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Did United States Sub-Prime Crisis Cause Seylan Bank Distress? A Case Study

Lahiru Raneesha Kalupahana[a] and Manjula Kumara Wanniarachchige[b]

[a]*Faculty of Management and Finance, University of Ruhuna, Sri Lanka, raneeshakalupahana@gmail.com*

[b]*Faculty of Management and Finance, University of Ruhuna, Sri Lanka, wmanjulak@gmail.com*

Abstract

Seylan Bank PLC, the sixth largest commercial bank in Sri Lanka, faced a deposit run towards the end of December 2008. This was a severe blow to the Sri Lankan financial system because no other commercial bank in the country had suffered a similar situation in the past. Since this distress occurred along with the US subprime crisis, it was often presumed that Seylan Bank failure was directly attributable to the crisis. This paper sheds a light on the Seylan Bank's profitability and financial stability over the period from 2004 to 2008 while exploring its links with other financial institutions to investigate the causes of distress. The evidence suggests that the Seylan Bank distress was mainly resulted from the long standing management deficiencies prevailed in the bank rather than due to direct effects of the US subprime crisis. Failure of the Golden Key Credit Card Company Ltd. can be directly attributed to the crisis. The resulting contagion effects have triggered the distress in the bank which was already vulnerable to an external shock even though severe issues in the fundamentals of the bank could not be observed. The findings of the study emphasize the necessity of a dynamic regulatory framework and measures to increase the financial literacy among the public to maintain a satisfactory level of financial system stability.

Keywords: *bank run; contagion effect; financial distress; Seylan Bank; US subprime crisis*

1. Introduction

Banks play a vital role in the economy mainly by intermediating funds from savers to investors (Zervos & Levine, 1998). Further banks contribute to economic development through maintaining the payment system and maturity transformation of the funds. Healthy banking system is an important component of a well-functioning financial system particularly in countries where the banking systems dominate the financial systems (Barth, Caprio, & Levine, 2004). Unlike non-financial enterprises, banks are highly leveraged and fragile. Hence the public confidence is vital for an efficient financial intermediation. Importantly, financial distress in a bank can occur as a result of confidence collapse even if the fundamentals of the bank or the fundamentals of the associated non-financial enterprises are not affected. Further, a distress in one bank may transmit to other banks through contagion effect if a remedial measure is not taken promptly particularly when the distressed bank is systemically important in the banking system of the particular country concerned. Sometimes, a crisis in the non-financial industry can be transferred into the banking system, if some of the systemically important banks are closely linked with the distressed enterprises. Therefore, allowing banks to engage in a wide range of activities or allowing banks to choose among a broader assortment of risky ventures may increase bank fragility by increasing the potential external risks (Barth, Caprio, & Levine, 2004). Confidence of the public towards a bank collapses when a bank fails to honor the request of depositors due to lack of liquidity. This situation is called a bank distress. According to Shin (2009) causes of bank distress are not straightforward. Fundamental deterioration of a bank's health is not the only cause behind a distress. Panics are another cause for distress where failing banks are often illiquid rather than insolvent (Friedman & Schwartz, 1963).

Well-known United States (US) subprime crisis resulted mainly from the decade-long real estate bubble and confidence collapse in the shadow banking system in US quickly spread into other segments of the US financial system as well as other countries within a very short period of time (Rajkumar, 2008). This restricted credit and caused a worldwide panic and collapse of a large number of financial institutions around the globe (Quinn, 2008). Sri Lankan banking system fairly withstood the US financial crisis even though some of the cascading effects of US subprime crisis were visible. For example, some of the unauthorized deposit acceptors failed to honor their commitments towards depositors in the midst of this external shock due mainly to their poor financial management. Additionally, few registered finance companies faced distress (Sunday Times, 2011). For example, Golden Key Credit Card Company Ltd. (GKCCC) collapsed in December 2008. This firm belonged to a large business conglomerate, namely, Ceylinco Group of Companies, which owned a number of financial businesses including the Seylan Bank. Importantly these incidents reduced the credibility towards unauthorized deposit acceptors and loosely regulated finance companies; and the public became relatively more cautious.

Importantly, the Seylan Bank PLC, one of the systemically important banks in Sri Lanka, faced a sudden distress in line with the US subprime crisis. For example, Seylan Bank's deposit run occurred towards the end of December 2008, a few days after the GKCCC collapse. Interventions of monetary authorities were required to control the situation. Even though Seylan Bank was a part of the Ceylinco Group, the bank remained as an independent commercial bank. Furthermore, the status of the bank was virtually transparent as the bank had been listed in the Colombo Stock Exchange and was under the direct supervision of the Central Bank of Sri Lanka (CBSL). Apart from Seylan Bank other finance companies affiliated to the Ceylinco Group also had to face the negative consequences of GKCCC failure. This was a severe blow to the banking system in Sri Lanka. Even though there were instances where financial institutions collapsed in Sri Lanka, none of the commercial banks had suffered a similar situation in the past. Due mainly to the sequence of these events, it is commonly argued that the Seylan Bank distress was a direct consequence of the US Subprime crisis. Even though there is no substantial economic link between the events in the US and in Sri Lanka, self-fulfilling nature of these events lends them a compelling rationality.

The fact that a leading bank faced a distress, when none of the other banks were hit by the subprime crisis, is puzzling. US subprime crisis appeared as the main cause behind the issue since it triggered the distress. However, sufficient number of studies has not been conducted to investigate the real causes behind Seylan Bank distress amidst US subprime crisis. Therefore, how a leading Sri Lankan commercial bank is exposed to a foreign crisis remains unclear. Hence this paper explored the real causes behind the Seylan Bank distress while shedding a light on the fundamentals of the bank as well as potential effects of the US subprime crisis.

The paper is organized into five sections including this introduction. Section two reviews related literature. Section three discusses the methodology used in the study. Section four discusses the results and findings. Finally section five concludes the paper.

2. Literature Review

Financial crisis is a disruption to the financial markets during which adverse selection, and moral hazard problems get worsened. Sharp declines in asset prices, failures of large financial and non-financial firms, and resulting contractions in economic activities are common symptoms of financial crises (Kindleberger, 2005; Reinhart & Rogoff, 2008; Caprio, 1998). Financial crisis can interrupt the process of financial intermediation (Mishkin, 1996). Therefore, financial crisis can be damaging and contagious requiring immediate response from policy makers (Laeven & Valencia, 2012).

Financial crises may be caused by bank specific factors or by external factors which are largely beyond the control of individual banks (Thomas & Balino, 1987). External factors generally encompass collapse of public confidence, improper monetary policy, etc. On the other hand, fraud and irregularities in bank management are bank specific factors that can reasonably be controlled by the banks. However, each financial crisis is unique and the causes of the financial crises as well are different from one scenario to another (Kindleberger, 2005). Based on the experiences during past financial crises, shortcomings in bank supervision, high interest rates, over expansion of financial institutions and credit, hyper-inflation, poor management of foreign exchange, weaknesses in liberalizing policies, political instability, poor debt management, and poor corporate governance can be identified as common causes behind financial crisis (Cumby & Wijnbergen, 1989; Sanhueza, 2001; Sachs & Huizinga, 1987; Francisco, 2000; Radlet & Sachs 2000).

In general, bank runs and panics are closely associated with financial crises (Kindleberger & Aliber, 2005). Krugman (1999) identifies three main reasons behind panics. First, a panic is likely when short-term debts exceed short-term assets. Second, non availability of single market creditor who is capable of supplying all the credit necessary to pay off existing short-term debts may trigger banking panics. Finally, unavailability of a lender of last resort may pave the way for a panic. Banking panics create liquidity problems as well as insolvency problems in banks. Importantly, panics associated with one bank can spread into other banks due to contagion effects. Contagion effects of some of the crises had spread even into less vulnerable countries. Therefore, large bailout programs or nationalization of banks has become popular rescue operations by national regulators to maintain the confidence on financial markets and to maintain the stability in the economic system (Caprio & Klingebiel, 1997).

US subprime crisis, started in 2008, was the first major worldwide crisis occurred in the 21st century. Misallocation of investment made possible by the financial engineering is commonly identified as the main cause behind this crisis (Diamond & Rajan, 2009). Nevertheless, real estate bubble and deterioration of financial position of banks were the immediate outcomes associated with the crisis (Mishkin, 2008).

Originally, the crisis stemmed from the real estate market due mainly to excessive credit expansion. For example, when extending credit towards real estate financing, the financial institutions did not care much about the repayment ability and credit worthiness of the borrowers because the real estate prices were increasing rapidly. However, collapse of the real estate bubble caused a rapid increase in non-performing loans (NPL) because the asset prices decreased and the borrowers did not have repayment capacity. As a result, several leading financial institutions which had high exposures to real estate market were collapsed. This was followed by a confidence collapse in the financial market and led to a major financial crisis. Thereafter, the crisis rapidly spread into financial systems with high international exposures in other countries as well. Emerging markets were not an exception in the later stages. This type of contagion occurs because a financial crisis in one country acts as the sunspot that triflers self-fulfilling expectations of a crisis in another country (Allen & Gale, 1999). For example, in the absence of perfect information investors may believe that a financial crisis in one country could trigger a crisis in another country (Dornbusch, Park, & Claessens, 2000). This behavior may be based on rationally or irrationally concluded decisions. Importantly, if the crisis was resulted from weak fundamentals, the investors in the countries that have similar weaknesses may think that their countries also face a similar situation.

Crises can spill over to other countries through real links, financial links, or capital market imperfections such as herd behavior or panics (Schmukler, Zoido, & Halac, 2004). The financial systems in fundamentally weak countries are more vulnerable to this type of external shocks (Caprio, Kunt, & Kane, 2008) since they are subject to the reaction of domestic as well as foreign investors. Imperfections in international financial markets and external factors that determine the capital flows make open economies more prone to crises.

When the public lose confidence in their economic and social systems, the consequences can be terrible. Initially, a few individuals start believing a bad news and spread it among others as well. Gradually more and more people tend to herd and believe in the bad news. Ultimately, the majority tend to accept the news as truth even when this public opinion is not based on a fundamental analysis. In this sense, social contagion is severe and acts as an epidemic. Ultimately, the infection becomes normal, and those who are not infected become odd.

3. Methodology

The study employs case study method as the main data analysis technique, to determine whether US subprime crisis had directly or indirectly affected the Seylan Bank distress. This may also reveal whether the distress is mainly resulted from other causes that have nothing to do with the subprime crisis.

When analyzing the causes leading to Seylan Bank distress it was required to view the situation from various but interrelated perspectives. First, an attempt is made to investigate the possibility that the distress be a result of a long-term issue that made the bank vulnerable to internal or external shocks. This was achieved thorough an assessment of the financial standing and the management standards of the bank. The data extracted from the annual reports published by the Seylan Bank and CBSL together with the information published by rating agencies were used for analysis. Behavior of factors like NPL, staff cost, profitability, asset quality and liquidity, and return on equity were given the primary focus. The results were compared with similar leading private commercial banks in Sri Lanka to identify the discrepancies. Information collected through interviews held with the staff of the bank was also used during the analysis to assess the actual situation prevailed in the bank since its incorporation. Second, an attempt is made to identify the key possibilities under which the panic of the GKCCC can spread into the Seylan Bank. To this end, performance and interlinks among the bank and other members of the conglomerate were analyzed while paying special attention on how closely the customer and investor perception on the group is linked to that of the bank. Third, an attempt is made to analyze the sequences of events that took place in the financial system after and prior to GKCCC collapse. Here, special attention was paid to the incidents occurred in line with the subprime crisis. This helps to understand how other banks and financial institutions behaved amidst this global financial meltdown. Thereby, an attempt is made to identify how and why only a single bank is affected.

Outcomes of these investigations were then synthesized to form an overall assessment on how the Seylan Bank distress occurred along with the US subprime crisis and resulting GKCCC failure.

4. Results and Findings

CBSL has been strictly monitoring the functions of commercial banks in Sri Lanka. However, there were number of informal and unauthorized financial institutions operating outside the regulatory framework and supervisory monitoring of the CBSL. At the time of US subprime crisis, a large number of depositors in Sri Lanka had placed their money with these financial institutions despite the warnings issued by the CBSL. But when the effects of subprime crisis started appearing, substantial number of depositors of such unauthorized financial institutions became cautious and rushed to withdraw their savings from those institutions expecting a contagion effect. Meanwhile, CBSL publicly declared six finance companies as unauthorized financial institutions in September 2008 (CBSL, 2008). Here, many of these financial institutions failed to fulfill their commitments towards depositors due to lack of liquidity. Consequently a number of such firms were collapsed. Along with this, for example, Sakvithi House Constructions (Pvt) Ltd defaulted around LKR one billion owing to around 2800 individuals (Sunday Times, 2010). Further, in October 2008, another unauthorized deposit acceptor, *Danduvan Mudalali,* was arrested by the police where the amount of deposits accepted illegally amounted to around LKR 50 million (Transparency International Sri Lanka, 2009). Concurrently, GKCCC collapsed in December 2008.[1] Failure of GKCCC can be considered as the first signal appeared in Sri Lanka concerning the gradual impact of the US crisis (Financial Times, 2008). The amount of deposits placed at GKCCC by the public at the time of collapse amounted to around LKR 26 billion (The Island, 2009). Unlike the collapse of other unauthorized financial institutions, the effect of GKCCC failure on Sri Lankan financial system was severe. More precisely, its affiliation to a large business conglomerate, to which a leading commercial bank, the Seylan Bank, was also affiliated, aggravated the concerns about potential contagion effects of US subprime crisis. Within weeks of the GKCCC collapse, a bunch of other deposit-taking firms affiliated to the same conglomerate faced liquidity issues (Sunday Times, 2011).

1 *Nevertheless, it is often claimed that the GKCCC failed due mainly to internal problems rather than due to external causes resulting from the US crisis (Financial Times, 2008).*

Seylan Bank is the sixth largest commercial bank in Sri Lanka (Fitch, 2012). However, performance of the bank has been substantially poor in a number of aspects compared to other leading commercial banks in the country. First, the bank has expanded its operations rapidly since its incorporation in 1988. For example, as illustrated in figure 1, the number of branches has increased from one to 75, 86, 108 respectively in 1995, 2002 and 2005. This rapid growth paved the way for the bank to become fifth largest commercial bank, in terms of assets, in Sri Lanka by 2008 even though it fell down to sixth place in 2009. However, the bank had not been able to raise enough equity capital along with its expansion. Thus, as illustrated in table 1, the capital adequacy ratio of the bank has remained slightly below that of other leading commercial banks. Therefore, the bank had to incur additional costs on borrowings which were necessary to ease the liquidity position of the bank. As a result, since its early years, the gearing ratio of the bank was more than 20 times when the industry average was below 15 times. This remained at a higher level even up to the distress.

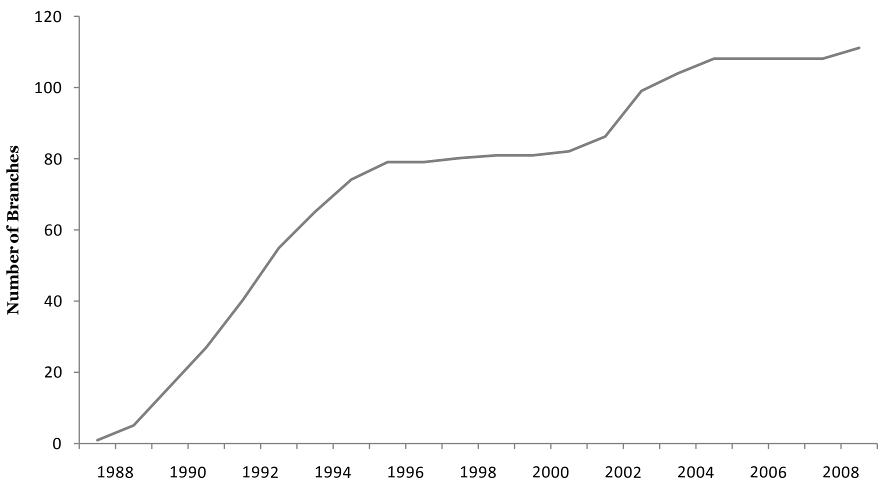

Figure 1: Expansion of branch network of the Seylan Bank

Second, along with the increase in outreach, the deposit base of the bank was also widened. For example, during the first five years, the deposit base of the bank increased by nearly ten times relative to 1989. In contrast, the deposit base of Sampath Bank PLC, a bank established concomitantly, expanded just by 1.5 times during the same period. Under such expansion in the deposit base, Seylan Bank had to expand its loan portfolio as well in line with the deposit growth to maintain its profitability. For example, the average annual loan growth during first five years amounted to 86 percent whereas the loan growth of Sampath Bank was just 39 percent. This type of rapid lending have, probably, necessitated the Seylan Bank to adopt a relatively flexible lending approach. However, the bank had not developed a system to ensure sound credit screening and monitoring process mainly owing to lack of experience of the employees. This was evident from the fact that one of the main initiatives taken by the newly appointed chief executive officer (CEO) is to inculcate a professional credit culture in the bank (Samaraweera, 2012). The recovery process had also been relatively poor. Consequently, the NPL was increased substantially. Further, the bank had granted loans to companies affiliated to its own group and some of these loans had become non-performing.[2] During ten year period starting from 1999, the NPL ratio of the bank was ranging from 13 to 20 percent. As illustrated in table 2, these figures are extremely high compared to other commercial banks. Furthermore, this trend had continued up to the distress.

Third, from the outset, Seylan Bank was in the forefront in providing a personalized customer service. Importantly, the client base of the bank mainly consisted of retail customers, i.e. mid-sized corporate clients

2 *However these loans had been rescheduled by the management to avoid being reflected in the NPLs. These facts were revealed during the investigations carried out by the CBSL after the distress.*

and Small and Medium Enterprises (SMEs). According to Seylan Bank Fitch Rating (2004), these two segments have accounted for around 73 percent of the loans as of April 2004. Further, most of the operations of the bank were handled manually due to lack of automation. Hence, to maintain this customer oriented approach, the bank had to recruit adequate human resources. Thus the number of employees and personnel costs in the bank increased considerably. Simultaneously, the retail customer base of the bank did not contribute much towards the profitability of the bank. As a result, as illustrated in table 3, the profit per employee of the bank had been remarkably lower compared to other leading commercial banks.

Fourth, as illustrated in table 2, overall cost-to-income ratio of the bank was comparatively higher. Income of the bank had declined due to poor recovery process and the interest expenses were high due mainly to higher interest rates offered to depositors. Finally, due to inadequate equity capital and reserves to facilitate increased business volumes, the bank had to raise additional capital at high costs and compelled to increase the lending rates. For example, as illustrated in table 2, the interest rate spread of the bank was the highest except for years 2007 and 2008. Due to these high lending rates the bank could not attract and retain prime borrowers who were concerned with interest rate. Largely the bank had to depend on average quality borrowers who were not much concerned with the borrowing rate. This increased the risk exposures of the bank by increasing the probability of default in the loan portfolio.

Due to the combined effects of the factors discussed above, the return on assets (ROA) of the bank had been substantially below the industry average. For example, as illustrated in table 3, ROA of the bank had been below one percent when other banks have maintained it well above one percent. Importantly, ROA fell drastically in 2008. Earnings per Share of the bank had also been well below that of other commercial banks as illustrated in table 3. Further, Fitch Ratings Lanka downgraded Seylan Bank's national long-term rating to 'BBB+ (lka)' from 'A- (lka)' in the year July 2008 well before the signs of a deposit run appears. At the same time, Fitch downgraded the ratings of the bank's subordinated debentures to 'BBB (lka)' from 'BBB+ (lka)' (Seylan Bank Fitch Rating, 2008). Importantly, Fitch Ratings of the bank had always been below that of other leading commercial banks. This type of poor performance can be a major factor behind the less attractiveness of Seylan Bank share. For example, as illustrated in table 1, the net asset value and the market value of the Seylan Bank share had remained almost at the same level depicting a quite contrasting situation compared with other leading commercial banks. This is because prudent investors are not prepared to pay more than the net asset value, if the company concerned is not performing well.

Moreover, credibility of the Group's directors had been deteriorated and the transparency of intra-group transactions was also unsatisfactory. For example, the Group had more than 250 companies. There was substantial amount of intra-group transactions (Financial Times, 2008) and financing involving the Seylan Bank as well. These transactions were not transparent and it was difficult to ascertain the origins and distribution. Additionally, Ceylinco Group had established a number of overseas companies in which the sources of funds utilized to setup these companies were not clear. Therefore, the investors doubted whether the group has diverted their funds to set up these companies. Further, the bank had signed contracts deemed unfavorable to the bank's own interests with other intra-group companies (Seylan Bank, 2009). These factors collectively had constrained the bank's ability to raise equity and debt; and thereby increased financing cost.

These management deficiencies made the bank vulnerable to a crisis. However, the depositors remained loyal to the bank, even when they were aware of the long standing weaknesses, owing to the overall confidence and stability of the Sri Lankan banking system since no major incident has happened till the GKCCC issue. But collapse of GKCCC triggered the bank run. More specifically, the Group Chairman, immediately after the collapse of GKCCC, promised to settle the dues by disposing his shares in the Seylan Bank (Chandrasekera, 2009). Further, the Chairman admitted that the GKCCC was mismanaged and a number of fraudulent activities took place. This news created doubts about the stability of the Group as a whole. Being a highly leveraged financial institution, the effect was severe on Seylan Bank. This can be taken as the most proximate cause that triggered the Seylan Bank distress. However initial foundation for a potential distress has already been laid as discussed before.

Table 1: Value of shares and Capital Adequacy Ratios of leading private commercial banks

Bank	2004			2005			2006			2007			2008			Average		
	NAV[a]	MV[a]	CA[b]	NAV[a]	MV[a]	CA[b]	NAV[a]	MV[a]	CA[b]	NAV[a]	MV[a]	CA[b]	NAV[a]	MV[a]	CA[b]	NAV[a]	MV[a]	CA[b]
Seylan Bank	49.1	30.0	10.5	55.4	36.8	10.3	37.9	35.0	11.7	41.9	32.0	12.7	41.8	28.5	9.4	45.2	32.5	10.9
Commercial Bank	51.0	159.8	13.2	98.0	135.5	12.1	70.0	190.0	11.6	97.0	147.0	13.7	104.0	67.0	13.3	84.0	139.9	12.8
Sampath Bank	75.8	62.8	11.6	81.8	90.0	13.8	96.2	109.8	11.6	124.4	120.0	11.9	141.9	68.0	12.4	104.0	90.1	12.3
HNB	90.4	57.0	11.3	95.4	112.5	11.6	54.9	155.8	11.4	78.2	122.5	12.0	87.4	69.8	11.4	81.3	103.5	11.5

Note: NAV denotes Net Assets Value of a share (LKR); MV denotes Market Value of a share (LKR); CA denotes Tier 2 Capital Adequacy (%)

Source: [a]Annual Reports of Selected Commercial Banks, [b]Fitch ratings

Table 2: Non-performing Loans, Cost-to-Income Ratio, and Interest Rate Spread of leading private commercial banks

Bank	2004			2005			2006			2007			2008			Average		
	NPL[a]	CIR[b]	IRS[c]	NPL[a]	CIR[b]	IRS[c]	NPL[a]	CIR[b]	IRS[c]	NPL[a]	CIR[b]	IRS[c]	NPL[a]	CIR[b]	IRS[c]	NPL	CIR	IRS
Seylan Bank	15.3	62.0	5.7	12.9	56.8	5.2	11.3	59.1	5.0	12.6	66.3	5.0	14.4	73.7	4.9	13.3	63.6	5.2
Commercial Bank	5.3	56.8	4.1	3.2	54.3	3.6	2.7	61.0	3.7	3.0	47.9	4.7	5.2	46.2	4.7	3.9	53.2	4.2
Sampath Bank	8.2	54.8	4.5	5.9	52.2	4.4	5.3	58.0	4.2	6.7	56.8	4.1	7.3	59.6	4.9	6.7	56.3	4.4
HNB	9.8	70.4	4.0	8.4	62.3	4.3	7.1	59.3	4.8	6.0	64.3	5.2	6.8	65.9	5.2	7.6	64.4	4.7

Note: NPL denotes Gross Non-performing loans ratio (%); CIR denotes Cost-to-Income Ratio (%); IRS denotes Interest Rate Spread (%)

Source: [a]Fitch Ratings,[b]Annual Reports of Selected Commercial Banks, [c]RAM Ratings

Table 3: Profitability of leading private commercial banks

Bank	2004			2005			2006			2007			2008			Average		
	P/Emp	ROA	EPS	P/Emp	ROA	EPS	P/Emp	ROA	EPS	P/Emp	ROA	EPS	P/Emp	ROA	EPS	P/Emp	ROA	EPS
Seylan Bank	117.5	0.5	4.9	186.0	0.7	8.2	226.0	0.7	6.7	238.0	0.7	5.5	39.6	0.1	0.9	161.4	0.5	5.2
Commercial Bank	603.3	1.4	6.0	744.3	1.5	9.0	589.4	1.5	9.0	1095.0	1.7	17.0	1056.3	1.6	17.0	817.6	1.5	11.6
Sampath Bank	364.9	1.0	12.0	437.9	1.1	12.1	504.2	1.1	14.9	475.4	0.9	15.3	598.1	1.0	20.5	476.1	1.0	15.0
HNB	233.6	0.7	12.5	388.5	1.0	15.1	518.0	1.2	18.9	697.0	1.4	12.8	732.4	1.3	13.7	513.9	1.1	14.6

Note: P/Emp denotes profit per Employee; ROA denotes Return on Assets (%); EPS denotes Earnings per Share (LKR)

Source: Annual Reports of Selected Commercial Banks

The sequence of events that took place in the non bank financial sector subsequent to US subprime crisis reveals that unmonitored and unregistered deposit acceptors were the first to collapse. For example, two of the leading unauthorized deposit acceptors, namely, *Sakwithi* and *Danduvan Mudalali* failed. Further, financial institutions like The Finance and Guarantee, Ceylinco Investment and Realty Ltd., Ceylinco Profit Sharing Ltd., and Ceylinco Shriram were also hit during the US financial crisis. Importantly, all of these institutions were affiliated to the Ceylinco Group and some of them were not authorized as a financial institution. Worst of all was the collapse of GKCCC. When GKCCC collapsed many unfavorable hidden factors relating to Ceylinco Group was surfaced. This was the beginning of the sequences that led the Seylan Bank towards the distress.

5. Conclusion and Implications

Even though US subprime crisis did not affect Sri Lankan economy directly, some of the cascading effects could be observed in a number of sectors. For example, due to declined economic activity of buyer markets, e.g. America and Europe, Sri Lankan export sector was affected severely. As a result, unemployment rate increased noticeably while creating a downward pressure on the overall economic activity as well. Apart from that, the financial system got affected due to the US subprime crisis. For example, contagion effects caused a substantial deterioration of the public confidence towards loosely regulated and non-regulated financial institutions. Collapse of the GKCCC can also be directly attributed to the US subprime crisis. This created a severe blow to the banking system as well because Seylan Bank and GKCCC belonged to the same business conglomerate, the Ceylinco Group. More precisely, collapse of GKCCC created a fear in the depositors of Seylan Bank as well about its resilience. This resulted in a sudden bank run. Fortunately, the intervention of the CBSL was successful and the bank could be brought under control while preserving the financial system stability.

It is commonly argued, primarily based on the sequence of the events, that the Seylan Bank distress is a direct consequence of the US subprime crisis. However, analysis in this paper shows that Seylan Bank distress occurred due to a set of long standing management deficiencies that had already weakened the stability of the bank. Nevertheless, the crisis acted as the trigger. For example, over expansion, poor credit screening and monitoring, and lack of transparency in management actions within the group, etc. have deteriorated the profitability and resilience of the bank while making the bank less attractive for investors. However, due to the overall optimism prevailed towards the banking system in Sri Lanka, the Seylan Bank could withstand and attract deposits. Finally, collapse of confidence in the overall financial system triggered the distress in the bank because it was vulnerable even to a minor external shock.

The case of Seylan Bank has three main implications. First, the regulators need to be more vigilant and extra cautious when a systemically important bank belongs to a business conglomerate which owns other (particularly less regulated) financial institutions. Second, an effective framework for improving financial literacy of the public on a regular basis is essential to encourage informed decisions and to avoid sudden panic. Third, dissemination of financial information to a wider range of audience on key financial institutions must also be encouraged while tightening the regulatory monitoring of the CBSL. Arms length monitoring practiced under the Anglo American framework can be supplemented with a network of relationship-based banking to foster a dynamic regulatory framework with sufficient attention to individual systemically important financial institutions. Nevertheless, appropriateness of such a hybrid regulatory framework for Sri Lanka is yet to be explored.

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