Spotlight: Econ Op-eds in Summary

Week ended 28th July '21

In Summary

The underneath contains summaries of the articles given above, including key extracts from these articles.

1. CBSL restrictions imposed on LCBs
By: Tennakoon Rusiripala

- The CBSL imposed restrictions on the repatriation of profits for foreign commercial banks and suspended discretionary dividend payments, share buybacks and outlined restrictions to curtail non-essential expenditure for LCB's and LSB's. These guidelines came into effect on 1st July 2021 and are set to last till 31st December 2021 and were imposed by the CBSL to help ease foreign exchange pressures of the country.

- Prior to this, the President had issued directives to SOE's to prevent wasteful expenditure. These however, failed to bring about the effect required, and the CBSL has now stepped in to monitor restrictions it has imposed. A recent COPE inquiry details instances where state banks sidetracked compliance procedures using deceptive tactics. Such tactics were also witnessed in two State banks in the 90's as uncovered by an international audit firm.

- There has been criticism levied against certain banks on fraudulent lending practices and that the current loan loss provisioning criteria is not being adequately recognized, where certain advances should have transferred to the non-performing category. The CBSL needs to keep a watchful eye of such issues within the banking sector, especially that of tax violations, which take place to a large extent within the sector.

Effective 1 July 2021, Licensed Commercial Banks and Licensed Specialised Banks operating in Sri Lanka are required to be guided by the restrictions imposed on them by the Central Bank till 31 December 2021..

These restrictions appear to be short-term measures taken by the CBSL, mainly to address the Foreign Exchange Reserve quandary currently befallen the country overriding all other financial problems. They are applicable to all Licensed Commercial Banks including those incorporated outside Sri Lanka, which in effect brings all foreign-owned commercial banks too under the stipulations.

These restrictions infer an implied further adverse effects in relation to the bank performance compared to the key indicators of the previous years, due to the impact of the COVID-19 outbreak.. The financial statements for 2021 are still awaiting the finalisation of the external audit requirements and according to the restriction imposed on the foreign commercial banks operating here, who will not be permitted to repatriate any of their declared profits already made. CBSL envisages according to its own estimates the LCBs to experience impediments in the growth of assets and business expansion areas due to the shocks from the pandemic-affected business environment.

These considerations are neither irrelevant nor unjustified in the context of the unpredictability and uncertainties devolving round the pandemic situation continuing unabated in a global sense. In a practical perception, the restrictions imposed, sound more logical as preventive actions which when applied commonly across the industry would not cause any particular disadvantage to any single bank.

As the regulator, the CBSL will have to be mindful of possible capital shortfalls induced or taking place due to the prevailing situation. The country is experiencing a keen concern about the need to maintain a sound and strong banking industry with guaranteed liquidity and capital adequacies. They will be more helpful to the local banks both in the State and Private sector. The conditions they are expected to adhere to are in keeping with the directive issued earlier by the President to the SOEs with a view to stop wastage and improve efficiency.

When we look at the restrictions now imposed by the CBSL, it appears that they have identified the possible problem areas more specifically, maybe under the scope of their responsibility as a supervisor and the regulatory framework of promoting corporate governance and capital requirements of the banking industry.

The private sector banks with public quoted shares are required to refrain from buying back their own shares. We have noticed some 'unsavoury movements' in our share market operations recently. The CBSL has stepped in to curtail any contributory actions on the part of the LCBs in this regard.

The restrictions also extend to the curtailment of increasing the management allowances and payments to Board of Directors. CBSL has restricted this area probably with their past experience and also presuming that there is a possibility of a tendency to resort to such practices even under troubled circumstances. But it could have been more effective if the CBSL brought in this restriction to cover any and all enhancements and increases of all sorts, possible under their rights of normal operations.

Perhaps the CBSL may not be aware of the highly extravagant special allowances and perks that have been granted to the top executives of the banks, particularly in the State sector. Some of these were even highlighted in the recent Parliamentary COPE inquiries causing alarm even among the not so caring legislators, making them raise their eyebrows.

Banks have been directed to exercise prudence and refrain as far as possible from incurring non-essential expenditure. The restrictions specify certain areas such as advertising, business promotions, gift schemes, entertainment, sponsorships and travelling, etc. A careful examination will show that most of these expenditure items serve a different purpose than the needs superficially canvassed in their favour.

It is noteworthy that the President's directive given earlier to the SOEs to stop wasteful expenditure also covered these areas. But what we observed was that without the intervention and oversight by a supervisory and regulatory authority, the directives did not have the desired effect. Now in the context of the CBSL effectively monitoring the adherence to these restrictions they have enforced, we can expect some improvement.

In the State sector, as was revealed in the recent COPE inquiries, there have been many deceptive avenues to side track compliances including procurements. There had been instances where subsidiaries owned by State banks were used as agencies to engage in high value contracts involving constructions and supplies to bypass the procurement procedures. Therefore, the CBSL will have to focus on such matters to give effect to what they have enunciated.

If the CBSL is keen in ensuring a safe liquidity position in the banks with adequate capital they have to keep a close watch on their accounting practices. Under various stratagem banks can resort to mislead even the auditors by adopting controversial gimmicks. This is commonly seen in the loan loss provisioning and other areas where even the audit eye has failed to detect. Banks have callously disregarded some of the obligations they have in making loan loss provisions as well as other general provisions falling within their fiduciary responsibilities.

Just to quote an example, we can point out the case of inadequate provisions made by the two State banks in the late '90s first detected by the international audit firms leading to a highly contentious issue of calling the two banks insolvent. The major laxity was in the provisions that the banks were required to make in respect of Employee Retirement Benefit payments. It may be of interest to the regulator to know that the position today is much worse than it was when the highlighted revelations were made then.

With regard to the loan loss provisions too, the situation that prevails in some banks is not conducive to a position of maintaining a sound liquidity in keeping with the supervisory requirements of the regulator. Several advances continue to be kept in the current category although they remain qualified over a long period to be transferred as non-performing advances.

We are also hearing about public criticisms levelled against these institutions alleging fraudulent lending operations and loans of large amounts figuring as non-performing, some of those earmarked, to be written off under the sophisticated hair cut exercises. A number of advances to be treated in this manner happen to be facilities granted in foreign exchange for overseas projects. The irony of the matter is there is no one who can be held responsible for the poor risk assessment standards applied at the time of granting these facilities.

The foreign-owned banks should be kept under surveillance of the CBSL like all other banking institutions. There are many instances of regulatory violations including huge tax evasions in this sector. We are also aware of certain questionable cultures introduced by some foreign banks, for example, the infamous oil hedging deal which cost a huge sum in foreign exchange to our country.

Any repatriation of profits or foreign exchange in the form of capital withdrawals should be carefully monitored by our regulatory authorities. Hence the imposition of restrictions in this manner is a timely and a much-needed precautionary action taken by the CBSL.

[Read More – Refer Daily FT]

2. How will the economic crisis be resolved?
By Nimal Sanderatne

- Sri Lanka is currently experiencing severely low foreign reserves amidst upcoming debt payments. Adding on to these existing woes the recent policies which are not quite favorable towards agriculture industry threatening food shortages and requirements for food imports. With low reserves there could be severe shortages on medicine. Fuel costs are likely to increase due to the increase in global fuel prices.

- With current economic situation of the country, there are three possible options to choose. A makeshift arrangement to borrow from countries or come to currency arrangements, borrow short term at high cost by issuing International Sovereign Bonds and obtain assistance of the IMF by coming to an extended fund facility.

- There is significant resistance by the government, central bank and economic advisors towards going to the IMF. The IMF facility would reject the current stringent import controls and most important come to an arrangement for a phased reduction of the current massive fiscal deficit. Such fiscal consolidation would be in the interest of economic stability and growth that are the stated objectives of the Central Bank.

Everyone is aware that the country is in an economic crisis. Especially that we are facing a severe crisis in foreign finances. Low foreign reserves have to meet foreign debt repayment obligations and pay for essential imports. When and how will the Government resolve the crisis in external finances?

Problems compounded

The difficulties in external finances have been compounded by denying fertilizer to farmers. The consequent reduction in agricultural output is decreasing food availability, necessitating food imports and reducing exports. The unavailability of fertilizer for smallholder tea cultivation is threatening their livelihoods, reducing tea production and tea exports. The reduction of tea export earnings from about US$ 1.2 billion a year will be a severe erosion of export earnings.

Food imports

The unavailability of fertilizer will reduce food production and increase food import needs. In short, increased import expenditure and reduced export earnings could erode foreign reserves to even a more perilous state.

Future

The full impacts of the current policies is yet to be seen. Severe hardships are likely later this year and in the next, unless the perilous foreign exchange crisis is resolved by foreign assistance.

Prices and shortages

Rising prices and shortages of food and essentials like medicines are inevitable. The unavailability of raw materials and spare parts for industry could reduce exports. The further spread of COVID and shortages of raw materials could jeopardize production of manufactured exports.

Threats

Furthermore, there are severe threats on the horizon that could aggravate the depleting foreign reserves and cause unbearable hardships to people. The withdrawal of the GSP plus concession for exports by the European Union (EU) countries and similar actions by the UK, USA and Canada would be a severe setback to exports.

Public finances

On the other hand, the state of public finances and inflationary pressures caused by monetary expansion would lead to severe financial difficulties for the government and deprivations to people, whose livelihoods are threatened by unemployment and loss of incomes. The possibility of another wave of the COVID could pose further threats to the economy by increasing the current high health costs and denying the destitute of government assistance.

Second half

These adverse developments are expected in the second half of this year and in 2022. Paradoxically, the adverse impact on the balance of payments this year has been the increasing import expenditure in spite of restrictions on imports. The second half of this year is likely to witness a widening of the trade deficit owing to increasing import expenditure on food, fuel essential raw materials and reduced agricultural exports. If further restrictions are imposed to counteract this, economic problems would be further aggravated.

Economic facts

The foreign reserves have depleted to as low as US$ four billion at the end of June. The foreign debt repayment of US$ one billion in a few days and expenditure on fuel and essential imports of food and raw material are likely to reduce foreign reserves to dangerous levels.

Public finances

The parlous state of the public finances with the fiscal deficit rising to an unprecedented 11 percent of GDP, while government expenditure on containing COVID is increasing are destabilizing the economy. Furthermore, the inadequacy of interventions to reduce the plight of the increasing unemployed and destitute are serious economic and social problems facing the government.

Increased imports

Despite stringent import restrictions, imports have increased this year. Food and fuel imports have increased and are likely to increase further, later this year. Consequently, the trade deficit would widen to far above last year's US$ six billion. One expects it would be around US$ eight billion or more this year. Consequently, the balance of payments deficit at the end of the year will further erode the foreign reserves.

Imports

Fuel imports are likely to increase sharply owing to escalating international prices from about US$ 45 per barrel to about US$ 70. The recent increases in consumer fuel prices will not reduce fuel imports by much as the demand for these are inelastic. A large consumption of fuel is for thermal generation of electricity and public bus and rail transport.

Imports increasing

Import expenditure increasing despite import restrictions is a paradox that needs an explanation. The main reason for the increasing import expenditure is the escalation of international prices of fuel and food.

Fuel accounts for about 25 percent of total imports. International prices of fuel are increasing with the global economic recovery. Fuel prices that fell to US$ 30 per barrel and averaged around US$ 45 per barrel last year has risen to US$ 70 currently. Consequently, fuel import expenditure this year could be nearly double that of last year.

Food imports

Expenditure on food imports too have increased in spite of import restrictions owing to higher imports of rice and wheat. While there is a significant increase in prices of grains internationally, rice import volumes have increased owing to a shortfall in production, in spite of contrary reports of a bumper Maha harvest in 2020/21. The certain decrease in the Yala harvest this year would necessitate further increases in rice and wheat imports.

When and how?

How and when does the country extricate herself from this parlous state of external finances? Will the country use make shift arrangements and costly foreign borrowing to resolve immediate financial difficulties as and when facing a crisis? These are the questions uppermost in people's minds.

Three paths

There are three paths to resolve the nation's current economic crises. First, a makeshift arrangement to borrow from countries or come to currency arrangements to tide over immediate difficulties and keep limping along as we have done recently.

Second, borrow short term at high cost by issuing International Sovereign Bonds (ISBs).

Third, obtain the assistance of the International Monetary Fund (IMF) by coming to an extended fund facility. Such a facility will be a long term accommodation in several tranches (instalments) at low interest. Such an arrangement would boost confidence in the economy and enable us to borrow on more favorable terms.

Resistance

Why then is there such resistance by the Government, Central Bank and economic advisors to going to the IMF?

The IMF facility is given on condition that the Government follows prudent principles of good economic management. It would reject the current stringent import controls and most importantly, come to an arrangement for a phased reduction of the current massive fiscal deficit of about 14 percent of GDP. Such fiscal consolidation would be in the interest of economic stability and growth that are the stated objectives of the Central Bank.

There may be certain hardships and difficulties consequent on following the IMF prescription, but these are inevitable in the current economic impasse. Hard times are inevitable with or without an IMF arrangement.

For full article – Refer The Sunday Times