of banking companies. It enumerates that the presence of independent board of directors would improve CG and requires that at least a minimum of three directors or one third of the total number of directors be independent by January, 2010. This is particularly important in companies accepting public deposits for the benefit of less empowered shareholders who do not in general have a say or are not acknowledged. Therefore, the independence of directors is strictly defined. Direct or indirect shareholding of 1% in the relevant company makes a director non-independent. Also, representing a specific stakeholder results in the loss of independence of a director. A meeting of the board cannot be held unless the majority of the directors present are non-executive directors.

On the independence of directors, a statement made by Frank Brebeck from Price water house Coopers who spoke about CG in Europe can be considered to be profound. Accordingly, to be ascertained as an independent director the board must be convinced that the director does not harbour a material relationship (business, family or other) with the company either

directly or as a partner, shareholder or officer of an organization that has a relationship with the company as this will create a conflict of interest so as to jeopardize the exercise of his free judgment.

Further, it is mandatory to have two separate individuals as Chairman and CEO**.** The Chairman must be a non-executive and preferably an independent director. If the Chairman is not an independent director, it is mandatory to have an independent director designated as a Senior Director of the Board. Limitation on the number of directors is one of the main concerns of the Monetary Board with regard to banking companies and it is of the view that boards must ensure that they spend the right amount of time and energy on overseeing the various aspects of compliance and performance of the company on which they serve. The rules of the CG directions add to this requirement that a director prohibited from serving on the boards of two banks shall also not be over 70 years of age. However, consequent to a court order, a general exemption was given to all directors who have reached or would reach 70 years any time prior to 31st December 2008 and for those who were on the board of more than the specified number of companies to continue until end of 2011.

CG rules also make it mandatory for a banking company to constitute a minimum of four board sub-committees: Audit Committee, HR and Remunerations Committee, Nominations Committee and Integrated Risk Management committee. The composition and the functions of these committees are set out in great detail.

The mandatory provisions brought in by the CG directions of the CBSL has been a much welcomed development in ensuring that directors comply with the rules to improve the bank's performance. However, in practice, compliance with these directions by most companies has been unsatisfactory. For example, the recent financial crisis, more specifically in the non-banking financial sector was fundamentally due to a lack of accountability to their stakeholders including shareholders, depositors, employees and other groups.

Some other governance related issues that have arisen in the wake of the recent corporate collapses in Sri Lanka include accounting deficiencies, financial reporting deficiencies (window dressed accounts), absence of processes for identifying assessing and managing risks, negligence of auditors, organised crime in board rooms, utilisation of superannuation funds to meet financial difficulties of the company, lapses in regulatory oversight of issue of unauthorised debt instruments and deposit takings, lack of communication, failures in acquisitions or diversification strategies and aggressive overly ambitious expansion (eg: Ceylinco Group), increase of related party transactions, infighting within the board members and the management team's negligence, misconduct or failures.

GKCCC and the Sakvithi Scam (named after the miscreant who is deemed responsible for the investment scheme collapse) was a situation where many depositors of an estimated Rs.900 Million were defrauded by an unlicensed finance company with promises of very high interest rates.

In consideration of the above governance issues that have been well noted in the Sri Lankan corporate sector, the writer is of the opinion that the measures that have been introduced by the relevant legislators and regulators (including the CBSL) which have made it mandatory for licensed banks and non-bank financial institutions to comply with its CG directions, have in fact failed in demanding the display or demonstration of such compliance. In the wake of the above discussed corporate failures in the financial sector, the stakeholders of companies including the directors have made it evident that they were ahead of the regulators in the conduct and manipulation of their business. Thus, the regulators must take timely action and conduct random checks on companies to ensure compliance with the CG rules.

Even though it may be stated that directors of banking companies coming under the purview of the CBSL to a certain extent conduct their duties in a satisfactory manner, yet there are unlisted financial institutions in Sri Lanka which do not come within the purview of the CSE rules or/and directions of the CBSL. For example, with regard to the Ceylinco group, the majority of companies collapsed were private entities. Therefore,

it is necessary that the regulators make it compulsory for financial institutions or institutions that accept public funds to be listed in order to safeguard the long-term investments of the public. The author opines that it would be even more progressive if all companies, including private companies in Sri Lanka, are required to comply with CG rules so that it may provide a guarantee that directors have a responsibility towards taking into consideration the interests of the relevant stakeholder in promoting the success of the company. Further, weak financial reporting and auditing structures can be pointed out as some of the key causes for many of the Sri Lankan financial institute failures. Lack of rigorous accounting standards and auditing control in developing countries may create a relatively higher information discrepancy among stakeholders than in major developed countries (Cobham and Subramaniam 1998). Such circumstances were experienced in most of the incidents of collapses in financial institutions in Sri Lanka too. As independent auditing of financial institutions has become very important to avoid such failures in the banks, to strengthen the independence of the auditors the SEC issued a set of guidelines for listed companies relating to the audit and audit committees (Abhayawansa, 2008).

15. The CG Structure under the Company Law of Sri Lanka

The Companies Act has many provisions that encourage CG practices. The sections of this Act deal particularly with the treatment of capital, directors' duties and stakeholder rights, etc. The Companies Act introduced the Solvency Test to ascertain the financial health of a company. The provisions in the Act have sought to address how company law can make the board of directors more responsive towards shareholders and other stakeholder interests. It has also sought to address the incidents of corruption taking place in the boardrooms of Sri Lankan companies, by introducing provisions to bar directors of financially distressed companies coming in with the plea of lack of involvement in the event of a collapse of the company. The codification of the common law duties of directors in the Companies Act was a progressive step towards ensuring that the directors are apprised of what the law requires from them in the conduct of their functions. However, deliberate avoidance by the regulators or affected parties to utilise the provisions in the Companies Act in relation to duties of directors, the deliberate mismanagement of companies for a long period of time and the misuse of their fiduciary position and the failure to take appropriate action thereof with regards to those perpetrators has resulted in the company law regime in Sri Lanka falling short of the required expectations.

Even though law reform in Sri Lanka and the requirements of governance have sought to address the ambiguous role of the directors of a company and their responsibilities to the community at large, the corporate collapses that have occurred in Sri Lanka in the recent past have raised concerns regarding the effectiveness of these reforms and whether legislators have been successful in ensuring that the board of directors of a company take the interests of shareholders and stakeholders into consideration when furthering the interests of the company. The principles of CG ensure that certain minimum standards of behaviour are set out to directors of a company and whatever decision made by them is subject to scrutiny.

Accordingly, the author is of the view that if the company law regime in Sri Lanka was imposed with great effect with regard to the directors' duties to the stakeholders, the majority of corporate collapses in the recent past could have been avoided. Since the law is not stringent enough to institute actions, the alleged perpetrators are still roaming free whilst the innocent investors and employees of those companies remain aggrieved.

Therefore, if the company law in Sri Lanka is to circumvent a repetition of the GKCCC scandal or any other corporate scandal for that matter, it is mandatory that the relevant stakeholders of a company i.e. the shareholders, creditors, employees, suppliers, regulators and the community are apprised of the duties of the directors of a company. It is also important that the regulators take timely action to curb the repetition of the recent collapse in the financial sector.

16. Case Study of Pramuka Savings and Development Bank (PSDB) and Seylan Bank

The above analysis of the financial and banking landscape of Sri Lanka offers clear examples of instances where financial institutions have failed due to the lack of CG. PSDB and Seylan Bank are two fine examples of such scenarios.

PSDB, a bank authorized by the CBSL to accept deposits from the general public, failed due to the weak internal auditing and the lack of CG within the organization. Corruption, mismanagement, lack of supervision, conflicts of interests with regards to the Board of Directors and the lack of a business strategy paved the way for its collapse. A 2002 ICASL report revealed that the non-performing loans ratio of the banks were as high as 80%. It was further revealed that the directors had failed to comply with their respective duties in order to ensure the management of bank affairs in a safe and sound manner. If the board of directors had performed the obligations required of their role and complied with the principles of CG, it would have ensured that the bank would not have faced such detriment but rather that their business strategy was subject to closer scrutiny. This situation brought to light the need for the CBSL to continuously supervise banking activities.

Another notorious instance of financial collapse was that of the GKCCC, which was also the controlling shareholder of Seylan Bank, is an example of the extent of irregularities pertaining to the conduct and ethical behaviour of the Ceylinco group directors and other professionals involved. Poor financial management within the internal organization has been attributed as one of the core reasons for this collapse. In order to cover the liquidity of the GKCCC, the board of directors of the Ceylinco Group used the money of the depositors of Seylan Bank. The fear that this created consequently resulted in depositors withdrawing their deposits. It is evident that the board of directors failed to abide by the CG principles of ensuring an effective system which secured the integrity of information, internal controls, business continuity and risk management. Had they acted according to the required framework, such a collapse could have been prevented. The failure of GKCCC had a detrimental impact on the country's economy, resulting in the loss of public faith in financial intuitions (especially private institutions) - a negative impact which the central bank had to work on mitigating. Thus, the CG rules which were to act as a deterrent to unethical business practices have been the subject of much controversy in assessing whether it stringently demanded the demonstration of the exercise of directors' duties. In certain instances, when directors of listed entities are requested to declare their independence in terms of section 7.2 of the Listing Rules of the Colombo Stock Exchange (CSE), they do not bother to fill any information that is required by the said declaration and assigns the task of filling in this information to their personal assistant or the company secretary who may not be aware of all of the factors that constitute his 'independence'.

Analysts conclude that it was the volume of inter-company transactions that resulted in the collapse of GKCCC and many other companies in the Ceylinco group, more specifically inter-company lending arrangements made without adequate security. 'The Case Study – Seylan Bank PLC Annual Report 2009' widely agrees that Seylan Bank, a listed commercial bank had taken on excessive and unjustified lending exposures regarding many companies within the Ceylinco Group and had signed contracts deemed unfavourable to the bank's own interests in order to obtain services from or deliver services to a large number of Ceylinco companies. The GKCCC collapse had a devastating impact on thousands of savers and pensioners and almost brought down Seylan Bank, resulting in the State intervening to aid Seylan Bank in the fear that its collapse would catastrophically undermine the entire banking system in Sri Lanka. Similarly, a large number of non-bank financial institutions have also collapsed primarily due to corporate excesses perpetrated by the senior management of these institutions.

"Setting the tone at the top" is a key concept of CG, which the above financial institutions clearly failed to follow. Instead, the top management and board of directors colluded in the misappropriation of public

funds and failed to ensure ethical internal management. Such failures provided sufficient evidence that voluntary compliance with CG mechanisms was not feasible and mandatory measurements should be introduced to ensure stability.

17. Conclusion

The CG rules applicable to listed companies including banking companies in Sri Lanka were revised and new codes of conduct were introduced in response to the corporate collapses with a view to safeguard the investing public. Its introduction has brought in changes to board behavior and the conduct of the board and the management in furtherance to the companies' responsibility towards its shareholders and other stakeholders. Licensed banks in Sri Lanka are required to ensure good governance, risk management, compliance frameworks etc. in their respective banks. However, a question arises as to whether these CG standards are adequate to build investor confidence and preserving the soundness of the banking system. The effectiveness of CG in Sri Lanka is debatable, due to the recent corporate scandals that took place in public listed companies. Whether companies are genuinely complying or merely glossing over the truth in an effort to meet the minimum disclosure requirements is debatable.

It is evident from the preceding discussion that Sri Lanka's current CG approach is unsatisfactory either because of legislative loopholes and/or enforcement mechanisms.The CG regime should be a holistic framework which emphasize prudent integrated risk management framework, foster compliance culture and resolution plan for banks. Banks need to be prepared for resolution measures in the event of a distressed situation. That responsibility needs to be vested with the Board of Directors under the CG regime to uphold the financial system stability. Measures should also be taken to uphold ethical behaviour and integrity of the Board of Directors, KMPs and all other employees. It is therefore important to ensure the strict enforcement of applicable laws against wrongdoers and people who breach CG regulations to discourage such violations. Further, in order for CG to be effective, there has to be an independent monitoring or auditing mechanism in place, backed up by a robust and meaningful regulatory framework. A sound regulatory framework is one that is not static, but evolves continuously to meet changing conditions. Finally, for the fruition of the purpose, the stringent provisions are essential imposing harsher civil and criminal penalties to act as a deterrent.

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