Chapter 7
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Advancing Corporate Governance in the Banking Sector in Sri Lanka: Assessing Regulatory Frameworks and Supervisory Roles

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ABSTRACT

In the aftermath of the civil war in Sri Lanka, the country has witnessed a significant increase in economic development, with the banking sector assuming a pivotal role in financing growth and fostering economic prosperity. This chapter investigates the importance of Corporate Governance (CG) within Sri Lanka's banking sector, recognizing its profound influence on public trust and confidence, essential for ensuring the stability of financial institutions. The chapter critically examines the state of CG development and its implications, focusing on the adequacy of regulatory frameworks provided by key legislative Acts such as the Companies Act, Banking Acts, and Securities Act and other pertinent regulations. It highlights the crucial role of a robust governance culture within the banking sector and emphasizes that banking institutions are crucial for maintaining a healthy economy. The banking industry stands as the cornerstone of Sri Lanka's economy and operates in a highly regulated environment. Banks play a critical role by taking public deposits and facilitating financial transactions for individuals and businesses, thereby contributing significantly to economic stability and growth. Given the country's past economic challenges, establishing solid governance practices within the banking sector is imperative for steering Sri Lanka towards a more resilient and prosperous future. The Central Bank of Sri Lanka (CBSL) emerges as a key player in this narrative, exhibiting continuous improvement in its supervisory capacity. Through the enforcement of stringent measures and the adoption of BASEL principles, the CBSL demonstrates a steadfast commitment to enhancing CG within the banking industry. Additionally, the CBSL has mandated a comprehensive code of CG, stressing the importance

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of full compliance from banks within a specified timeframe. However, despite these advancements, challenges persist in addressing CG issues within the banking landscape. This study sheds light on the scope, impact, and effectiveness of the supervisory and regulatory oversight of the CBSL, while also highlighting ongoing challenges. By critically evaluating regulatory frameworks and supervisory roles, this chapter aims to contribute to the ongoing discourse on advancing CG in the banking sector in Sri Lanka, ultimately fostering a more stable and resilient financial ecosystem.

Keywords: Corporate governance; collapses; banking sector; regulatory frameworks; economic development.

1. INTRODUCTION

The banking sector stands as the bedrock of any economy, serving as the primary conduit for financial intermediation and economic development. In Sri Lanka, as in many other nations, the vitality of this sector is indispensable for ensuring smooth economic functioning and sustained growth. However, to fully harness the potential of the banking industry and safeguard against systemic risks, a robust corporate governance (CG) framework is imperative. CG within the banking sector not only underpins financial stability but also fosters trust and confidence among stakeholders, including depositors, investors, and regulatory authorities. Given the inherent structure of the banking industry, it is noteworthy that approximately 80% of banking assets are typically funded through depositor's funds, with a minimal percentage, ranging between 5% to 10%, attributed to equity investments [1]. Consequently, banks are obligated to adhere to exemplary behavioral standards and prioritize the safeguarding of the interests of individuals who have entrusted them with their savings, thereby facilitating the operations and investments of these businesses [2].

Banks, as the apex financial bodies and dominant financial intermediaries, play a crucial role in facilitating economic activities, thereby contributing to the overall stability and development of the economy. However, with their central position comes the responsibility to establish and uphold a solid governance culture, ensuring the trust and confidence of stakeholders. In recent times, the importance of sound governance practices has been underscored by global banking crises, highlighting the necessity for effective regulatory frameworks and supervisory roles. Amidst the fierce competition and complexities inherent in the banking sector, banks are compelled to follow a highly regulated environment while effectively managing risks. Failure to uphold sound governance practices can have far-reaching consequences, as witnessed in past banking crises characterized by mismanagement, abuse of power, and irregularities in handling depositors' funds. Furthermore, in today's interconnected global financial landscape, uniform standards in governance have become imperative. Governments worldwide have implemented governance reforms, particularly in the banking sector, to ensure consistent standards across borders, reflecting a broader concern for the stability of the financial system.

As aforementioned, the banking industry in Sri Lanka stands as the cornerstone of the economy, channeling savings into investments and facilitating economic growth. Hence, a comprehensive evaluation of CG within Sri Lanka's banking sector is essential. This chapter explores the imperative of CG within Sri Lanka's banking sector, highlighting its profound influence on public trust and confidence, which are indispensable for ensuring the stability of financial institutions. Through a critical examination, this study assesses the challenges confronting the banking sector in Sri Lanka regarding CG, emphasizing the importance of robust regulatory frameworks and effective supervisory roles in cultivating a healthy governance culture. By examining existing regulatory frameworks and supervisory mechanisms, the aim is to evaluate the adequacy of existing measures and propose avenues for advancement. Central to this exploration lies the recognition of the pivotal role banks play in economic development, as they mobilize savings, facilitate investment, and drive growth. Within the complex landscape of financial regulation, banks occupy a unique position, subject to stringent oversight owing to their systemic significance. The study elucidates the interplay between regulatory structures, governance practices, and the resilience of the banking sector, highlighting the necessity of aligning governance standards with international best practices.

Furthermore, the investigation probes into past instances of governance lapses within banks, emphasizing the repercussions of mismanagement and inadequate risk mitigation strategies. By learning from past failures, stakeholders can fortify governance frameworks, mitigate risks, and enhance the integrity and stability of the banking sector. In light of the interconnectedness of global financial systems, the study acknowledges the imperative of harmonizing governance standards across borders. It underscores the role of regulatory convergence in promoting consistency and coherence in banking governance, thereby strengthening investor confidence and fortifying financial stability.

Through a focused examination of CG principles within the banking sector, this chapter endeavors to offer a thorough analysis of CG principles within Sri Lanka's banking sector, shedding light on the complex regulatory dynamics and supervisory requirements essential in nurturing a banking industry characterized by resilience, accountability, and trustworthiness. Through a critical evaluation of these key components, this chapter’s aim is to contribute to the ongoing discourse on fostering a robust governance culture within Sri Lanka's banking landscape, ultimately enhancing financial stability and fostering sustainable economic development.

1.1 Statement of Problem

The Sri Lankan banking sector plays a crucial role in the country's economy. However, there have been concerns regarding the effectiveness of CG practices in this sector. It is essential to evaluate and address the challenges faced by the banking sector in terms of governance, particularly by improving regulatory frameworks and supervisory roles to ensure the stability and integrity of financial institutions, as there have been cases of mismanagement, abuse of power, and other irregularities that compromise public trust and confidence in the sector. It is essential to evaluate the effectiveness of current measures in promoting a robust governance culture and mitigating systemic risks, especially in light of banking crises and evolving regulatory landscapes.

Ensuring the trustworthiness and accountability of banks is paramount for maintaining depositor confidence, attracting investments, and sustaining economic growth. Harmonizing governance standards with international best practices is necessary for enhancing the resilience and competitiveness of Sri Lanka's banking sector. This requires aligning governance frameworks with global benchmarks to strengthen investor confidence and promote financial stability. The ultimate goal is to foster a governance culture that supports sustainable economic development. The erosion of stakeholder trust and confidence due to governance lapses poses significant challenges. Effective CG practices within the banking sector are instrumental in mobilizing savings, facilitating investment, and driving growth, thus necessitating a comprehensive examination of governance challenges and opportunities.

The statement of problem for this study is that weak or inadequate CG practices within the banking sector can significantly amplify financial instability and expose banks and financial institutions to heightened risks. Such deficiencies not only erode investor confidence in the stability of the banking industry but also prompt investors to divert their capital towards alternative investment avenues. Therefore, mandatory adherence to CG principles for banks and financial institutions is essential to promote a culture of trust and confidence, ensuring that banking operations are conducted with due regard for responsibility and accountability. Strengthening CG practices within the sector is expected to strengthen the safety and integrity of individual banks, thereby enhancing the overall stability of the banking sector.

1.2 Research Objective

This research examines the impact of CG regulations that apply to the banking industry in Sri Lanka and its impact on public trust, confidence, and financial institution stability. It aims to highlight the significance of strong regulatory frameworks and effective supervisory roles in promoting a healthy governance culture. It seeks to determine if the existing regulations protect the public and instill confidence. The study aims to identify areas for improvement in regulatory frameworks and supervisory mechanisms to mitigate systemic risks. The research endeavors to align governance standards with international best practices and emphasizes the need for harmonizing these standards globally. Ultimately, this research contributes to promoting a robust governance culture within Sri Lanka's banking sector, enhancing financial stability and facilitating sustainable economic development.

2. RESEARCH METHODOLOGY

This study is based on qualitative research and relies primarily on primary and secondary sources of data for investigation. Primary data is collected through legal statutes, while comprehensive range of publications has been consulted for secondary data, including scholarly journals, textbooks, legislative documents, academic writings, newspaper articles, and online resources. These secondary sources provide a strong foundation for the analysis and insights presented in the study, ensuring a well-informed and robust examination of the subject matter.

3. LITERATURE REVIEW

In the contemporary context, CG varies considerably from one country to another and even within different organizations, influenced by various factors including political and economic conditions. For instance, companies operating in developed nations typically have dispersed shareholders and function within stable political and financial environments, supported by well-established regulatory frameworks and effective CG practices. Conversely, in developing countries like Sri Lanka, CG mechanisms may face challenges due to political instability, leading to economic disruptions and increased defense expenditure, consequently resulting in a widening fiscal deficit. In such contexts, CG assumes heightened importance as it directly impacts the growth prospects of the economy [3]. The essence of CG lies in its role as a mechanism to mitigate the loss of potential value arising from the separation of ownership and control within firms [4]. Moreover, sound CG practices are viewed as instrumental in reducing risks for investors, fostering the attraction of investment capital, and enhancing the overall performance of companies.

In the exploration of CG within Sri Lanka's banking sector, a comprehensive review of relevant literature is indispensable. CG structures were evident during the reign of Kings in ancient Sri Lanka, though the term "corporate governance" was not used explicitly [5]. Heenetigala [3] elaborates that during this period, governance was structured according to the caste system, which established distinct hierarchies. Sri Lanka's governance framework experienced a significant shift in 1977 when open economic policies were adopted by Manawaduge [6]. These policies led to improvements in both local and foreign investments and resulted in the establishment of various companies for diverse business purposes. Along with the introduction of new laws and regulations, many governance practices, such as disclosure requirements, board responsibilities, and audit procedures, were embedded within them at the time [5]. The formalization of CG initiatives in Sri Lanka began in the 1990s with the introduction of voluntary codes of best practices, which focused on the financial aspects of CG [7].

The Organization for Economic Cooperation and Development (OECD, 2004) has outlined that CG frameworks should prioritize their impact on economic performance, market integrity, and the incentives they create for market participants to promote transparent and efficient markets. However, implementing CG practices in emerging markets, such as Sri Lanka, presents unique challenges. As a result, these complexities can hinder the implementation of good CG practices, potentially compromising returns on investment. Sound CG practices are imperative for fostering sustainable economic growth, employment, and financial stability, thereby contributing to the broader global economy (OECD, 2004). CG has garnered heightened attention in recent decades, particularly in the aftermath of global financial crises and corporate scandals worldwide [8]. Furthermore, CG promotes the efficient allocation of resources within firms and economies, enhances investor and creditor confidence and contributes to long-term performance by being responsive to societal needs.

The literature highlights the paramount importance of CG in the banking sector of Sri Lanka, tracing back to seminal works such as John Exeter's report in 1949 on the establishment of the Central Bank for Ceylon. Exeter identifies the banking system as a cornerstone of economic stability and underscores the necessity of supervisory measures to safeguard against mismanagement and public loss of confidence [9] This sentiment is echoed by Moonesinghe [1], who emphasizes the sentiment that ‘money serves as the foundation of every capitalist economy, with a select group of highly compensated individuals in the financial services sector being tasked with safeguarding society's bank deposits, investments, and, at times, even their precious metals like gold. Central to this observation is the profound notion that corporate responsibility primarily entails trust, known as fiduciary responsibility, wherein the public entrusts their deposits to bank management. Consequently, the foremost obligation of bank management lies with their depositors rather than their shareholders’. Shleifer and Vishney [10] elaborate on the essence of CG as a mechanism to ensure fair returns for external capital providers, particularly relevant in contexts where ownership is separated from control.

Maw and Michael [11] broaden the scope, framing CG not only as a means to protect shareholders but also as a regime essential for the well-being of employees, customers, and the national economy. Dinc [12] examines specifically the banking sector, revealing its unique role in governance and financing, where banks act as primary entities for their shareholders and exert significant influence through cross-shareholding arrangements. Exploring the importance of CG in banks, Dinc [12] further emphasizes the complex relationships and power dynamics within banking systems, emphasizing their pivotal role in governance and financing. Given banks' centrality in the economy, CG failures within the banking sector can have far-reaching consequences, potentially triggering financial crises with ramifications transcending national borders. Thus, understanding and addressing CG challenges within the banking sector is of paramount importance.

Further substantiating the significance of CG in the Sri Lankan banking context, Sivaraja et al. [13] emphasize its role in driving financial efficiency within commercial banks. This underscores the vital link between CG practices and the overall performance of the banking sector in Sri Lanka. In light of the importance of financial stability, regulatory bodies such as the CBSL play a crucial role in overseeing and enforcing regulatory frameworks to ensure stability and safeguard against systemic risks (CBSL, 70-71). Moreover, Dinc [12] warns of the far-reaching implications of CG failures within banks, stressing the potential for such failures to precipitate financial crises with reverberating effects across national borders.

In the context of Sri Lanka's banking sector, the significance of CG becomes particularly pronounced. Stability within the banking system is paramount for economic growth, with good CG serving as a foundation for achieving similar standards across other firms. Banks, with their diverse stakeholders including governments, regulators, and depositors, rely heavily on robust governance frameworks to inspire market confidence and attract capital through enhanced disclosure and transparency. Moreover, effective CG ensures that companies not only prioritize the interests of specific groups but also consider the broader communities in which they operate, thereby contributing to societal well-being.

Wijewardena [2] rightly points out that the prevailing protective attitude of regulatory bodies towards banks has resulted in a relaxed approach towards adhering to ethical practices. This leniency can be compared to a student's decreased commitment to studies when they know that examiners will prevent them from failing. Wijewardena further notes that banks, buoyed by this protective shield, may be more likely to take unnecessary risks, ignore internal safety protocols, and engage in unethical conduct. This behavior, known as moral hazard, poses a significant threat to a bank's well-being and overall stability, increasing the likelihood of failures and placing an unexpected burden on regulatory authorities. Wijewardena also highlights ‘banks' susceptibility to customer influence since their deposit base is composed of numerous small deposits lacking effective oversight by the board and management decisions. Deposit holders lack the leverage or voice to exert control individually, while collective action is hindered by high transaction costs. Consequently, the lack of active involvement by depositors and creditors in overseeing a bank's affairs incentivizes the board and management to prioritize their interests over their obligations to depositors and creditors [2]. This emphasizes the critical importance of robust CG practices within the banking sector to mitigate such risks and ensure responsible stewardship of stakeholders' interests.

According to Hopt (2021), the Basel Committee on Banking Supervision recognized as the foremost authority on banking regulation and supervision worldwide, commences its 2015 Guidelines on CG principles for Banks by emphasizing the pivotal role of effective CG in ensuring the proper operation of the banking sector and the broader economy. The literature emphasizes the crucial role of CG in promoting stability, trust, and efficiency in Sri Lanka's banking sector. It highlights the complex dynamics involved, which require robust regulatory frameworks and vigilant oversight to ensure the soundness of financial institutions and the overall economy.

4. THE CONCEPT OF CORPORATE GOVERNANCE

The term "Corporate Governance" lacks a singular, universally accepted definition. Instead, it represents a multidisciplinary concept that is subject to international debate and encompasses various characteristics. CG comprises a framework of laws, processes, policies, customs, and institutions that influence how an organization's business is conducted by its management. Fundamental principles such as transparency, accountability, and integrity guide the operation of these mechanisms.

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.”

The OECD definition makes it clear that CG serves as the framework through which various stakeholders of a company engage and collaborate in order to promote long-term wealth creation while adhering to the principles of good corporate citizenship. CG is increasingly recognized as a crucial component of financial stability, essential for instilling trust and confidence in banks, particularly in the wake of financial failures, fraud, and questionable business practices that have eroded investor confidence. The World Bank defines CG as “concerns the system by which companies are directed and controlled. It is about having companies, owners and regulators become more accountable, efficient and transparent, which in turn builds trust and confidence.”

The Cadbury Report, a seminal document in the field of CG defines it as "the system by which companies are directed and controlled... CG is about promoting corporate fairness, transparency, and accountability [14]." According to the Principles of CG by the Basel Committee on Banking Supervision, CG is " a set of relationships between a company’s management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance. It helps define the way, authority and responsibility are allocated and how corporate decisions are made [15]".

It is evident that CG is a complex concept that includes various relationships, processes, and mechanisms that direct and control companies, including those in the banking industry. CG emphasizes the importance of stakeholders such as management, boards of directors, shareholders, and regulators in shaping the governance framework of organizations. These definitions collectively emphasize the importance of effective direction, control, transparency, accountability, fairness, and stewardship within organizations to ensure that they operate in the best interests of all stakeholders, including shareholders, employees, customers, and the broader society.

5. DEFINITION OF A BANK

A bank is a financial institution that provides a range of financial services to individuals, businesses, and governments, making it a vital part of the economy.

They act as intermediaries between depositors who have excess funds and borrowers who require capital, thereby facilitating the flow of money in the economy. Apart from financial intermediation, a bank provides various key services such as payment services, investment services, risk management, and financial services. It is important to note that the banking industry is constantly evolving due to technological advancements, regulatory changes, and shifts in consumer preferences. As a result, modern definitions of banks may also include digital banks, fintech companies, and other non-traditional financial institutions that offer innovative ways of banking, often referred to as neobanks or challenger banks [16].

The term 'bank' encompasses a range of meanings and its interpretation varies depending on the nature of the banking activities involved. Section 16 of the Banking Act, No. 30 of 1988 (1988 Act) stipulates that only Licensed Commercial Banks or Licensed Specialized Banks are permitted to use the terms 'bank, banker, banking,' or their derivatives, translations, or equivalents in any language without prior approval from the Monetary Board. A notable distinction between Licensed Commercial Banks and Licensed Specialized Banks lies in their permitted activities. Licensed Commercial Banks are authorized to accept demand deposits from the public, operate current accounts for customers, and act as authorized dealers in foreign exchange, enabling them to conduct a broad spectrum of foreign exchange transactions. Conversely, Licensed Specialized Banks are allowed limited engagement in foreign exchange transactions with the approval of the CBSL [17].

The term 'banks' as defined in Section 2 of the Bills of Exchange Ordinance No. 25 of 1927 of Sri Lanka refers to "a body of persons, whether incorporated or not, who engage in the business of banking." Furthermore, Section 86 of the 1988 Act provides a codified interpretation of "banking business," defining it 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”.

The term "banking institution" is defined in Section 124, the interpretation section of the Central Bank of Sri Lanka Act No. 16 of 2023 (CBSL Act), to include various entities. This includes commercial banks operating within the country, as well as agencies or institutions, whether established by statutory enactment or otherwise, acting on behalf of the Government, engaged in activities such as extending loans, advances, or investments, or accepting deposits from the public. Additionally, any other person or entity designated as a banking institution by the Minister of Finance through an official Gazette notification under this Act, for the purposes outlined within this Act.

The above statutory definition under the CBSL Act provides a broader and more inclusive compared to the definition provided in the 1988 Act. It gives a comprehensive framework for defining entities falling under the ambit of "banking institutions" within the regulatory scope of the CBSL. It reflects a modernized approach to regulating banking activities, accommodating a wider range of entities involved in banking functions. By explicitly incorporating government agencies or institutions acting on behalf of the Government within the definition, the CBSL Act acknowledges the diverse landscape of banking services and the involvement of various entities in financial activities.

6. BANKING COMPANY

In Sri Lanka, the legal definition of a "banking company" is not explicitly outlined within statutory frameworks. Instead, the Companies Act No. 7 of 2007 (2007 Act) governs the formation and operation of companies in the country. Under this act, a company is a distinct legal entity registered under a specific name and possesses the authority, as outlined in its Articles of Association, to engage in various business activities both domestically and internationally. Additionally, a company is vested with all requisite rights, powers, and privileges necessary for conducting its business within the legal frameworks of Sri Lanka or any other jurisdiction. The licensing and regulation of entities involved in banking activities fall under the purview of the Banking Legislation. These legislations mandate that entities conducting banking operations must operate as limited liability companies in compliance with the provisions of the Companies Act. As per the definitions provided in Sections 2(6) and 86 of the 1988 Act, a "banking company" is essentially a company duly incorporated under the Companies Act. Notably, upon issuance of a license by the Monetary Board, a public limited company transforms into a banking company and is authorized to conduct banking business.

According to the definitions provided in Sections 2(6) and 86 of the 1988 Act, a "banking company" refers to a company duly incorporated under the Companies Act. Additionally, as outlined in Section 124 of the CBSL Act, a "financial institution" includes licensed commercial banks and licensed specialized banks as defined in the 1988 Act. Therefore, when considering all the provisions together under the CBSL Act, it becomes evident that entities engaged in banking operations must function as limited liability companies in accordance with the provisions of the Companies Act.

Furthermore, licensed commercial banks, as banking companies, are subject to oversight from both the Companies legislation and the Banking legislation. Section 61(1) of Part IX of the CBSL Act, which stipulates the supervision and resolution of financial institutions, empowers the CBSL to regulate, license, register, and supervise all financial institutions. The regulatory framework outlined in these statutes empowers the CBSL to issue directives and guidelines tailored specifically for banks and financial entities, aimed at ensuring the stability of the banking system and mitigating the risk of banking crises. These regulations serve the overarching goal of ensuring the stability and robustness of the country's banking sector, encompassing various governance-related aspects.

One significant facet is the establishment of "fit and proper" criteria by the CBSL, which outlines the standards for evaluating the suitability of individuals serving as directors, and senior management personnel within banks. Moreover, the CBSL issues CG Directions, which provide detailed guidelines for licensed banks and financial institutions regarding governance practices. These directions cover crucial areas such as the composition of boards, risk management strategies, and the implementation of effective internal controls. Furthermore, to ensure the proper CG practices within banks, the CBSL mandates adherence to prudential standards that outline specific requirements. These standards encompass the development of robust risk management frameworks, the establishment of internal audit functions, and the board's oversight responsibilities concerning key operational functions. This dual regulatory oversight ensures adherence to legal standards and safeguards the integrity of the banking sector in Sri Lanka.

7. THE SIGNIFICANCE OF CONFIDENCE IN THE BANKING SECTOR

Confidence plays a vital role in the banking sector for several reasons. Firstly, it depends on the trust between financial institutions and their customers. This trust is particularly important in relation to depositors' faith in a bank's reliability, which encourages them to entrust their funds to the institution. Such trust is crucial to maintain stability within the financial system. Furthermore, confidence in banks significantly contributes to overall financial stability. Customers who have faith in the strength and dependability of banks are less likely to withdraw their funds during economic uncertainty or financial upheavals, thus mitigating the risk of bank runs and systemic crises. Additionally, confidence in a bank's stability allows it to access funding from various sources, including deposits and loans, at favorable rates, ensuring liquidity and facilitating lending activities. Moreover, the perception of confidence in the banking sector directly affects market sentiment and investor behavior. Positive perceptions can boost stock prices and lower borrowing costs for banks, whereas negative sentiments can adversely affect profitability and investor confidence. Finally, confidence fosters adherence to regulatory standards and best practices. Banks strive to maintain the trust of regulators, investors, and the public by demonstrating transparency, robust risk management practices, and compliance with applicable laws and regulations. Confidence is essential for maintaining stability, promoting economic growth and ensuring the smooth operation of financial markets, serving as the bedrock of trust and credibility in the relationships between banks, their customers, and the broader economy.

According to Hopt (2021), it is widely acknowledged ‘in theory, practice and supervision that banks hold a unique status compared to non-banking institutions. The distinctiveness of banking systems is often characterized by frequent banking crises and inherent structural vulnerability. Banks are frequently perceived as 'too big to fail' and 'too interconnected to fail’. This results in the need for state intervention whenever a bail-in is not feasible or fails to address the situation effectively.’ ‘One thing that remains constant for banks is the importance of good CG. Whether banks are local or international, serving individuals or businesses, operating in traditional branches or online, their success will always rely on strong governance’ [18].

In Sri Lanka, as in many economies worldwide, banks hold significant influence over the financial system. Given the critical role they play in the economy, it is vital to ensure the safe conduct of banking operations. Banking involves monetary activities such as raising funds through deposits and debt securities, lending and investing these acquired funds and facilitating domestic and international payments through various services. The operations of banks heavily rely on public confidence, as any loss of trust can disrupt the entire financial system, subsequently impacting the broader economy. Thus, safeguarding public trust in banks is crucial to maintaining stability within the financial sector and promoting sustained economic growth.

Former Governor of the CBSL, Cabraal, has highlighted the differences between the banking sector and the broader financial sector. Companies usually raise funds by selling shares, whereas banks rely mainly on public investments in the form of deposits. This reliance on public funds places significant responsibilities on banks to ensure the operational resilience of their institutions, as they are entrusted with safeguarding these funds in a specialized manner. Banks act as intermediaries, effectively allocating funds from savers to borrowers, thereby playing a crucial role in the financial ecosystem. Additionally, banks serve as pivotal agents within the payment system by facilitating and processing payments domestically and internationally through their services. Central to their function is maintaining financial stability, which is dependent on the trust and confidence of the public. Cabraal emphasizes that the loss of public confidence in banks could result in a systemic banking crisis, underscoring the critical importance of maintaining public trust for the sound operation of financial institutions [19].

In the wake of major corporate collapses, most developed countries have implemented new regulations governing CG. These measures aim to ensure transparency and accountability in management. These collapses occurred worldwide in recent years and significantly damaged investor confidence. They highlighted the dangers of CG breakdowns and raised doubts about the effectiveness of governance regimes in place at the time. Consequently, the topic of CG has gained widespread acceptance as a means of improving governance standards and boosting investor confidence.

The 2008 crisis was followed by fierce debate, and it became obvious that banks needed professionalized CG structures [18]. The concept of CG emerged in the United Kingdom (UK) and the United States of America (USA) as a response to shareholders' concerns about the potential misappropriation of their funds by corporate managers. This concern led to the rapid spread of CG principles. The fundamental belief was that active shareholder engagement in CG would increase transparency, accountability, and the wealth-generating capacity of companies. CG is widely known for its significant impact on the growth prospects of an economy. By implementing robust CG practices, companies can reduce risks for investors, attract investment capital, and enhance overall performance [20].

In the banking sector, effective CG plays a pivotal role in facilitating smooth operations and achieving organizational objectives. It involves the strategic management of the bank by its board and senior executives, who oversee strategic objectives, operations, risk management, and regulatory compliance. CG ensures efficient control and administration, encompassing robust risk management, internal controls, and compliance procedures. Transparency and ethical conduct are fundamental, with checks and balances in place to prevent misconduct. Strong governance promotes the long-term viability and sustainability of banks by guiding them efficiently, administering them effectively, and maintaining ethical transparency.

8. THE CRUCIAL ROLE OF GOOD GOVERNANCE IN THE BANKING SECTOR

The effective governance is crucial in the banking sector for various reasons. Firstly, good governance practices ensure the financial stability of banks by creating robust risk management frameworks, transparent decision-making processes, and effective oversight mechanisms. This helps banks withstand economic shocks and mitigate systemic risks. Additionally, transparent governance practices build trust and confidence among stakeholders, including depositors, investors, and regulators, which strengthens the institution's financial position. Sound governance practices also promote prudent risk management by helping to identify, assess, and mitigate various risks such as credit, market, and operational risks. Furthermore, compliance with regulatory requirements and industry standards is essential to safeguard depositors' funds, prevent financial crime, and maintain the stability of the financial system. Effective governance practices help banks navigate regulatory complexities and uphold legal and ethical standards. Also, well-governed banks are better positioned to achieve long-term sustainability and profitability by aligning corporate strategies with stakeholder interests, fostering a culture of integrity and accountability, and promoting responsible business practices. Essentially, prioritizing transparency, accountability, and risk management through good governance practices is indispensable for ensuring the stability, trustworthiness, and long-term success of banks in today's complex and dynamic financial landscape.

As aforementioned effective CG plays a crucial role in ensuring the integrity and efficiency of financial markets. The OECD has highlighted the importance of promoting good governance practices among companies, as it helps to strengthen investor confidence, attracting investors capable of providing capital for the continued growth and development of these enterprises. On the other hand, inadequate CG systems pave the way for corrupt and fraudulent business practices, leading to financial distress, diminished competitiveness, and the depletion of corporate assets and resources. Such outcomes inevitably drive investors away, which ultimately impede the economic progress of the country. Therefore, it is clear that good CG serves as a powerful instrument for instilling socio-economic discipline within businesses, thereby promoting a conducive environment for sustainable growth and development.

The corporate scandals and failures that occurred globally during the 1980s and early 1990s highlighted the importance of regulators and investors enacting changes in CG, particularly for publicly listed companies. The failures exposed significant lapses, including deficiencies in accounting and financial reporting, inadequate risk management, and internal controls. Investigations into the causes of these failures revealed recurring themes, such as investors being kept uninformed about critical developments and the dissemination of misleading financial statements resulting from "creative accounting" practices.

Sri Lanka's banking and finance sector has faced a series of catastrophic failures, leading to a dark period in the country's economic landscape. The collapses began with the Pramuka Savings and Development Bank in October 2002, setting off a chain reaction of financial turmoil. Subsequent to this, the collapse of Golden Key Credit Card Company Limited (GKCCC) in 2008 amplified concerns about the stability and integrity of financial institutions. These collapses extended beyond regulated entities, including unregulated deposit-taking institutions like "Sakwithi" and "Daduwan." These events highlighted significant lapses in oversight and governance within the financial sector, exposing vulnerabilities that had far-reaching consequences.

Among the other finance companies that fell apart were Lankaputhra Development Bank, Mercantile Credit Limited, Touchwood Investments PLC, Entrusted Securities PLC, Central Investments and Finance PLC, Standard Credit Finance Ltd, ETI Finance Company, and Swarnamahal Financial Services PLC. Their collapse not only shook investor confidence but also spotlighted systematic weaknesses in CG mechanisms. The CBSL revealed a troubling statistic: out of the 43 registered finance companies, 13 had already collapsed. This alarming revelation served as a stark reminder of the urgent need for reforms and stricter regulatory oversight within the financial sector.

In addition, corporate failures like Union Trust and Investment Ltd, House and Property Traders Ltd (HPT), Translanka Investments Ltd, and Home Finance Limited, have contributed to growing concerns surrounding financial stability and governance. These failures serve as poignant reminders of the critical importance of robust governance frameworks, stringent regulatory oversight, and proactive measures to safeguard the interests of investors and ensure the stability of the financial system. The repercussions of these failures are far-reaching, and they highlight the need for comprehensive reform to prevent such crises from recurring in the future.

These collapses severely undermined the public's trust and confidence in finance companies as a whole. ‘Although these failures did not result in the entire financial system collapsing, they had a profound adverse impact, similar to a "financial tsunami". As a result, many deposit-taking institutions, particularly finance companies, experienced significant distress due to the loss of public confidence’ [21]. The reasons for these failures are numerous, including the abuse of power and resources, irregularities in lending and managing depositors' funds, deficiencies in CG practices, inadequate internal controls and risk management, financial reporting irregularities, and a lack of transparency.

Seylan Bank PLC is another local example where depositors suffered significant losses. Fortunately, the CBSL, as a responsible regulator, intervened and implemented the necessary measures. In response to these scandals, the CG regulations that apply to listed companies in Sri Lanka were revised, and new codes of conduct were introduced. The objective was to safeguard investors and restore and maintain public confidence in the entire financial system. Similarly, there was a need to focus on good behavioral practices of CG for banks and financial institutions to prevent the recurrence of such devastating incidents and to build and maintain trust and confidence in the overall financial stability of the country. Regulatory bodies have taken various measures, making CG in the banking sector a crucial subject of discussion, recognizing the adverse impact of bank failures on a country's economy and the uncertainty they reflect in the financial sector.

During a recent discussion, Cabral emphasized the importance of effective CG practices. He mentioned that the current standards only represent the foundational requirements. Cabral also drew attention to the CG regulations established by the SEC, which primarily target listed companies. These regulations focus on aspects such as independent directors and specialized committees, such as audit, remuneration, and nominations committees. Cabral also highlighted that banking and insurance laws have specific governance measures that regulatory bodies introduce to ensure sound governance within these sectors. Cabral expressed concern over the scarcity of proper independent directors in Sri Lanka and emphasized the critical role they play in driving effective CG. He stressed the need for improvements and stated that CG should be ingrained in organizational culture and values. He emphasized that CG should be heartfelt and ingrained as a cultural norm within organizations [22]. As Cabral advocated for the enhancement of CG, it is important to ingrain these principles into the culture and values of organizations, especially within the banking sector, to ensure their stability and integrity.

Hence, in the banking industry, CG is crucial for ensuring financial stability and building trust and confidence among stakeholders. Effective CG practices are essential for promoting transparency, accountability, and integrity within banks, given the inherent risks associated with banking operations and the significant impact of banking failures on the broader economy. CG in the banking industry comprises setting objectives, monitoring performance, and allocating authority and responsibility in a manner that aligns with the interests of stakeholders and regulatory requirements. By adhering to CG principles, banks can enhance their resilience to financial shocks, mitigate risks, and foster sustainable growth. Accordingly, CG in the banking industry establishes robust relationships, structures, and processes that promote sound decision-making, accountability, and transparency, ultimately contributing to the stability and trustworthiness of the banking sector.

9. EVOLUTION OF CORPORATE GOVERNANCE IN SRI LANKA

This section of the chapter will provide a brief overview of the evolution of CG in Sri Lanka. The focus will be on outlining key developments and trends in CG practices within the context of Sri Lanka. However, in Section 13 of this chapter, the CG structure under the company law of Sri Lanka is examined in detail. Section 13 explores various aspects of CG, including legal requirements, regulatory frameworks, and practical implementation within the Sri Lankan business landscape.

As mentioned in the literature review, CG in Sri Lanka has roots in ancient times, with governance structures based on the caste system. The adoption of open economic policies in 1977 improved investments and established companies for diverse purposes. Despite the absence of the term "corporate governance," many governance practices were embedded in new laws, including disclosure requirements, board responsibilities, and audit procedures. The formalization of CG initiatives began in the 1990s with voluntary codes of best practices.

The evolution of CG in Sri Lanka has undergone significant changes over time due to both internal and external factors. Initially, CG practices were informal and lacked comprehensive regulatory frameworks, with a primary focus on legal compliance rather than transparency, accountability, and shareholder rights. However, in response to domestic and global developments, Sri Lanka has made substantial progress in enhancing CG standards. Significant financial sector reforms were introduced in the 1990s, aimed at promoting transparency, strengthening regulatory oversight, and boosting investor confidence. Additionally, CG codes were introduced in the early 2000s, developed by organizations such as the Institute of Chartered Accountants of Sri Lanka (ICASL) and the Colombo Stock Exchange (CSE), to enhance transparency, accountability, and board effectiveness. Regulatory bodies like the Securities and Exchange Commission of Sri Lanka (SEC) have played a crucial role in enforcing CG standards, requiring listed companies to comply with codes and disclose relevant information.

Between 1997 and 2008, Sri Lanka implemented significant CG reforms, despite having enjoyed relative stability in the past. The aim was to enhance CG by adopting voluntary codes, designed to protect the interests of various stakeholders. To achieve this, ICASL pioneered CG initiatives, drawing from recommendations outlined in the Cadbury Committee Report. In 1997, ICASL formulated and published a voluntary Code of Best Practice, which focused on the financial aspects of CG applicable to all listed companies. Subsequently, ICASL released the Code of Best Practice on Audit Committees in 2002, followed by the publication of the comprehensive Code of Best Practice on CG in collaboration with the SEC in 2003. The 2003 Code aimed to align CG practices in Sri Lanka with international standards and included a broader range of principles to ensure effective corporate board functioning compared to the previous codes. In 2004, the SEC issued guidelines on audit and audit committees, initially for voluntary compliance by listed companies, with the intention of subsequent mandatory enforcement. However, these guidelines did not achieve the expected mandatory status.

In 2005, ICASL, SEC and CSE collaborated to strengthen the CG framework in Sri Lanka's secondary market. They aimed to revise the 2003 Code and drafted a new code in 2006, taking inspiration from CG codes of various jurisdictions such as the UK, New York-USA, Singapore, and Malaysia. The objective was to tailor rules that were relevant to Sri Lanka's context. In January 2007, the SEC announced through a press notice that the revised 2006 Code would soon be implemented after making some minor adjustments. During the interim period, some rules from the draft 2006 Code were included in the Listing Rules of the CSE, which were to be enforced from April 1, 2007. All listed companies in Sri Lanka were mandated to comply with these rules from April 1, 2008. In 2013, the SEC and ICASL revised the Code of Best Practice to align it more closely with the UK CG Code and establish detailed CG standards. However, despite these revisions, the Code of Best Practice remains voluntary, raising concerns that its effectiveness may be limited to superficial improvements without mandatory enforcement. Compared to other jurisdictions, Sri Lanka has mandatory rules primarily regarding Board Composition, Audit Committees, Nominating Committees, and Remunerations Committees. Some companies have developed their own codes of CG, enhancing the existing regulatory framework.

In order to improve CG practices among banks, the CBSL issued a mandatory Code of CG for Licensed Commercial Banks in April 2008. The code became effective on January 1, 2008, and all banks were required to fully comply by January 2009. The code consists of two main components: principles to guide interpretation and rules for strict compliance. It covers a wide range of topics, including the responsibilities of the board, board composition, criteria for assessing the fitness and propriety of directors, delegation of management functions, roles of the chairman and CEO, establishment of board-appointed committees, and procedures for related party transactions and disclosures. Certain contentious provisions have special transitional provisions. Additionally, the Central Bank of Sri Lanka issued CG Directions to Licensed Commercial Banks under the Banking Act, Direction No. 11 of 2007, to manage the multitude of risks inherent in their operations, ensuring financial system stability and enhancing CG practices.

The Code of Best Practice 2017, issued by ICASL, is a significant measure towards strengthening CG in Sri Lanka. The latest version of the code brings in critical changes to improve board composition, conduct of board meetings and the roles and responsibilities of the board and audit committee. It also includes new areas like establishing a related party transaction committee, reporting on cybersecurity, and taking into account environment, society, and governance (ESG) considerations. Although this code is voluntary, it is recommended that all banks follow it to maintain the integrity and stability of the financial system. However, there is still a challenge in ensuring full compliance with the code as financial institutions have the discretion to implement these practices. This discretionary approach often leads to variations in adherence among companies.

Therefore, it is commendable to introduce a mandatory code in Sri Lanka that covers both principles and rules. Given the significant role played by banks as financial intermediaries, the code serves as a reminder of their broader responsibilities. By strengthening the banking system and building trust and confidence among the public, individuals will be encouraged to use banks as safe places to save their money.

The Continuing Listing Requirements, approved by the SEC and enforced by the CSE, mandate that all entities with securities listed on the exchange must adhere to the rules on CG and any additional regulations introduced by the CSE. The board of directors of each listed entity is responsible for ensuring ongoing compliance with the exchange's rules for as long as their securities remain listed. Rule 7.10 Continuing Listing Requirements mandates that all listed entities comply with specified CG. Listed entities must publish an affirmative statement in their annual reports containing an affirmative statement on compliance with CG standards. The board of directors must include at least two non-executive directors or equivalent to one-third of the board, whichever is higher. A certain proportion of non-executive directors must be independent, and each must declare their independence annually. Listed entities must also have a remuneration committee and an audit committee, with the Audit Committee consisting of at least two independent non-executive directors or non-executive directors with the majority being independent.

Non-compliance with CG rules requires market announcement within one day, with the intention to rectify within three months. If non-compliance persists, securities may be transferred to the Watch List, and the SEC may grant a further compliance period. If non-compliance persists beyond six months, trading may be suspended, with the possibility of extension.

The above Continuing Listing Requirements are enforced by the mandate CG provisions for all listed entities. These provisions establish a framework for adherence to governance standards. They require listed entities, including listed banks, to uphold CG principles such as board composition, independence of directors, and the establishment of audit and remuneration committees. In theory, these provisions aim to promote transparency, accountability, and effective oversight within banking institutions which are crucial for maintaining investor confidence and financial stability. By requiring listed banks to disclose their compliance with CG standards in their annual reports and imposing enforcement actions for non-compliance. This incentivizes adherence to best practices.

However, the effectiveness of these provisions in enhancing CG within banks depends on their implementation and enforcement. While the regulations provide a solid foundation, their effectiveness may be influenced by factors such as regulatory oversight, enforcement mechanisms, and the commitment of banks' management and boards to upholding governance standards. To evaluate the success of these provisions, it is essential to assess the extent of compliance with the requirements, the effectiveness of enforcement actions in addressing non-compliance, and any improvements in governance practices within the banking sector over time. Additionally, stakeholder feedback and independent assessments of banks' governance practices could provide valuable insights into the impact of these provisions on overall governance quality and investor confidence in the banking sector.

10. REGULATION OF BANKS BY THE CBSL

Part of this chapter explores the CBSL's regulatory framework and oversight mechanisms for effective CG in the banking sector, highlighting its supervisory and regulatory departments, macro-prudential authority, and strategies for addressing systemic risks, and its importance in sustainable economic growth and financial stability. The CBSL is the primary regulatory authority overseeing the banking industry, empowered by the Central Bank of Sri Lanka Act No. 16 of 2023 (CBSL Act). Additionally, laws like the 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 provide supplementary regulatory powers to the CBSL. In this chapter, only the relevant provisions of the CBSL Act relevant to the CG are examined and all statutory provisions referenced in this section are from the CBSL Act.

In its role, the CBSL ensures the maintenance of a stable financial system, emphasizing CG principles. This entails establishing and enforcing a robust legal framework to govern financial institutions, ensuring their compliance with regulatory standards. Furthermore, the CBSL regulates and supervises key financial institutions, promoting transparency, accountability, and integrity in their operations. It optimizes conditions in crucial financial markets to uphold stability and oversees payment and settlement systems to maintain efficiency and reliability. Moreover, the CBSL acts as the lender of last resort, continuously monitoring the financial system to mitigate risks and safeguard against disruptions, thereby reinforcing CG within the banking sector.

The CBSL serves as the macro-prudential authority in the country (S. 63 (1)), is responsible for implementing financial policies and undertakes various measures to achieve macro-prudential objectives and ensure the stability of the financial system (S.7 (1) (h) and S.61 (8) (c)). Macro-prudential policies are designed to prevent significant disruptions in credit and other essential financial services necessary for maintaining stable economic growth. To fulfill its role effectively, the CBSL possesses various macro-prudential powers. The CBSL has the authority to request, collect, compile, analyze, or publish data, information, and statistics relevant to macro-prudential oversight (64 (1) (b)). Additionally, the bank conducts stress testing and simulation exercises (64 (1) (c)) to assess the resilience of financial institutions and the overall system to adverse shocks. Furthermore, under s. 68, CBSL has the mandate to designate certain financial sector participants as systemically important (SIPs) based on their significance to the financial system's stability (64 (1) (d)). These SIPs are subject to enhanced macro-prudential oversight and are required to adopt and apply specific macro-prudential instruments aimed at mitigating systemic risks (S. 64 (1) (f)). This comprehensive approach to macro prudential regulation helps safeguard the stability and resilience of the financial sector in Sri Lanka.

The CBSL undertakes various measures to enhance financial stability and mitigate systemic risks within the financial sector. One such measure involves formulating strategies and policies aimed at addressing identified systemic risks effectively (S. 64 (1) (g & h)). By closely monitoring domestic and international financial regulatory developments, the CBSL remains abreast of emerging risks and advises on legislative or regulatory measures to strengthen financial stability. Additionally, the CBSL collaborates with relevant financial sector authorities (FSAs) to develop and propose increased prudential standards applicable to regulated financial sector participants (S. 64 (1) (j & k)). This includes facilitating information sharing and cooperation among FSAs to foster a cohesive regulatory environment. Furthermore, the CBSL plays a key role in proposing recommendations to the Financial System Oversight Committee (FSOC) for issuance to the public or FSAs, thereby contributing to the overall resilience and stability of the financial system (S. 64 (1) (l)). Through these concerted efforts, the CBSL endeavors to uphold financial stability and safeguard the interests of stakeholders in the Sri Lankan economy.

The CBSL has several supervisory and regulatory departments to oversee and regulate banks and non-bank financial institutions (NBFIs) in accordance with the powers vested in it by the CBSL Act (S. 61). The Governing Board is the main regulatory authority for both banks and NBFIs, and it is empowered by the CBSL Act to serve as the primary regulator (S. 2). The Governing Board is responsible for overseeing the administration and management of the affairs of the CBSL, determining the general policy of the CBSL, other than the monetary policy (S. 8). Under the purview of the Governing Board, CBSL issues licenses to banks, regulates their operations, and issues directives to ensure compliance (S.7 (1) (f).

The CBSL also has specialized departments dedicated to specific aspects of financial oversight. The Department of Bank Supervision plays a crucial role in overseeing and regulating the operations of banks, ensuring their compliance with established guidelines and standards. It relies on the periodic information provided by banks to fulfill this responsibility. Through regular examinations, both scheduled and at the discretion of the CBSL, the department ensures the efficient management of commercial banks and other banking institutions. It also prioritizes safeguarding the interests of depositors, highlighting the importance of accountability and integrity within the banking sector.

Meanwhile, the Department of Payments and Settlements is responsible for overseeing payment systems and settlement mechanisms to ensure efficiency, security, and stability in financial transactions. The Domestic Operations Department handles matters related to domestic monetary policy implementation, managing liquidity in the financial system, and regulating domestic financial markets. On the other hand, the Department of Foreign Exchange oversees foreign exchange transactions, regulates foreign exchange markets, and manages the country's foreign reserves. Additionally, the Financial Intelligence Unit (FIU) serves as the coordinating unit responsible for liaising with other enforcement authorities to combat financial crimes such as money laundering and terrorist financing. Through collaboration with various enforcement agencies, the FIU works to ensure the integrity and security of the financial system. Collectively, these departments, together with some other departments within the CBSL play a crucial role in maintaining stability, integrity, and efficiency in the banking and financial sectors of Sri Lanka.

As aforementioned, CG is a key aspect of the CBSL's regulation of banks, ensuring transparency, accountability, and effective oversight within the banking sector. The CBSL issues guidelines and directives to banks, emphasizing the pivotal role of the board of directors, risk management committees, and internal control functions in maintaining effective governance practices. These guidelines stress principles of transparency, integrity, and accountability, which banks must adhere to in their operations. The CBSL monitors compliance through regular inspections and assessments, ensuring that banks uphold high standards of CG. Additionally, banks are required to disclose financial information in accordance with prescribed accounting standards, providing stakeholders with timely and accurate information to promote transparency and market confidence. By promoting strong CG practices, the CBSL aims to enhance the stability, integrity, and efficiency of the banking system, contributing to sustainable economic growth and financial stability in Sri Lanka.

11. THE VITAL ROLE OF REGULATING AND SUPERVISING THE BANKING INDUSTRY

Regulation and supervision play a crucial role in CG. Banking regulations are designed to ensure financial stability by mitigating risks and preventing systemic crises, which are vital for safeguarding the interests of shareholders and stakeholders [23]. Additionally, regulations aimed at protecting depositors' funds through mandated capital requirements and risk management practices contribute to ensuring transparency and accountability in CG. Moreover, measures to promote market confidence, such as disclosure requirements and transparency standards, promote trust among investors and stakeholders, enhancing the governance framework of banks. Furthermore, regulations targeting the prevention of financial crime, including money laundering and terrorist financing, are essential for upholding ethical standards and integrity within banking institutions, thus reinforcing CG principles. Also, regulations promoting financial inclusion ensure that banks serve the needs of all segments of society, promoting fairness and inclusivity in CG [23]. Overall, effective regulation and supervision in the banking industry contribute significantly to upholding CG standards, which are essential for maintaining trust, integrity, and stability within financial institutions.

As per CBSL, 'the Supervision Department of the CBSL plays a pivotal role in ensuring the stability and integrity of the banking sector through various functions. It employs various regulatory and supervisory measures, such as formulating and issuing prudential regulations to licensed banks, aimed at maintaining sound banking practices and safeguarding the interests of depositors and stakeholders. The department is also responsible for reviewing and amending relevant Acts and regulations in alignment with current market developments, international standards, and best practices to ensure regulatory effectiveness. Moreover, it oversees the licensing of commercial banks and specialized banks in Sri Lanka, ensuring compliance with regulatory requirements. Continuous supervision of licensed banks is conducted, a key component of supervision to monitor their operations and adherence to regulatory standards, supplemented by periodic statutory examinations to assess their financial health. The department processes and facilitates requests for regulatory approvals from licensed banks, ensuring regulatory compliance and efficiency. In cases where necessary, regulatory actions are initiated with the approval of the CBSL's Governing Board to address non-compliance or risks within the banking sector. Additionally, the department supports market-driven consolidation initiatives among licensed banks to promote a stronger and more resilient banking industry. Strengthening communication with banks, auditors, and other stakeholders is emphasized to foster transparency and collaboration, while capacity-building initiatives are undertaken to enhance the skills and capabilities within the banking sector, ensuring its long-term viability and stability. All regulatory and supervisory measures work together to ensure the solvency of banking institutions, which in turn supports public confidence in the banking system as a whole' [24].

The Supervision Department of the CBSL enforces regulatory and supervisory measures across four key areas: prudential regulation, monetary regulation, systemic regulation, and consumer protection. The department primarily uses two methods to oversee banking institutions: examinations and problem resolution. Banks are required to undergo statutory examinations every two years. These examinations include both on-site and off-site assessments, leveraging the widely recognized CAMEL model, which focuses on evaluating Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity [25]. The on-site examination emphasizes the identification and management of banking risks, along with evaluating the adequacy of resources to mitigate such risks. On the other hand, off-site surveillance involves periodic review of information provided by banks, including annual reports and financial statements. The primary goal of off-site surveillance is to detect early warnings of potential issues, enabling timely remedial action.

To enhance the safety and stability of the banking system and to achieve financial system soundness, the CBSL has implemented new directives concerning the maintenance of capital adequacy by banks, in alignment with the BASEL II framework. The primary objective of these directives is to mitigate risks inherent in the management of banks. The BASEL Committee on Bank Supervision has underscored the importance of governance requirements across various key areas within banks. These include the composition and effectiveness of the Board of Directors, the structuring of compensation packages, the roles and responsibilities of senior management, the establishment of robust risk management frameworks, the function of the internal audit department, the transparency of disclosures, and the supervisory oversight provided by regulatory authorities. The adoption of strong governance practices in these areas is essential for fostering trust, maintaining integrity, and ensuring accountability within banking institutions. By adhering to these governance standards, banks can better manage risks, enhance operational efficiency, and safeguard the interests of stakeholders. Moreover, a sound governance framework contributes to building resilience, fostering innovation, and promoting sustainable growth within the banking sector. Therefore, the CBSL's emphasis on implementing BASEL II directives underscores its commitment to promoting a stable, secure, and resilient banking system that supports the broader goals of economic development and financial stability in Sri Lanka.

The CBSL has adopted the Basel capital adequacy standards, which are compulsory for all licensed banks since January 2008. This means that all banks must follow the Standardized Approach for credit risk, the Standardized Measurement Approach for market risk, and either the Basic Indicator Approach or the Standardized Approach for operational risk while computing capital charges for capital adequacy requirements (CBSL). The CBSL has enhanced its capital adequacy standards in line with Basel III regulations since 2015, in accordance with international norms. These measures ensure that banks maintain sufficient capital reserves to bear potential losses, thereby reducing the risk of financial instability and protecting overall financial stability. Adherence to these standards can inspire stakeholders' trust in banks while preserving their crucial role as capital providers.

As Jayamaha [26] has highlighted ‘Basel II is a framework introduced by the Basel Committee on Banking Supervision, aimed at enhancing risk management practices and CG within the banking sector. The framework consists of three pillars: minimum capital requirements (Pillar I), supervisory review process (Pillar II), and market discipline (Pillar III). Under Pillar I, banks are encouraged to adopt the Standardized Approach for credit risk measurement, with adjustments tailored to local conditions. Operational risk is addressed through the Basic Indicator Approach, focusing on business continuity planning and internal risk management systems. CBSL may allow banks to transition to more advanced approaches, such as Internal Ratings Based (IRB), based on their capabilities and readiness. Pillar II emphasizes the importance of internal capital adequacy assessment processes (ICAAP) and ongoing evaluation of banks' risk profiles. Pillar III encourages market discipline through public disclosure of risk exposures and capital adequacy’.

‘Key implementation issues in Sri Lanka include determining the appropriate capital adequacy ratio, applying risk evaluation techniques, addressing financial reporting and accounting standards, and managing operational risks effectively. Regulatory considerations also include handling cross-border transferability issues and ensuring compliance by financial conglomerates. Proper definition of capital instruments, such as hybrid capital, remains a critical concern, with efforts underway to establish standard definitions before the implementation of Basel II in 2008. Regarding on-site examinations, CBSL examiners conduct regular visits to banks and carefully examine their books and accounts to evaluate their financial health and identify any areas of concern' [26].

12. DIRECTORS GOVERNANCE DYNAMICS IN BANKING COMPANIES

The role of directors in the governance of banking companies is undeniably crucial, as they are responsible for ensuring the stability, transparency, and accountability of financial institutions. This section of the study explores the complex dynamics of directorship within banking companies. In the banking sector, both the board and management play a crucial role to play in the decision-making and governance processes of a company, as they are responsible for ensuring effective governance in making decisions regarding strategic direction and operational policies. Shareholders do not have the authority to intervene directly in business operations and instead rely on rights conferred to them under the Companies Act. They depend on the board to make informed decisions that safeguard their interests and ensure the stability of the company. Effective CG is demonstrated when the board operates independently and actively contributes to shaping banking strategies, with a priority on the stability and security of depositors' funds and assesses the potential risks associated with various business decisions.

As stated, the board of directors of a bank plays a pivotal role in governing banking institutions. Directors in the banking sector are held to a heightened fiduciary duty compared to those in other companies, due to the inherent complexities and risks associated with financial operations. Their primary obligation is to safeguard the interests of various stakeholders, including depositors, shareholders, and creditors while upholding regulatory compliance and ethical standards. Therefore, it is essential for banks to attract and retain experienced and conscientious directors who can significantly impact the success of the financial institution. Building trust and confidence in these directors' abilities requires implementing robust internal management and accountability structures in every bank and financial institution operating within the financial system. These structures form the foundation of the CG framework for banks and financial institutions, as emphasized by Moonesinghe [1].

Corporate fairness, transparency, and accountability principles [27] are promoted to prevent one stakeholder group from misappropriating the cash flows and assets of another stakeholder group. As such, directors of a company are required to use their best efforts to ensure the company is well-managed and improved regularly. The board of directors of a bank should take overall responsibility and accountability to ensure proper management of the affairs, safety, and stability of the bank [27a]. Since the board is responsible for strategy and risk management, they must identify the main risks and ensure that the necessary strategy is implemented to handle such risks in a prudent manner. Given the responsibility of balancing various interests simultaneously, the board must ensure that communication policies are clear between the bank and all relevant stakeholders, including depositors, creditors, and shareholders. They must also articulate the aspirations and rights of all stakeholders through their actions.

As mentioned earlier, the 2008 and 2013 codes of CG outline in great detail the various responsibilities of the board, directors, and management among other areas. These codes include a range of responsibilities for the board, which means that both the board and the management will be subject to increased scrutiny and checks and balances. Some of these responsibilities include ensuring that a sound business strategy is formulated and implemented, implementing effective systems to safeguard the integrity of information, internal controls, and business continuity, adopting sustainable business development strategies, ensuring compliance with laws, regulations, and ethical standards, and more. Additionally, the directors are expected to regularly meet with the key management personnel to review policies and monitor progress toward achieving corporate objectives [27a].

Banks that accept public deposits are mandatorily required by law to disclose the details of their directors. The company secretary is responsible for obtaining a statement of all related party interests to prevent directors from misusing their position for personal gain. This includes avoiding conflicts of interest, insider trading, providing favors to related parties, and self-dealing. To maintain transparency and avoid even the appearance of a conflict of interest, directors should not participate in any matter in which they have a personal interest. In case a director is involved in an important company matter, the matter should be discussed and voted upon in a board meeting with the presence of independent non-executive directors [27a].

The amendment to Section 42 of the Banking Act of 2005 introduced a test to determine whether a director is fit and proper. This test requires the approval of the CBSL before a person can be appointed to the board of a bank. While the shareholders of banks are primarily responsible for appointing competent and experienced individuals with high integrity and capabilities to manage the bank, the CBSL has 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 can remove directors and impose sanctions [27a]. Therefore, even if all shareholders want a particular person to be appointed as a director, the CBSL has the right to deny such a person a seat on the board. However, the new CBSL Act does not contain a similar provision.

Directors and officers of banks have a responsibility to ensure that the bank management has the appropriate attributes and is "fit and proper" according to the regulations [1]. This includes implementing policies and objectives that benefit investors and build public trust and confidence. It's crucial for bank management to understand that regulators prioritize the stability of the bank for depositors and the financial system.

The CG rules have measures in place to ensure that directors are independent in the context of banking companies. The presence of an independent board of directors can improve CG. Therefore, the rules require that at least one-third of the total number of directors or a minimum of three directors be independent by January 2010 [27a]. This is particularly important for companies that accept public deposits to benefit less empowered shareholders who may not have a say in the company. The independence of directors is strictly defined. A director with direct or indirect shareholding of 1% or more in the relevant company is non-independent. Also, representing a specific stakeholder results in the loss of independence of a director. A board meeting cannot be held unless the majority of the directors present are non-executive directors [27a].

During a discussion about CG in Europe, Frank Brebeck from Price Waterhouse Coopers made a statement on the independence of directors. According to him, a director can be considered independent only if the board is convinced that the director has no material relationship, be it business, family, or otherwise, with the company. This includes being a partner, shareholder, or officer of any organization that has a relationship with the company. This is important because such relationships can create a conflict of interest that may compromise the director's ability to exercise free judgment.

It is required for a banking company to have two distinct individuals in the roles of Chairman and CEO. The Chairman must be a non-executive and preferably an independent director. If an independent director is not serving as the chairman, a senior director of the board must be appointed from among the independent directors. One of the main concerns of the Monetary Board with regard to banking companies is the limitation on the number of directors. Therefore, the board must ensure that they spend the right amount of time and effort on overseeing the various aspects of compliance and performance of the company that they serve. Additionally, according to CG directions, a director is prohibited from serving on the boards of two banks and also not be over 70 years of age (Monetary Board of the Central Bank, SLRSPS 4752) [28]. However, a general exemption was given to all directors who have reached or would reach 70 years any time before 31st December 2008 and for those who were on the board of more than the specified number of companies to continue until the end of 2011, following a court order.

CG rules have made it obligatory for banking companies to form a minimum of four board sub-committees: Audit Committee, HR and Remunerations Committee, Nominations Committee and Integrated Risk Management Committee. These committees have been described in great detail, including their composition and functions, through the CG rules. This move towards CG has been widely appreciated by many as it ensures that directors follow the regulations that enhance a bank's performance. However, in practice, many companies have not been following these regulations adequately, which has led to issues like the recent financial crisis in the non-banking financial sector. This crisis was primarily attributed to a lack of accountability towards stakeholders like shareholders, depositors, employees, and others.

After recent corporate collapses in Sri Lanka, there have been additional governance issues highlighted. These issues include deficiencies in accounting and financial reporting, lack of processes for risk identification and management, auditor negligence, presence of organized crime in boardrooms, misuse of superannuation funds to address financial difficulties, regulatory oversights leading to unauthorized debt issuance and deposit taking, communication failures, unsuccessful acquisitions or diversification attempts, overly ambitious expansion strategies (as seen with the Ceylinco Group), increase in related party transactions, internal conflicts among board members, and management negligence, misconduct, or failures. The GKCCC and the Sakvithi Scam (named after the person responsible for the collapse of the investment scheme) involved an unlicensed finance company defrauding numerous depositors of around Rs. 900 million through enticing promises of exceptionally high-interest rates.

Given the governance issues prevalent in the Sri Lankan corporate sector, it is evident that the measures implemented by relevant legislators and regulators, including the CBSL, mandating licensed banks and non-bank financial institutions to adhere to CG directives, have failed to effectively enforce compliance. In the wake of the above discussed corporate failures in the financial sector, stakeholders, including directors, have indicated that they were more adept at maneuvering and manipulating business practices than the regulators. Hence, regulators should promptly take action and conduct random inspections of companies to ensure adherence to CG regulations. S. 67 (1) (c) of the CBSL Act grants CBSL the power to conduct on-site inspections.

Although directors of banking companies under CBSL supervision are required to perform their duties adequately, there are unlisted financial institutions in Sri Lanka that are not subject to CSE rules or CBSL directives. For instance, many collapsed entities within the Ceylinco group were private entities. Therefore, regulators should mandate those financial institutions or those accepting public funds to be listed to safeguard the long-term investments of the public. The extension of CG rules to all companies in Sri Lanka, including private ones, will ensure that directors prioritize stakeholder interests to promote the success of the company. Weak financial reporting and auditing structures are significant contributors to many Sri Lankan financial institution failures. Developing countries often lack rigorous accounting standards and auditing controls which leads to information disparities among stakeholders [29]. This was evident in numerous financial institution collapses in Sri Lanka. Recognizing the importance of independent auditing, the SEC issued guidelines for listed companies concerning audits and audit committees to enhance auditor independence [30].

Despite the focus on CG in banking institutions, there are still challenges in achieving full compliance with regulatory requirements in Sri Lanka. Despite the CBSL issuing stringent guidelines and directives, there are gaps in regulatory enforcement, which have led to corporate collapses and financial frauds. Directors of banking companies face various governance issues, including a lack of accountability. Some prioritize short-term gains over long-term sustainability, which is detrimental to stakeholders. Regulatory compliance continues to be a concern, particularly among unlisted entities, due to weak enforcement and regulatory arbitrage opportunities. Moreover, deficiencies in audit and reporting structures result in information asymmetry, undermining stakeholder confidence and increasing the risk of financial mismanagement.

13. THE CG STRUCTURE UNDER THE COMPANY LAW OF SRI LANKA

CG in Sri Lanka is primarily regulated by the Companies Act No. 7 of 2007 of Sri Lanka (2007 Act), along with various codes, guidelines, and directives issued by regulatory authorities such as the Securities and Exchange Commission of Sri Lanka (SEC), Colombo Stock Exchange (CSE) and the Central Bank of Sri Lanka (CBSL). These regulations aim to ensure transparency, accountability, and fairness in the management and operations of companies, including banking institutions. This section of the chapter discusses the key provisions of the 2007 Act related to CG. It also explores the CG rules and regulations established by different statutory and non-statutory bodies, with the aim of identifying and addressing any shortcomings in these provisions and regulations. The Institute of Chartered Accountants of Sri Lanka (ICASL) introduced the 'Code of Best Practice' on the financial aspects of CG in 1997, which played a significant role in introducing CG principles in Sri Lanka. This adoption occurred within five years after the Cadbury Report. While CG was not entirely absent in Sri Lanka before 1997, it was primarily limited to the companies' legislation. For instance, the Companies Act No. 17 of 1982 (1982 Act) included provisions prohibiting insider trading (Section 220 - 1982 Act) and providing statutory remedies to minority shareholders in cases of oppression and mismanagement (Sections 210 and 211 - 1982 Act). Directors were also subject to common law duties of care and skill. As discussed earlier, the CBSL has issued a set of CG Directions that are specifically designed for licensed commercial banks and licensed specialized banks.

13.1 The Companies Act No. 7 of 2007

The 2007 Act is the primary legislation governing corporate entities in the country and has many provisions that encourage CG practices. It outlines the legal framework for the establishment, management, and dissolution of companies, including their CG structure. The 2007 Act was created to address the changing needs of the modern corporate world. The 1982 Act was deemed insufficient, leading to restrictions on the growth of companies. The 2007 Act introduced the solvency test (S. 57) to ascertain the financial health of a company and introduced a significant change by codifying directors' duties to make the board of directors more responsive towards shareholders and other stakeholder interests. This legislation simplified the general principles of directors' duties, which had previously been derived from centuries of judicial precedents and common law, into a more accessible and straightforward statutory framework. The scholars appreciate the codification of the common law duties of directors in the 2007 Act as a progressive step towards ensuring that the directors are apprised of what the law requires from them in the conduct of their functions.

Unless otherwise specified, all statutory provisions referenced in this part are from the 2007 Act.

The 2007 Act was introduced to combat the corruption occurring in the boardrooms of Sri Lankan companies. It includes provisions that prevent directors of financially distressed companies from claiming a lack of involvement in the event of a collapse of a company. Unfortunately, the 1982 Act was not effectively enforced, resulting in regulators and affected parties failing to utilize provisions related to the duties of directors. This led to deliberate mismanagement of companies, misuse of fiduciary positions and a lack of appropriate action against perpetrators, ultimately resulting in the company law regime in Sri Lanka falling short of expectations.

The 2007 Act establishes the core duty of directors as acting in good faith and in the best interests of the company (Section 187). It further stipulates that directors must avoid actions or decisions that violate the provisions of the Act or the company's articles (Section 188). Additionally, the 2007 Act prohibits directors from engaging in reckless or grossly negligent conduct and requires them to exercise a reasonable degree of skill and care in discharging their duties (Section 189). The 2007 Act imposes obligations on directors to address significant capital losses (Section 220) and instances of insolvency (Section 119) within the company promptly. If directors fail to take appropriate action in such cases, they may face personal liability for any losses incurred by the creditors of the company. In cases of neglecting duties during insolvency, directors can be found guilty of an offense and subjected to fines, which are currently capped at two hundred thousand rupees. However, this nominal fine may not be a sufficient deterrent. A more effective approach would be to impose fines proportional to the magnitude of losses resulting from the failure to act.

Directors are also mandated to disclose any transactions with the company in which they have a personal interest (Section 192) to the board of directors. While the company retains the option to void such transactions within six months of disclosure (Section 193), directors are still permitted to vote on these matters and participate in related meetings, despite evident conflicts of interest. Implementing a statutory prohibition, subject to the company's articles, on involved directors participating in decisions concerning transactions in which they have a vested interest would offer a more robust mechanism for addressing such conflicts. This would enhance transparency and mitigate potential conflicts of interest more effectively.

Section 168(1) (f) mandates that annual reports disclose the remuneration and other benefits provided to directors during the accounting period. However, this provision falls short as it only requires the total remuneration paid to all directors to be disclosed, without specifying individual amounts. Consequently, shareholders are unable to determine the exact remuneration received by each director. This lack of transparency can obscure the true picture, particularly when executive directors receive significantly higher salaries compared to independent non-executive directors. Shareholders are thus unable to evaluate whether executive remuneration aligns with their experience, skills, and contributions to company profits. A more robust approach, similar to the UK's requirement for quoted companies to produce a directors' remuneration report for each financial year, would enhance transparency. Requiring shareholder approval of the directors' remuneration report at a general meeting would further strengthen CG practices and promote accountability in remuneration decisions.

The 2007 Act has made some commendable strides in advancing CG. However, it has certain inadequacies that need to be addressed. One issue of concern is the imposition of fines of two hundred thousand rupees on directors for their failure to act in cases of serious capital loss or insolvency. Such a penalty appears disproportionate when considering the potential magnitude of financial loss and socio-economic harm resulting from directorial inaction. Such a discrepancy represents a significant shortfall in the effectiveness of the legislation as a deterrent. A crucial principle in establishing penalties is ensuring that they correspond appropriately to the extent of loss incurred and damage caused. Without such alignment, penalties may fail to serve as an adequate deterrent, thus undermining the objectives of the Act.

On the other hand, the provisions of the 2007 Act that impose fines not exceeding one million rupees or imprisonment not exceeding five years, or both, for willful false statements in required documents is commendable. This robust penalty scheme serves to highlight the seriousness of providing inaccurate information in returns, reports, certificates, balance sheets, or other essential documents mandated by the Act. Therefore, any director, secretary, auditor, or officer who makes such a willful false statement will face not only a substantial penalty but may also be imprisoned (Section 511). However, despite the severity of the penalties outlined in section 511, there is a notable lack of information regarding any instances of prosecution under this provision. This raises concerns about the efficacy of enforcement mechanisms within the Act and underscores the need for more rigorous oversight and implementation.

Despite efforts to reform laws in Sri Lanka and improve governance, the ambiguous role of company directors and their responsibilities to the community remains a concern. Recent corporate collapses have raised questions about the effectiveness of these reforms and whether lawmakers have succeeded in ensuring that directors prioritize the interests of shareholders and stakeholders when making decisions for the company. The CG principles establish minimum standards of behavior for directors and require their decisions to be subject to scrutiny. The majority of these corporate collapses could have been avoided if the Sri Lankan company law regime had been more stringent in imposing directors' duties on the stakeholders. Currently, the law does not impose stringent penalties and allows alleged wrongdoers to continue to go unpunished, leaving innocent investors and employees of these companies to suffer.

To prevent corporate scandals like the Golden Key Credit Card Company (GKCCC) debacle or similar incidents from happening again, Sri Lanka's company law framework must prioritize transparency, accountability, and regulatory oversight. It is crucial to ensure that all relevant stakeholders of a company, including shareholders, creditors, employees, suppliers, regulators, and the community, are well-informed about the duties and responsibilities of company directors. By enhancing stakeholder understanding of the fiduciary duties and obligations of directors, there is a greater potential for early detection and prevention of corporate misconduct or mismanagement. Regulators must play a proactive role in monitoring and regulating corporate activities to prevent systemic risks and protect the interests of stakeholders. Timely intervention and enforcement of regulations are crucial in curbing any emerging issues or irregularities within the financial sector. Regulators should maintain a robust regulatory framework that includes stringent oversight mechanisms, regular audits, and transparent reporting requirements to ensure compliance with CG standards and financial regulations.

To prevent future corporate scandals, it is essential to promote CG, including board independence, risk management, internal controls, and transparency in financial reporting. This can be achieved through ongoing education and training programs for directors, executives, and employees to instill a strong ethical culture and promote adherence to regulatory standards. In addition, strengthening greater transparency and accountability in corporate decision-making processes can help build trust and confidence among stakeholders. Companies should regularly communicate with shareholders and other stakeholders, providing updates on key developments, financial performance, and strategic initiatives. Open dialogue and engagement with stakeholders can help identify potential risks and vulnerabilities early on, enabling prompt corrective action and mitigating the impact of any adverse events.

Overall, preventing corporate scandals requires a multi-faceted approach that involves regulatory reform, enhanced stakeholder engagement, and a commitment to ethical business practices. By addressing these critical aspects, Sri Lanka can strengthen its CG framework and minimize the likelihood of future corporate failures and scandals.

13.2 The Collaborative Code of Best Practice by the Institute of Chartered Accountants and the Securities and Exchange Commission of Sri Lanka

Sri Lanka has made significant advancements in CG in recent years, which can be attributed to the Code of Best Practice established by the Institute of Chartered Accountants of Sri Lanka (ICASL) in 1997. Since then, the Code has undergone several revisions, with the Securities and Exchange Commission of Sri Lanka (SEC) and the ICASL working together to make substantial improvements. Collaborative revisions occurred in 2005, 2008, and 2013 [31], with the latest version of the Code closely aligned with global CG standards. The 2013 edition of the Code was developed after a comprehensive review of international frameworks, including those of the UK, the US, Singapore, Australia, Malaysia, and India. It presents detailed standards for CG practices, which are expected to improve CG in Sri Lanka.

Although the Code of Best Practice is comprehensive, it is important to note that compliance with it is entirely voluntary. This voluntary status raises concerns about the Code's effectiveness. Without mandatory compliance, there's a risk that the Code may only be superficially followed, lacking any meaningful impact. To truly enhance CG practices, there is a strong argument for making compliance with the Code mandatory. This would provide a more robust framework for accountability and ensure that the standards outlined are actively implemented, rather than being viewed as optional or merely symbolic.

13.3 Rules, Codes, and Guidelines on Corporate Governance Introduced by the Colombo Stock Exchange and the Securities and Exchange Commission

The CSE and SEC rules, codes, and guidelines on CG outline the standards and practices that listed companies are required to adhere to in order to promote transparency, accountability, and investor confidence. The Colombo Stock Exchange (CSE) requires all listed entities to comply with mandatory CG obligations, commonly known as "mandatory rules." Rule 7.10. is a mandates that entities include a statement in their annual reports confirming their compliance with the mandatory rules. Alternatively, if they are unable to confirm compliance, they must provide a clear explanation for their inability to do so, adhering to the 'comply or explain' approach. However, some argue that a robust oversight mechanism is necessary within both the CSE and the SEC to assess the reasons provided for non-compliance. It is essential to evaluate the validity and acceptability of these reasons. If the reasons provided for non-compliance are deemed inadequate or unreasonable, there should be consequential actions. In the Sri Lankan context, relying solely on companies to self-report their compliance status and provide reasons for non-compliance may be insufficient. Therefore, it is imperative to establish a system that ensures thorough scrutiny of compliance statements and non-compliance justifications. This would promote accountability, strengthen CG practices, and promote transparency within the CSE-listed entities.

Listed entities are required to follow certain rules regarding the composition of their board of directors. Specifically, they must have at least two non-executive directors or one-third of the total number of directors, whichever is higher (Rule 7.10.1). If this ratio is not met, adjustments must be made within 90 days of the change taking effect (Rule 7.10.1.). Additionally, if there are only two non-executive directors, both must qualify as 'independent' directors. In all other cases, a minimum of two or one-third of the non-executive directors (whichever is higher) must meet the independence criteria determined by the board and stated in the annual report (Rule 7.10.3.a.). However, there is a significant concern regarding the provision that allows the board to override the independence criteria set out in Rule 7.10.4 and deem a director as 'independent'. This discretionary power gives the board the ability to bypass the strict requirements for director independence, which is unacceptable. Furthermore, the lack of a mechanism to assess the board's rationale for doing so is highly problematic.

Therefore, it is imperative that boards exercise their discretion judiciously and in the best interests of the entity and its stakeholders.

It is concerning that the board may bypass the quota for independent non-executive directors, especially when it comes to the composition of the remuneration committee. According to Rule 7.10.5, the committee must have at least two independent non-executive directors or a majority of non-executive directors that are regarded as independent. This means that the remuneration committee may be filled with members that the board considers independent, even if there is no objective evidence to support this classification. This gap presents a significant vulnerability that could be taken advantage of, resulting in potential abuse. To ensure that CG practices in listed companies remain effective and trustworthy, it is important to address these shortcomings and protect against potential conflicts of interest and abuses of power.

The audit committee holds significant responsibilities, including overseeing the preparation, presentation, and adequacy of disclosures in financial statements, ensuring compliance with financial reporting requirements, evaluating internal controls and risk management processes, assessing the independence and performance of external auditors, and making recommendations to the board regarding their appointment, re-appointment, and removal, as well as approving their remuneration and terms of engagement (Rule 7.10.6.b). The committee must have a minimum of two independent non-executive directors or a majority of non-executive directors deemed independent, depending on which criterion is higher as per Rule (7.10.6.a).

It is essential that the majority of the audit committee comprises independent non-executive directors due to the critical nature of these oversight functions. However, the board's discretionary authority to determine the status of directors as 'independent' introduces the potential for interference, which could compromise the integrity and effectiveness of the operations of the audit committee. Therefore, robust governance mechanisms are necessary to ensure the independence and objectivity of members of the audit committee, which will safeguard the reliability and credibility of financial reporting processes within listed entities.

On October 13, 2017 [32], the SEC issued a directive to the CSE to include regulations regarding violations of CG standards by listed public companies. This directive resulted in the creation of a new provision, Rule 7.10.7, which is part of the mandatory governance rules. However, Rule 7.10.7 is considered ineffective as it only requires companies to promptly announce any non-compliance with the requirements outlined in Rule 7.10 to the market via the CSE within one market day, with the intention to rectify within three months. Subsequently, the company must rectify the non-compliance within three months. Failure to do so leads to the company being placed on the 'Watch List.' Further remedial action must be announced, and the SEC may grant a further compliance period. If non-compliance persists beyond six months, trading may be suspended, with the possibility of further extension. After six months, the matter may be referred to the CSE Board of Directors for a determination on delisting. During this period, certain individuals, such as directors, the CEO, their close family members, the parent company, and any company wherein these individuals hold fifty percent or greater share of voting rights, are not allowed to trade in the company's securities without prior approval from the SEC.

However, Rule 7.10.7 does not impose any sanctions against the board of directors or other responsible parties for violating CG rules specified in Rule 7.10. This omission raises concerns regarding the effectiveness of enforcement mechanisms and accountability measures within the regulatory framework. The absence of punitive measures directed at the board of directors or other implicated individuals diminishes the deterrent effect and fails to adequately address instances of non-compliance with CG standards. To enhance regulatory effectiveness and ensure adherence to governance rules, it is essential to introduce sanctions or penalties applicable to responsible parties for violations, thereby reinforcing the importance of compliance and accountability in listed public companies.

The SEC Rules of 2001, which were published in the Extraordinary Gazette No. 1215/2 on December 18, 2001 [33], provide a mechanism for enforcing CG standards within listed companies. According to Rule 3(1) of these regulations, every company listed on a stock exchange, as well as those applying for listing, must comply with the listing requirements established by the respective stock exchange. This obligation applies to both existing listed companies and those seeking listing, regardless of whether the application was made before or after the implementation of the stock exchange's listing requirements. Additionally, companies are required to comply not only with the initial listing requirements but also with any subsequent amendments, additions, or variations made to these requirements from time to time.

While Rule 3(1) of SEC rules of 2001is an important mandate for ensuring compliance with listing requirements, it has certain limitations and areas that need improvement. Firstly, while the rule establishes the obligation for companies to comply with listing requirements, it does not explicitly outline the specific consequences for non-compliance. Secondly, enforcement mechanisms beyond mere compliance monitoring are necessary to ensure effective regulation and accountability within the listed company landscape. Therefore, while Rule 3(1) establishes a foundational framework for governance enforcement, further provisions addressing enforcement procedures and penalties for non-compliance would enhance its efficacy in promoting robust CG.

Rule 17 of SEC rules of 2001 mandates that the board of directors of every listed company is responsible for ensuring ongoing compliance with all the listing requirements of the licensed stock exchange on which it is listed. This responsibility remains in effect as long as the company remains on the official list of such stock exchange. Therefore, both the company and its board of directors are obligated to adhere to the listing rules. Any violation of these rules will trigger the provisions outlined in section 51 (1) of the SEC Act Act No. 36 of 1987 (1987

Act). This section specifies that any person who breaches the provisions of the Act or any requirements established under it, gives false information knowingly, or wilfully obstructs the performance of duties by Commission members or its officers or servants, shall be regarded as guilty of an offense under the Act. Section 51 (2) states that if someone is convicted of an offense under this Act that doesn't specify a penalty, they can be sentenced to a maximum of five years' imprisonment or a fine up to ten million rupees, or both, after a summary trial by a Magistrate.

Rule 17 of the SEC Rules of 2001 emphasizes the responsibility to follow the listing requirements set by licensed stock exchanges and places significant emphasis on the board's duty to ensure compliance with these standards. The board is accountable for adhering to these standards. Section 51(1) of the 1987 Act addresses various forms of non-compliance, including breaches of the Act, knowingly providing false information, and obstructing the duties of Commission members. Non-compliance can result in potential imprisonment or fines.

13.4 The Securities and Exchange Commission Act No. 19 of 2021

The Securities and Exchange Commission Act No. 19 of 2021 (SEC Act 2021) replaces its predecessor, the 1987 Act and introduces significant provisions aimed at improving CG and transparency in listed public companies. One notable aspect is the requirement for timely submission of annual reports to the SEC, which must include a report on CG policies and other information mandated by the SEC. Section 73 of the SEC Act 2021, mandates filing annual reports with the SEC within five months of the balance sheet date. This report must include a CG policy report and other SEC-required information. Part III of the Act highlights the importance of promptly disclosing financial information by listed companies to ensure compliance with best CG practices. Corporate disclosure is crucial as it communicates internal information to external stakeholders. It serves to convey a company's performance to investors, enhancing transparency and governance. Investors rely on such disclosures to evaluate a company's performance and governance practices, facilitating prudent investment decisions. By mandating timely reporting and emphasizing CG, the Act aims to strengthen investor confidence and uphold market integrity. These provisions, while imposing regulatory requirements, ultimately contribute to a healthier and more accountable corporate environment, benefiting both investors and listed companies alike.

The SEC Act 2021 grants the Commission or market institutions the authority to request information from listed companies if any misconduct is suspected (Section 85). Enforcement measures can be taken against companies found to be in violation of the Act or related regulations (Section 86). Additionally, a requirement stipulate that directors and chief executive officers of listed companies must adhere to fit and proper criteria established by the Commission or approved exchange rules (Section 89(2)). Auditors of listed companies (Section 90), market institutions (Section 74), and market intermediaries (Section 108) are required to report any irregularities discovered during their duties. The

Act specifies the nature of these irregularities and the recipients of such reports, contributing to improve CG within these entities and mitigating systemic risks within the securities market.

The SEC Act 2021 outlines provisions that are a significant step towards promoting transparency and accountability in the corporate sector while mitigating systemic risks inherent in the securities market. These measures align with evolving CG standards and aim to enhance investor confidence while reducing risks related to non-compliance. Although some may perceive these regulations as burdensome, they serve a crucial role in safeguarding the integrity of the securities market and promoting sustainable business practices. The Act holds directors, CEOs, auditors, and market participants accountable for their actions, thus promoting transparency and integrity in the market. These steps are essential for ensuring the smooth functioning of businesses and strengthening investor confidence. As such practices are increasingly embraced by the business community as part of evolving CG frameworks, they are not impediments but rather crucial safeguards for sustainable business operations.

As aforementioned the CG structure in Sri Lanka is made up of a combination of legal provisions, regulatory directives, and guidelines aimed at promoting transparency, accountability, fairness in corporate management and responsible business practices among companies, addressing issues like director responsibilities, financial reporting, and enforcement mechanisms. Compliance with these regulations is essential for maintaining investor confidence, safeguarding stakeholders' interests, and ensuring the long-term sustainability of businesses.

The 2007 Act modernized CG in Sri Lanka by codifying directors' duties, introducing solvency tests, and establishing accountability and liability provisions. However, enforcement mechanisms are lacking, with nominal fines for breaches and insufficient penalties for false statements and transparency regarding director remuneration and conflicts of interest needs improvement.

The voluntary Code of Best Practice formulated by the ICASL and the SEC outlines comprehensive CG standards but lacks mandatory compliance, limiting its effectiveness. The current mandatory rules within the CSE listing regulations are limited in scope and do not fully address certain aspects of CG. Companies can legally circumvent these rules. While the CSE and SEC enforce mandatory CG rules for listed companies, concerns arise regarding penalties for non-compliance and discretionary powers granted to boards, potentially compromising independence and accountability. Boards of directors can circumvent independent director requirements by claiming compliance despite questionable independence. This could lead to evasion of listing rules, despite not violating the rules. This could weaken the regulatory framework's effectiveness in ensuring genuine adherence to governance standards, as neither the company nor the board would face any repercussions. To address this issue, more stringent penalties, both civil and criminal, should be introduced to serve as effective deterrents against non-compliance.

The SEC Act 2021 introduces significant reforms to strengthen CG and transparency in listed companies, mandating timely reporting and enhancing enforcement mechanisms. While these measures align with global CG standards and aim to strengthen investor confidence, challenges remain in ensuring effective implementation and enforcement.

14. CONCLUSION

The above analysis highlights the critical role of effective governance practices in promoting transparency, accountability, and integrity within banking institutions. Failures in governance, as evidenced by past corporate collapses, highlight the need for comprehensive regulatory frameworks and stringent supervisory roles. The banking sector plays a significant role in the economic stability and development of Sri Lanka, as is the case in many other countries. Effective CG practices are crucial to promote financial stability, accountability, integrity, and stakeholder trust, mitigate risks, and support sustainable growth. Corporate collapses both globally and in Sri Lanka have emphasized the need for reforms and stricter oversight. The CBSL is responsible for regulating and supervising the banking sector, implementing policies to maintain financial stability and mitigate systemic risks. The CBSL issues licenses regulates operations, and ensures compliance with directives, promoting transparency and market confidence through timely financial disclosures. Regulatory bodies such as the SEC and CSE have revised CG regulations and introduced new codes of conduct to restore public trust. However, to ensure resilience amidst global economic complexities and maintain public trust and confidence, a robust CG framework is crucial.

The current regulatory framework that oversees CG practices in Sri Lanka has certain strengths. The Companies Act of 2007 is notable for its significant reforms. Collaborative efforts between regulatory bodies like the SEC and the ICASL have led to comprehensive CG standards, contributing to the improvement of governance practices in the country. The SEC Act 2021 is also a significant milestone, introducing reforms aimed at strengthening CG and transparency in listed companies through timely reporting and enhanced enforcement mechanisms.

However, despite these strengths in advancing CG standards, there are several weaknesses and areas for improvement within the current framework. Sri Lanka needs to overcome challenges such as weak enforcement mechanisms and compliance gaps. A major issue is the lack of robust enforcement mechanisms for CG regulations. Nominal fines and insufficient penalties for non-compliance may fail to serve as effective deterrents. Additionally, the voluntary nature of the Code of Best Practice raises concerns about its effectiveness, as companies may choose not to comply without facing consequences. The discretionary powers granted to boards, particularly concerning director independence, pose risks of non-compliance and undermine the effectiveness of CG regulations. Challenges also remain in ensuring the effective implementation and enforcement of reforms introduced by the SEC Act 2021, highlighting the need for robust oversight and regulatory measures.

To address these weaknesses and enhance the efficacy of the CG framework, several recommendations are proposed. Firstly, enforcement mechanisms should be strengthened by imposing more stringent penalties, both civil and criminal, for non-compliance with CG regulations. Secondly, considering the mandatory nature of compliance with the Code of Best Practice could ensure greater adherence to CG standards among companies. Addressing the discretionary powers granted to boards requires the introduction of mechanisms for independent oversight and scrutiny to prevent potential abuses. Moreover, efforts to implement and enforce reforms introduced by the SEC Act 2021 should be enhanced, including the provision of adequate resources for regulatory bodies to carry out their mandates effectively. Continuous monitoring, communication, and capacity building efforts by regulatory authorities like the CBSL are essential to address emerging challenges and promote the long-term stability of the banking sector. Furthermore, enhancing collaboration among regulatory bodies and promoting a culture of accountability and ethical conduct within banking companies are crucial steps toward ensuring the stability and integrity of the banking sector in Sri Lanka.

By addressing these challenges and implementing recommended measures, Sri Lanka can strengthen its banking sector's resilience, promote investor confidence, and support sustainable economic development in the long run. Also Sri Lanka can strengthen its CG framework, promote transparency and accountability, and foster investor confidence in its corporate sector.

COMPETING INTERESTS

Author has declared that no competing interests exist.

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