

Banking Regulation 2021

Contributing editors

Gregory J Lyons, Alison M Hashmall, Chen Xu, Josie Dijkers and Amy Aixi Zhang



Publisher

Tom Barnes

tom.barnes@lbresearch.com

Subscriptions

Claire Bagnall

claire.bagnall@lbresearch.com

Senior business development manager

Adam Sargent

adam.sargent@gettingthedealthrough.com

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Banking Regulation 2021

Contributing editors**Gregory J Lyons, Alison M Hashmall, Chen Xu,
Josie Dikkers and Amy Aixi Zhang****Debevoise & Plimpton LLP**

Lexology Getting The Deal Through is delighted to publish the fourteenth edition of *Banking Regulation*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes a new chapter on Greece.

Lexology Getting The Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.lexology.com/gtdt.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, Gregory J Lyons, Alison M Hashmall, Chen Xu, Josie Dikkers and Amy Aixi Zhang of Debevoise & Plimpton LLP, for their assistance with this volume.



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For further information please contact editorial@gettingthedealthrough.com

Contents

Introduction	3	Lebanon	95
Gregory J Lyons, Alison M Hashmall, Chen Xu, Josie Dikkers and Amy Aixi Zhang Debevoise & Plimpton LLP		Carlos Abou Jaoude, Eddy Maghariki, Fouad El Cheikha and Souraya Machnouk Abou Jaoude & Associates Law Firm	
Andorra	4	Luxembourg	104
Miguel Cases and Laura Nieto Cases & Lacambra Abogados SLP		Michael Schweiger and Adrien Pierre Loyens & Loeff	
Australia	13	Monaco	112
Andrea Beatty, Chelsea Payne and Chloe Kim Piper Alderman		Olivier Marquet, Anne-Fleur Wagler and Michael Dearden CMS	
Egypt	21	Singapore	119
Mahmoud Bassiouny and Ahmed Mohie Matouk Bassiouny		Elaine Chan and Chan Jia Hui WongPartnership LLP	
Ghana	28	South Africa	127
Theophilus Tawiah and Peggy Addo WTS Nobisfields		Joz Coetzer and Marianna Naicker White & Case LLP	
Greece	36	Sri Lanka	146
Elena Papachristou and Vivian Efthymiou Zepos & Yannopoulos		Heshika Rupasinghe Tiruchelvam Associates	
Hungary	48	Sweden	154
Zoltán Varga and Zóra Lehoczki Nagy és Trócsányi		Carl Hugo Parment and Martin Järvengren White & Case LLP	
India	60	Switzerland	161
Veena Sivaramakrishnan and Soummo Biswas Shardul Amarchand Mangaldas & Co		Patrick Hünerwadel, Shelby R du Pasquier, Marcel Tranchet, Maria Chiriaeva and Isy Isaac Sakkal Lenz & Staehelin	
Indonesia	67	United Kingdom	171
Miriam Andreta, Sinta Dwi Cestakarani and Prisca Octavia Rumokoy Walalangi & Partners		Edite Ligere 1 Crown Office Row	
Italy	75	United States	185
Marcello Gioscia, Gianluigi Pugliese, Benedetto Colosimo and Alessandro Corbò Ughi e Nunziante		Gregory J Lyons, Alison M Hashmall, Chen Xu, Josie Dikkers and Amy Aixi Zhang Debevoise & Plimpton LLP	
Japan	87		
Yoshiyasu Yamaguchi, Hikaru Kaieda, Tae Ogita and Ken Omura TMI Associates			

Sri Lanka

Heshika Rupasinghe

Tiruchelvam Associates

REGULATORY FRAMEWORK

Key policies

1 | What are the principal governmental and regulatory policies that govern the banking sector?

Banks in Sri Lanka are established under the Banking Act and require Monetary Board approval. There is no difference between foreign and local banks. Licences are issued to both commercial banks (LCBs) and specialised (or savings or deposit) banks (LSBs).

Banks must either be public companies or a branch office of a foreign bank registered under the Companies Act.

There are several banks owned by the government, partly to address the issue of most privately owned banks being concentrated in the capital and partly for resource allocation into priority sectors – eg, agriculture, small industry and regional development.

Bank supervision, by the Banking Supervision Department of Central Bank of Sri Lanka (CBSL) is based on standards set by the Basel Committee for Banking Supervision. Currently, the Basel III guidelines relating to capital, leverage and liquidity are applicable.

Banks are categorised based on the Internal Supervisory Rating system of banks. This takes into consideration quantitative measures (eg, Capital Adequacy, Asset Quality, Management, Earnings and Liquidity (ie, CAMEL model components)) and qualitative measures (eg, assessment of banks' compliance with statutory or regulatory requirements, internal controls and the standards of corporate governance).

Recent efforts by the Financial Intelligence Unit of the CBSL to combat money laundering have resulted in Sri Lanka being delisted from the Financial Action Task Force (FATF)'s Grey List and Sri Lanka is no longer monitored by FATF.

Sri Lankan banks have recently introduced digital facilities including online banking, payment gateways and other cashless transacting forms. Presently, Sri Lanka's digital laws are in the formative stages.

Regulated institutions

2 | What are the defining characteristics of a bank to be caught by the banking laws and regulations? Is non-bank fintech regulated differently?

Banks are regulated under the Banking Act. The key features identified are:

- receiving funds from the public;
- acceptance of money deposits payable upon demand (by cheque, draft, order or otherwise);
- use of such funds for advances, investments or any other operation either authorised by law or by customary banking practices. There are various laws and regulations covering both the receiving of funds from the public.

All fintech operations are meant to comply with some guidelines that are also applicable to banks on storage of data etc, but non-bank fintechs are not regulated under the Banking Act since they don't accept deposits. All Banks must comply with the minimum capital requirements.

3 | Do the rules vary depending on the size or complexity of the banking institution?

No.

Primary and secondary legislation

4 | Summarise the primary statutes and regulations that govern the banking industry.

The Banking Act and the Monetary Law Act are the primary statutes. CBSL also issues directions and circulars under these statutes. The directions specify ceilings on shareholdings and specific licensing processes.

The Payment and Settlement Systems Act empowers CBSL's Payments and Settlements Division to regulate and supervise payments, clearing and settlement systems, and prescribe relevant policies.

Banks are incorporated or registered under the Companies Act. The law also governs minority shareholders' interests.

The Foreign Exchange Act and regulations regulate foreign currency related matters.

The Financial Transactions Reporting Act, Prevention of Terrorism (Temporary Provisions) Act, Prevention of Money Laundering Act and Convention on the Suppression of Terrorist Financing Act, regulate the anti-money laundering and countering terrorist financing regime.

A cybersecurity bill and data privacy bill were proposed in 2019 and are currently in the process of being finalised before it is put to the parliament for enactment.

Regulatory authorities

5 | Which regulatory authorities are primarily responsible for overseeing banks?

The Monetary Board is the primary regulator of all banks since it issues all licences. The CBSL's various Divisions manage the supervision.

The CBSL's Bank Supervision Department is the key supervisor of banks. Payment, clearing and settlement is overseen by the Payments and Settlement Division.

Banks listed on the Colombo Stock Exchange (CSE) must comply with the CSE listing rules and are subject to regulation by the Securities and Exchange Commission of Sri Lanka.

Government deposit insurance

- 6 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

With effect from 1 October 2010, CBSL requires all LCBs, LSBs and registered finance companies to join the Sri Lanka Deposit Insurance and Liquidity Support Scheme.

Under the Sri Lanka Deposit Insurance Scheme Regulations, depositors will be compensated up to 600,000 rupees per depositor if a licence is suspended or cancelled by the Monetary Board.

Deposits insured under this scheme include demand, time and savings deposit liabilities of member institutions and exclude all borrowing instruments.

The banking sector in Sri Lanka consists of domestic, foreign and state-owned banks. Several of the leading and largest banks in Sri Lanka are government owned or have government participation. It is unlikely that the government will divest itself of the shares in the near future.

Transactions between affiliates

- 7 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Affiliate is referred to as 'related party' under Sri Lankan law.

Section 3(7) of the Banking Act Direction No.11 of 2007 (for LCB) and Banking Act Direction No.12 of 2007 (for LSB) requires the bank's board to avoid any conflicts of interest that may arise from any transaction of the bank with 'related parties' and to ensure that 'more favourable treatment' is not given to them.

Related parties are:

- any of the bank's subsidiary companies;
- any of the bank's associate companies;
- any of the directors of the bank;
- any of the bank's key management personnel;
- a close relation of any of the bank's directors or key management personnel;
- a shareholder owning a material interest in the bank; and
- a concern in which any of the bank's directors or a close relation of any of the bank's directors or any of its material shareholders has a substantial interest.

Types of transactions covered include:

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

'More favourable treatment' includes granting of 'total net accommodation', exceeding a prudent percentage of the bank's regulatory capital, as determined by the board, charging lower interest or paying more than the bank's deposit rate for a comparable transaction with an unrelated comparable counterparty; providing preferential treatment or providing or receiving services without an evaluation procedure.

Most banks are listed with CSE and are also expected to comply with the CSE's related-party transaction regulations.

Regulatory challenges

- 8 What are the principal regulatory challenges facing the banking industry?

The key regulatory concerns are the following.

- 1 Statutory Reserve Requirements (SRR) – LCBs must maintain reserves against deposit liabilities denominated in Sri Lanka rupees (ie, the proportion of the deposit liabilities that commercial banks are required to keep as a cash deposit with the CBSL). In 1981, the CBSL started to use open market operations and SRR to control the money supply. Over the years, the SRR has fluctuated and recently, due to covid-19, CBSL has cut its SRR to 2 per cent with effect from 16 June 2020, releasing approximately 115 billion rupees into the banking system. The low reserve requirement policy is utilised to make an impact on the liquidity of the banking system during the crisis. A lower effective rate of reserve requirement means lower costs for the banks. This means that banks can reduce lending interest rates.
- 2 Interest rate fluctuations and controls – CBSL resorts to interest rate fluctuations to conduct monetary policy. This has sometimes impacted banks as spending, is encouraged.
- 3 Currency inflation controls – an adverse shift in monetary policy leads to inflation. In the recent past, this has posed a crucial concern.
- 4 Caps on lending rates – Non-performing loans are an issue for most banks, especially during the pandemic. In response to concern over deceleration in credit demand and continued increases in non-performing loans, CBSL took measures to induce a reduction in market lending rates such as a reduction of the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR), the reduction of the SRR applicable on rupee deposit liabilities of LCBs and the imposition of caps on rupee deposit interest rates offered by the licensed financial institutions.
- 5 Inability to regulate and supervise sophisticated commercial banking systems – data privacy and cybersecurity issues especially with the high use of FinTech due to the Pandemic. Currently, Sri Lankan law doesn't provide for data privacy and cybersecurity.

The Sri Lankan FinTech SandBox was introduced to encourage as well as enable FinTech initiatives to promote efficiency and increase access to financial products and services.

Consumer protection

- 9 Are banks subject to consumer protection rules?

Yes. For example, specific requirements were introduced:

- *The Financial Ombudsman scheme of Sri Lanka* – an alternative dispute resolution mechanism for customers of the licensed banks and finance companies. However, prior to any complaint being submitted to the financial ombudsman, the complaint should first be referred to the Complaints Settlement Officer or Complaints Resolution Officer of the relevant financial institution.
- *Customer Charters of licensed banks and finance companies* – The CBSL has, under the Banking Act and the Finance Business Act, issued Customer Protection Frameworks to safeguard the rights and interests of financial customers. The salient obligations of the licensed banks and finance companies include providing factual information to customers, providing information in languages preferred by customers, facilitating customers to understand the terms and conditions, displaying key information and protecting customers from abusive debt collection practices.

Further, licensed banks and finance companies must publish audited financial accounts.

A proposed new Banking Act will provide a stronger financial consumer protection framework.

The recently established Financial Consumer Relations Department (FCRD) by CBSL will handle all external complaints and grievances directed to CBSL on entities regulated by CBSL under section 33 of the Monetary Law Act. Initially, the FCRD will only focus on financial consumer complaints and grievances on FSPs which are regulated by CBSL, with the objective of establishing an independent watchdog.

Future changes

10 | In what ways do you anticipate the legal and regulatory policy changing over the next few years?

Proposals for a new Banking Act are under way. Present proposals are changes to the types of banking licences currently issued, streamlining of approval to establish branches and other banking outlets, strengthening consumer protection, deposit insurance, governance, amalgamating both offshore banking unit and domestic banking unit operations into a single banking business, and improving resolution, enforcement and supervisory actions. It is also noted that the proposed act will govern the banking licences and regulation of banks in the upcoming Colombo International Financial Centre in the Colombo Port City.

Due to covid-19, banks may overhaul some of their protocols and policies around access management, finding ways to increase flexibility without compromising security.

The banking sector will move parts of its IT operations to public cloud environments. Most banks currently use their own private clouds. But in a lockdown and other similar emergency situations, these can be challenging to maintain. Cybersecurity will remain a top priority for banks in the future. Regulations on IT and security of banks may change quite significantly in the future.

Several regulatory measures aimed at enhancing efficiency of transmission of recent monetary policy measures to influence market lending rates are expected. CBSL expects a boost in the growth of credit and money supply expecting further reduction in lending rates and the anticipated improvement in investments. Capital ratios are expected to improve with the infusion of capital to meet the enhanced minimum capital requirements for banks by late this year. To strengthen crisis preparedness and resilience, banks must implement recovery plans to minimise the adverse impact on troubled banks and their potential spillover effects to the financial system.

SUPERVISION

Extent of oversight

11 | How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

The Monetary Board periodically calls for information, reports and returns as deemed necessary.

The Banking Supervision Division monitors financial conditions via periodic information provided. This includes weekly interest rates of deposits and advances, monthly returns on assets and liabilities, income and expense, classified advances and provisioning for bad and doubtful debts, statutory liquid assets, quarterly returns on capital adequacy, investments in shares, accommodation granted to related parties, interest spreads, foreign currency exposures, maturity gap analysis and annual returns on audited financial statements and abandoned properties.

- Both commercial banks (LCB) and specialist banks (LSBs) are also:
- 1 required to publish quarterly and annual audited financial statements including key performance indicators in the newspapers and websites within two months of the end of the period.
 - 2 subject to statutory examinations – a risk-based examination process is followed, focusing on an assessment and identification of banking risks, management of these risks and assessment of adequacy of resources to mitigate these risks. Matters in relation to non-compliance with prudential requirements and any weaknesses and deficiencies in the financial conditions, internal controls and systems and lapses in corporate governance of a bank are brought to the bank's board of directors' notice to ensure that corrective action is appropriately taken by the bank.

The Central Bank of Sri Lanka's Financial Intelligence Unit requires banks to comply with Anti-Money Laundering and Countering Terrorist Financing laws reporting requirements.

Enforcement

12 | How do the regulatory authorities enforce banking laws and regulations?

Once a banking licence is issued, the banks submit periodic reports to the Monetary Board, Bank Supervision Division, Payments and Settlements Department, Financial Intelligence Unit and Department of Foreign Exchange.

Failure to comply with any terms of a licence may lead to the suspension or cancellation of the licence. Generally, the management of a bank must notify the Monetary Board if a situation arises that may lead to the cancellation or suspension of its licence. Other stakeholders may also notify the Monetary Board.

If found to be in breach of laws and regulations, regulatory authorities may resort to imposing penalties.

For more serious cases, the authorities may even institute action at a magistrates' court. On conviction, the bank may be made liable to a fine or imprisonment or to both a fine and imprisonment.

13 | What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

Enforcement of banking laws and regulations are monitored through periodical reporting mechanisms. In this regard, accuracy and transparency is crucial. The key problem is communication and the lack of available information to the regulator.

Government-owned state banks are challenged by related-party transactions such as loans to non-performing state sector entities.

When looking to enforce banking matters, one common action taken is to institute action against defaulters of loans. An issue posed here is that the normal court process must be adhered to and this may involve considerable delays.

RESOLUTION

Government takeovers

14 | In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

Under section 10 of the Banking Act, where notice for a cancellation of a licence is issued, the Monetary Board may prohibit a commercial bank (LCB) from dealing with or disposing of its assets, entering into any transaction or class of transactions so specified, or soliciting deposits.

Where an LCB has failed to comply with the above, the Monetary Board may direct such bank to suspend all of its business and the Director of Bank Supervision to take charge of its business, books, records and assets. It is lawful for the Director of Bank Supervision to take the necessary steps for him to comply with this directive.

Takeover of banks by a regulatory authority has not been common. Rare examples were when Lankaputhra Development Bank was acquired by 100 per cent state-owned Regional Development Bank and the commencement of operation of Sri Lanka Savings Bank to provide relief to depositors and investors of the defaulted Pramuka Savings and Development Bank Limited.

However, it is quite a frequent act with regard to finance companies. In this case, to safeguard the interests of stakeholders, measures such as suspension of accepting new deposits, withdrawal of deposits and disbursement of loans and advances to facilitate the restructuring process are taken. Regulators also take steps to identify a potential investor within a reasonable time period, by calling for expressions of interest.

Bank failures

15 | What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

Where a bank considers that it is not likely to meet its obligations or risks of becoming insolvent or is about to suspend payments due to depositors and investors, under the Banking Act, it must inform the Director of Banking Supervision.

Once the Monetary Board authorises liquidation, the bank should cease to carry on business, repay depositors and other creditors and wind up all operations undertaken prior to the receipt of the authorisation (section 52 of the Banking Act).

No 'living will' concept in Sri Lanka for banks. However, planning ahead for crisis management using common banking tools are often employed.

16 | Are managers or directors personally liable in the case of a bank failure?

Directors are expected to act in the best interest of the company for which it serves and failure to do so, may, attract personal liability. This is applicable to banks as well. If the directors fail to fulfil their duties they could be found guilty of a criminal offence too.

Planning exercises

17 | Describe any resolution planning or similar exercises that banks are required to conduct.

Resolution measures under the Banking Act include orders of cease and desist from unsafe and unsound banking practices, vesting of banking business of a defaulting bank to another bank intending to acquire same, liquidation of a distressed bank. Monetary Law Act also facilitates suspension and restriction of banking business.

In general, there are some tools that can be used in crisis management:

- contingency planning;
- recovery and resolution planning; and
- deposit insurances.

CAPITAL REQUIREMENTS

Capital adequacy

18 | Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The Central Bank of Sri Lanka (CBSL) issues directions on this. Presently the Banking Direction No. 01 of 2016 together with Direction No.11 of 2019 is applicable as follows:

Components of capital	Capital adequacy ratio to be maintained
Common Equity Tier 1 including Capital Conservation Buffer	7.0%
Total Tier I including Capital Conservation Buffer	8.5%
Total Capital Ratio including Capital Conservation Buffer	12.5%

There are separate ratios for Domestic Systematically Important Banks, which are required to maintain additional Higher Loss Absorbency requirements as specified by the Monetary Board in the form of Common Equity Tier 1.

Commercial banks (LCBs) and specialist banks (LSBs) must develop and implement a sound Internal Capital Adequacy Assessment Process (ICAAP) as specified in Regulatory Framework on Supervisory Review Process. LCBs and LSBs are to submit a Board-approved ICAAP Document to the Director of Bank Supervision within five months from the end of its financial year.

As of 1 July 2017, LCBs and LSBs must disclose key information on regulatory capital, liquidity and risk management with the published financial statements. Manner of disclosures are specified in Schedule III to Banking Act Direction No. 01 of 2016 dated 29 December 2016.

Following the impact of covid-19, CBSL introduced debt moratoriums to individuals and businesses via banks. CBSL has provided flexibility by ensuring these moratoriums do not act as a trigger for a significant increase in credit risk.

19 | How are the capital adequacy guidelines enforced?

Enforcement is assured via disclosure reports. As of 1 July 2017, LCBs and LSBs must disclose key information on regulatory capital, liquidity and risk management together with the published financial statements.

Any bank in breach of the directions will be guilty of an offence.

Undercapitalisation

20 | What happens in the event that a bank becomes undercapitalised?

LCBs/LSBs that fail to comply with the minimum capital requirements under the Banking Directions cannot pay dividends, repatriate profits or adopts measures that further deteriorate their capital until the capital requirement is restored and confirmed by the Director of Bank Supervision.

Restrictions in terms of asset growth and branch expansion will be imposed – on LCBs and LSBs which are non-compliant with the above Directions.

Insolvency

21 | What are the legal and regulatory processes in the event that a bank becomes insolvent?

An LCB must inform the Director of Banking Supervision if it is about to become insolvent (section 49A of the Banking Act). For voluntary liquidation to commence, prior written authorisation of the Monetary Board must be obtained (section 51 of the Banking Act). Once authorisation is received to liquidate, the bank should cease to carry on business, repay depositors and other creditors and wind up all operations undertaken prior to the receipt of the authorisation (section 52 of the Banking Act).

Regarding LSBs, where CBSL thinks or upon information received from the bank that it is insolvent or is likely to become unable to meet the demands of its depositors or that its continuance in business is likely to involve loss to its depositors or creditors, the same shall be notified to the Monetary Board via CBSL Governor. Monetary Board may then make an order suspending business of the Bank.

Internally, the usual process for an insolvent company under the Companies Act must also be adhered to.

Recent and future changes

22 | Have capital adequacy guidelines changed, or are they expected to change in the near future?

As a result of the debt moratoria introduced to provide relief to pandemic-affected individuals and businesses, in certain cases capital conservation buffers were less stringent. Accordingly, Domestic Systemically Important Banks (D-SIBs) and non-D-SIBs were allowed to draw down their Capital Conservation Buffers by 100bps and 50bps, respectively, aiming to facilitate uninterrupted credit flows.

OWNERSHIP RESTRICTIONS AND IMPLICATIONS

Controlling interest

23 | Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank (or non-bank). What constitutes 'control' for this purpose?

Bank

Under Sri Lankan law, 'material interest' means the holding of over 10 per cent of the issued capital of a commercial bank (LCB) carrying voting rights. Thus, share ownership exceeding 10 per cent requires Monetary Board and Ministry of Finance approval.

As per the new Directions issued in September 2020:

- a maximum of 15 per cent in an LCB can be acquired as material interest;
- up to 20 per cent in an LCB or specialist bank (LSB) may be held by multilateral financial organisations, such as the World Bank, International Finance Corporation, Asian Development Bank and other similar Monetary Board approved institutions. This is subject to material interest so acquired being reduced to 15 per cent within a period of 10 years from the date of stipulation.

Nevertheless, where restructuring to avoid inadequacy of capital, insolvency or potential failure is required, the Monetary Board may, grant permission to acquire or hold voting shares in excess of 15 per cent subject to the acquired issued capital being reduced to 15 per cent within a period as may be determined by the Monetary Board on a case-by-case basis, provided also that such period shall not exceed five years from the date of granting permission. However, the above shall not apply to the ownership of issued capital carrying voting rights in LCBs established by a statute in which the ownership of a

majority of the shares is held by the government or public corporation or statutory body or LSBs that are established by a statute or under the Companies Act, No. 17 of 1982 in which the ownership of a majority of the shares is held by the government, public corporation or statutory body.

There are no limitations relating to the type of entities and individuals that may own a controlling interest. As per section 12(1C) of the Banking Act, the requirement is that an individual, partnership or corporate body either directly or indirectly or through a nominee or acting in concert with an individual, partnership or corporate body must obtain prior written approval of the Monetary Board given with the concurrence of the Minister to acquire a material interest in an LCB incorporated or established within Sri Lanka. Approval is subject to terms and conditions as the Monetary Board may deem fit.

For the purposes of this section 12(1C), 'acting in concert' means acting pursuant to an understanding to actively cooperate in acquiring a material interest in an LCB so as to obtain or consolidate, control of that bank.

'Control' is otherwise not specifically defined elsewhere.

Non-bank

As per Direction No. 08 of 2020, which will be effective from 1 January 2022, licensed finance companies (LFCs) must reduce the direct or indirect holding of shares carrying voting rights by any shareholder up to a maximum limit of 50 per cent of the issued capital carrying voting rights in the LFC, by 31.12.2033.

The Monetary Board may apply even more stringent restrictions on voting rights on the following grounds:

- such major shareholder, being an individual, is determined by the Monetary Board as an individual not fit and proper
- such major shareholder, being a company, a body corporate or an unincorporated body, has one or more directors or CEOs who are determined by the Monetary Board as individuals not fit and proper; or
- in the opinion of the Monetary Board that such major shareholder exerts significant influence or excessive power in decision making and operations of the LFC that would threaten the sound and prudent management of the LFC.

The above is not applicable to an LFC that is a subsidiary of a licensed bank or if special approval is given by the Monetary Board.

Foreign ownership

24 | Are there any restrictions on foreign ownership of banks (or non-banks)?

Banks

While there are no limits on foreign shareholding, the general limits apply to all.

The Monetary Board has issued directions regarding the maximum percentage of the share capital that may be held by:

- a company, an incorporated body, or an individual;
- in the aggregate by:
 - a company and one or more of its subsidiaries, holding company, a subsidiary company of its holding company or a company in which such company or its subsidiary company, or its holding company, or a subsidiary company of its holding company has a substantial interest; or
 - an individual and one or more of either his or her close relation; a company in which he or she has a substantial interest or in which his or her close relation has a substantial interest; its subsidiary company; its holding company; a subsidiary of such company's holding company; a company in which such

company or its holding company has a substantial interest; or an incorporated body other than a company in which the individual or his or her close relation has a substantial interest.

As per the new Directions issued in September 2020:

- a maximum of 15 per cent in an LCB can be acquired as material interest;
- up to 20 per cent in an LCB/LSB may be held by multilateral financial organisations, such as the World Bank, International Finance Corporation, Asian Development Bank and other similar Monetary Board approved institutions. This is subject to material interest so acquired being reduced to 15 per cent within a period of 10 years from the date of stipulation.

Nevertheless, where restructuring to avoid inadequacy of capital, insolvency or potential failure is required, the Monetary Board may, grant permission to any of the categories of the shareholders specified under the Banking Act to acquire or hold voting shares in excess of 15 per cent subject to the issued capital so acquired being reduced to 15 per cent within a period as may be determined by the Monetary Board on a case-by-case basis, provided also that such period shall not exceed five years from the date of granting permission.

However, the above shall not apply to the ownership of issued capital carrying voting rights in LCBs established by a statute in which the ownership of a majority of the shares is held by the government or public corporation or statutory body or LSBs that are established by a statute or under the Companies Act, No. 17 of 1982 in which the ownership of a majority of the shares is held by the government, public corporation or statutory body.

Non-banks

There are no limits on foreign shareholding, the general limits on ownership apply.

Implications and responsibilities

25 | What are the legal and regulatory implications for entities that control banks?

No specific provisions on this. However, if the entity acquiring control is publicly listed, CSE Listing Rules on disclosures and reporting must be adhered to. Further, any requirement imposed by CBSL when granting approval, if any, to the acquisition must be complied with.

26 | What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

No specific provisions on this. However, if the bank that acquires control is a public listed entity, any duties and responsibilities under the Listing Rules must be adhered to. Any requirement by CBSL when granting approval, if any, for the acquisition must also be complied with.

27 | What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

There are no specific provisions in this regard, unless specifically imposed at the point CBSL grants approval to hold a material interest.

CHANGES IN CONTROL

Required approvals

28 | Describe the regulatory approvals needed to acquire control of a bank (or non-bank). How is 'control' defined for this purpose?

Banks

Written approval of the Monetary Board with the concurrence of the Minister of Finance, is required for acquisition of a material interest in a commercial bank (LCB) or specialist bank (LSB) or branch of another LCB or LSB.

Section 12(1)(C) of the Banking Act requires Monetary Board approval for acquisitions of an LCB incorporated or established within Sri Lanka. The concurrence of the Minister of Finance is also required.

This means that an entity or individual may be a major shareholder depending on the proportion of shareholding owned or an entity or group of individuals may act in concert.

With reference to the definition of 'control', under Sri Lankan law, 'material interest' means the holding of over 10 per cent of the issued capital of an LCB carrying voting rights. New directions issued in September 2020 specify the maximum material interest that can be acquired, subject to certain exceptions. 'Control' is otherwise not specifically defined elsewhere.

Non-banks

Written approval is required for acquisition of a material interest in a finance or leasing company.

Foreign acquirers

29 | Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

Foreign acquisitions are not barred. The process is not different. However, the Sri Lankan foreign exchange laws and regulations will apply. For example, foreign acquirer must invest via an inward investment account.

30 | Under what circumstances can a foreign bank (or non-bank) establish an office and engage in business? For example, can it establish a branch or must it form or acquire a locally chartered bank?

Banks

Foreign banks can set up overseas branches here, subject to being registered as a branch office and being regulated through a licensing system. It need not acquire a local bank. The parent (foreign) bank should be a body incorporated outside Sri Lanka or formed in pursuance of any statute of a foreign country, royal charter or patent. A high level of control is exerted by the Central Bank of Sri Lanka (CBSL).

The branch of the bank should have a capital of not less than the minimum capital required by CBSL – which has to be assigned to the branch by its head office. As per the latest Direction No.05 of 2017, a foreign branch with assets over 100 billion rupees must maintain a minimum capital (as defined in the said Direction) of 10 billion rupees and a foreign branch with assets up to 100 billion rupees must maintain a minimum capital of 5 billion rupees.

Once established, the applicable capital adequacy ratios must be maintained. The Banking Act also specifies requirements for CEO and senior officers.

Non-banks

Foreign entities must register in Sri Lanka and obtain a licence to engage in finance and leasing activities. It cannot be registered as an overseas company branch office in Sri Lanka.

Factors considered by authorities

31 | What factors are considered by the relevant regulatory authorities in an acquisition of control of a bank (or non-bank)?

Some factors are adequacy of capital, ability to carry on in a competent manner and to meet obligations and liabilities of the bank to be acquired and its depositors and creditors, ability to raise adequate capital, experience or history in the banking sector, interest in other local banks and if so, the percentage, the validity and acceptability of documents submitted for approval, financial standing and ability to comply with the provisions of the Banking Act.

The Monetary Board must be satisfied that the bank to be acquired, the banking sector and country could benefit from the acquisition.

The factors that are considered by authorities in an acquisition of control of a non-bank is not specifically provided either but would largely be the same as for banks.

Filing requirements

32 | Describe the required filings for an acquisition of control of a bank.

There are no separate filings.

Time frame for approval

33 | What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

There is no stipulated time frame. This will vary depending on the factors such as the target, acquirer and reason for acquisition.

UPDATE AND TRENDS

Key developments of the past year

34 | Are there any emerging trends or hot topics in banking regulation in your jurisdiction?

In January 2020, the Governor of the Central Bank of Sri Lanka (CBSL) announced that Sri Lanka will enact a new Banking Act in 2021. It was also announced that regulations will also be introduced to supervise banks being set up in the Colombo International Financial Centre, situated in the Colombo Port City. The Governor also indicated that CBSL has revisited certain provisions of the Foreign Exchange Act and proposed amendments to the provisions of the said Act would be completed soon.

The CBSL is currently in the process of introducing an international transaction reporting system, a comprehensive monitoring system of cross-border transactions and foreign currency transactions through the banking system.

The covid-19 pandemic has been having a weighty effect on businesses and workplace configurations as social distancing is expected to continue in the months to follow. The banking industry has anyway been increasingly incorporating fintech into normal day-to-day operations in the past few years. But, leading from the hit from covid-19, with the need for social distancing and work from home concepts, the banking sector relied on fintech much more.

The introduction of the FinTech Sandbox is also a recent development to enable and promote fintech initiatives.

The Financial Consumer Relations Department was established by CBSL with effect from 10 August 2020 to safeguard the rights of consumers and investors in the financial industry in Sri Lanka.

In delivering the 2021 Budget Speech, the Prime Minister emphasised the requirement to reform the banking and financial sectors to ensure availability of credit and financing for the production process and associated transactions.



Heshika Rupasinghe

hrupasinghe@tiruchelvam.com

No. 116/10
Rosmead Place
Colombo 7
Sri Lanka
Tel: +94 11 2698110 / 019
Fax: 94 11 2696618
www.tiruchelvam.com

Subsequent to the initial impact on the sector due to covid-19, CBSL introduced a series of benefits for individuals and businesses, including debt moratoria. CBSL is striving to maintain a delicate balance between efficient flows of credit to businesses and preserving the durability of the financial sector.

Declaring cash dividends or repatriation of profits, engaging in share buybacks, increasing management allowances and payments to the board of directors is restricted until 31 December 2020.

The concern for CBSL is balancing its measures to assist banks to support the economy whilst not compromising international regulatory standards.

It is understood that regulatory tolerances for a very long period is not healthy in many aspects. Deviating from international best practices for a prolonged period could lead to future risks that potentially undermine the medium-term soundness and health of the banking system (IMF).

2021 budget proposals included tax exemption on gains on the realisation of Sri Lanka international sovereign bonds where the commercial banks purchase such bonds subject to a minimum of US\$100 million and also to suspend the risk-weighted provisioning under Central Bank Regulations for three years.

Further, in relation to the computing business income of banks the following deductions were proposed:

- anticipated losses of loans and doubtful debts;
- cost of funds incurred on providing loans as start-up capital to individuals who have completed vocational education for approved businesses identified as eligible for tax exemption; and
- expenditure incurred on acquisition of, or merger with, subsidiary companies.

Administration-wise, it was proposed that banks also be brought under one Large Tax Payer Unit, which will operate under the supervision of the Commissioner General of the Inland Revenue.

CORONAVIRUS**Coronavirus**

- 35 | What emergency legislation, relief programmes and other initiatives specific to your practice area has been implemented to address the pandemic? Have any existing government programmes, laws or regulations been amended to address these concerns? What best practices are advisable for clients?

The Central Bank of Sri Lanka introduced a debt moratorium for affected businesses and individuals. The deadline for submission of requests by eligible borrowers was extended until 10 December 2020. Tenure of the moratorium will not exceed six months from 1 October 2020 or a shorter period, as applicable. The moratorium is to be granted for both capital and interest. Relief was especially given to businesses and individuals operating in the tourism industry.

Clients are advised to liaise with their respective banks and financial institutions to avail such concessions so that such clients may better manage their finances, given the impact of the pandemic.

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