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IN THIS ISSUE

02 *Role of Central Bank in Financial Market Infrastructure: The Case of EURO Systems*

09 *The Future of Banking Industry with Automation and Artificial Intelligence (AI)*

18 *Importance of Strong Governance, Risk and Compliance Function for Banking Sector*

27 *Enhancing Financial Consumer Protection: Building a Strong Financial Future in Sri Lanka*

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Role of Central Bank in Financial Market Infrastructure: The Case of EURO Systems

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Introduction

The Euro system consists of the European Central Bank (ECB) and the National Central Banks (NCBs) of the member countries of the European Union which use Euro as their currency. Primary objective of the Euro system is the maintenance of price stability for the common good and further acting also as a leading financial authority, mainly aim to safeguard financial stability and promote European financial integration.

In pursuing euro system objectives, they attach utmost importance to credibility, trust, transparency, and accountability. And further they are aim for effective communication with the European citizens of Euro system is committed to conducting their relations with European and national authorities in full.

The monetary policy was transferred from the national central banks of 11 EU Member States to the ECB in January 1999. Greece joined in 2001, Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014, Lithuania in 2015 and Croatia in 2023. Since 1st, January 1999 the European Central Bank (ECB) has been responsible for conducting monetary policy for the euro area and this is the world's largest economy after the United States. The institutions of the Economic and Monetary Union (EMU) are largely responsible for establishing European monetary policy, rules governing the issuing of the euro and price stability within the EU.

Further, Euro-system consists of six Executive Board members and the governors of the central banks of 19 EU Member States. The European Central Bank is responsible for the prudential supervision of credit institutions located in the euro area and participating non-euro area member states, within the Single Supervisory Mechanism, which are comprises the national competent authorities. The Euro system is responsible for promoting the smooth operation of payment systems. As per the organizational structure of the ECB, the payment and settlement system infrastructure of the Euro system is under the purview of Directorate General of Market Infrastructure and Payments, and the related key functions are oversight, market integration, market infrastructure management and market infrastructure development.

The Euro financial market infrastructure is complex in nature and consists of the following components.

- ❖ Payment systems
  - 03- Large value payment systems
    - i. TARGET2- Trans-European Automated Real-time Gross Settlement Express Transfer.
    - ii. POPS - Pankkien On-line Pikasiirrot ja Sekit
    - iii. CLS - Continuous Linked Settlement System.
  - 30- Retail payment systems.
  - 22- Payment card schemes (16 Euro area schemes and 6 international schemes).
- ❖ Securities and derivatives market infrastructure (post-trade)
  - 10- Central counterparties.
  - 29 -Securities settlement systems.
  - 1- Trade repository.

Large value and retail payment systems are classified as Systemically Important Payment Systems (SIPS) based on at least two of the main criteria, specifically, the value of payments settled, market share, cross-border relevance, and provision of services to other infrastructures. Currently, four systems (TARGET2, EURO1, STEP2-T and CORE) are identified as SIPS. The payment systems which are identified as SIPS and that must comply with the ECB SIPS Regulation No. 795/2014. However, Regulations have been amended time to time on oversight requirements for systemically important payment systems (ECB/2017/32).

At present, Cyber risk is a growing concern in financial markets and individuals. The increasing trend has been continued in EU due to digital transformation and new regulatory initiatives. However, EU is continuously attending on cyber awareness and cyber insurance. Further they periodically review operational policies and procedures, especially following significant changes to the system to ensuring effective operational risk management. The publication of Regulation (EU) No 795/2014 (ECB/2014/28) has sets out specific requirements that are important to mitigate cyber risks.

Role of Central Banks in Payment, Clearing and Settlement Infrastructure

Payment systems are very important functioning of the financial system. Safe and efficient financial market infrastructures (FMIs) are critical to the effective functioning of the payments system. FMIs are essential for the well-functioning of the financial system. Further, they play a central role in facilitating clearance and settlement of financial transactions such as payments, securities, and derivatives contracts.Most central banks and other Banks around the world are support the economic activities by issuing banknotes and operating large-value payment and settlement systems, which create basic infrastructures of the economy. Considering economic developments and innovations in information technology the role of central bank in facilitating payment and settlement infrastructure is playing a more important role.

The soundness of FMIs is vital to support the monetary policy implementation process as well as to ensure financial market stability. The Central Banks involvement in FMIs is expected to enhance safety and efficiency of the payment, clearing and settlement systems. Central Banks perform

main three key roles to effectively to achieve this objective.

1. Operational role – As the operator, the central bank owns and operates facilities providing payment, clearing and settlement services. This typically involves the provision of account and settlement-related services.

2. Oversight role – As the overseer, the central bank initiates change with a view to ensuring that systems are safe and efficient. This typically involves the careful monitoring and assessment of existing.

3. Catalyst role – As the catalyst, the central bank plays an important role in private sector initiatives as a partner or facilitator of the overall efficiency of payment, clearing and settlement arrangements in both for the development of payment, clearing and settlement systems and for the establishment of market standards and practices. Further central bank act as the driver of economic development by ensuring price and macro-economic stability through appropriate monetary policy. It has an important role in supervising the financial sector to ensure that it functions well.

In addition to being the operator of the major FMIs in the Euro region, the oversight and catalyst roles contribute to enhance safety and efficiency of the overall financial market infrastructure. As per the statute of the European Central Bank, it is required to, promote smooth operation of payment systems, favour an efficient allocation of resources in an open market economy with free competition with ensuring efficient and sound clearing payment systems within the EU and other countries.

To enhance safety and efficiency of the retail payments, the European Central Bank is required to effectively discharge its responsibilities as an overseer and a catalyst.

Central Bank role as an Operator in financial market infrastructures

As the operator of a payment system, the central bank offers settlement in central bank money by allowing financial institutions to transfer among themselves funds held in accounts with that central bank. Central banks' payment systems are usually employed for the final settlement of claims originating from interbank operations and ancillary systems, such as systems for the clearing of retail payments, foreign exchange transactions

Role of Central Banks in Financial Market Infrastructure: The Case of the Euro system		
Operational Role	**Oversight Role**	**Catalyst Role**
• TARGET2 System • CCBM • TARGET2 Securities	• Legal basis - Article 105(2) of the Treaty and Article 22 of the ECB Statute • Standards • Scope of Oversight • Allocation of responsibilities within the Eurosystem	• SEPA- Single Euro Payments Area • Securities clearing and settlement

Objectives of the oversight and catalyst functions

Objective Address	Safety	Efficiency
Micro Level (Individual systems and arrangements)	Oversight	Oversight
Macro Level (Overall Market infrastructure)	Oversight	Catalyst

Source: Central bank oversight of payment and settlement systems, CPSS, BIS, Basel.

or securities transactions. Moreover, it is not uncommon for central banks to have an operational role in the settlement part only of retail payments. In some countries, the central bank also operates government securities settlement infrastructure on behalf of the government. A central bank will usually cooperate closely with the banking system when developing payments infrastructure. The central banks operational involvement in payment and settlement systems varies from country to country and it may also vary from system to system.

Central Bank as an Overseer in financial market infrastructures

The Central Bank play as the overseer of financial market infrastructures to ensuring the smooth function of payment systems. As an overseer, the Central bank need to monitor developments in the field of payment and settlement systems to assess the nature and scale of the risks inherent in these and to ensure the transparency of the arrangements concerning payment instruments and services. Further, central bank must assess the existing regulations with the developments of the payments system infrastructure and introduce new legislations when the market is not able to re-solve inefficiencies with the current regulations. With modern technology, disruptions in market could spread quickly through out the financial sector and put the whole system at risk. Disturbances in the financial sector may also have an impact on real economy. In some region, intermediations have been made by the regulator as and when necessary by issuing legislation to regulate the payment, clearing and settlement systems.

The Oversight Experience and regulations in Euro system

The oversight framework is covers assessing financial market infrastructures against international standards (e.g. Committee on Payments and Market Infrastructures (CPMI) / International Organization of Securities Commissions (IOSCO) Principles for Financial Market Infrastructures – 16 April 2012) and setting standards at the European union (EU) and Euro system level to assess the systems. The Euro system has developed an assessment methodology for payment systems, which is aimed

to ensuring a consistent and harmonized application of the SIPS Regulation and PFMI in the conduct of oversight assessments by the Euro system.

Accordingly, in the Euro region, intermediations have been made by the regulator as and when necessary by issuing legislative documents to regulate the payment, clearing and settlement systems. Some key regulations include.

- Regulation 2560/2001
  - Prohibited banks to apply different charges for domestic and cross-border credit transfers, card transactions or ATM withdrawals in Euro within the EU.
- Payment Services Directive (2007/64/EC)
  - Provided the legal platform for Single Euro Payments Area (SEPA) and the introduction of SEPA credit transfers and SEPA direct debits.
  - Applies to all EU currencies
  - Introduced the single license concept by which a license issued in one-member state allows to provide services throughout the EU. Diverse licensing criteria were introduced depending on the risk involved and three license categories, namely payment institutions, electronic money institutions and credit institutions, were specified.
- SEPA End-Date Regulation (260/2012)
  - February 2014 was set as the end date for migration to SEPA credit transfer and SEPA direct debit schemes (additional transition period was given by Regulation 248/2014)
  - Mandated the use of International Bank Account Number (IBAN) and eliminated the BIC
  - Prohibited the per transaction interchange fee for SEPA Direct Debits
- Directive on the Transparency and Comparability of Payment Account Fees, Payment Account Switching and Access to a Basic Payment Account
  - To promote financial inclusion, the Directive provides for the right to a basic payment account irrespective of a citizen's place of residence or financial condition
  - Improves the transparency of bank account fees
  - Makes it easier to switch bank account from one bank to another
- Payment Services Directive 2 (PSD2)
  - Taking the innovations in the industry into account, proposed to expand the scope to include payment initiation services, account information services and other similar services
- Regulation on Interchange Fees for Card based Payment Transactions (2015/751)
  - Introducing caps on interchange fees for consumer debit (0.2%) and credit (0.3%) cards
  - No territorial limitations for card issuing or acquiring
  - Limitations to the Honor All Cards Rule
  - Co-badging (more than one brand on a card) and choice of application

The oversight framework covers assessing financial market infrastructures against international standards (e.g. CPMI/IOSCO Principles for Financial Market Infrastructures – 2012) and setting standards to assess the systems at the EU and Euro system level.

Central Bank as a Catalyst in financial market infrastructures

Central bank as a catalyst, it is required to have a good knowledge of the financial system including all payments mechanism and infrastructure in the financial system, a vision and a strategy while maintaining right contacts and good relations with all players in the payments market to achieve the objectives.

Considering the high level of economic and social relevance in retail payments, the authorities involve actively in promoting retail payments. Accordingly, the Euro system's catalyst role in the Single Euro Payments Area (SEPA) is primarily based on the following.

- Harmonization of credit transfers, direct debits and cards is the basis and innovation should focus on access channels to these instruments.
- New market players and their innovative solutions should not lead to new market fragmentation
- Cooperation in the market, especially standards and business rules.
- Layered industry models instead of silo approaches

Adoption of ISO 20022

ISO 20022 is an international standard designed to simplify global business communication. This standard enables efficient payments clearing and settlement among financial institutions globally Further they use a common set of messages and language that the institutions agree to use in a consistent way. This ISO 20022 standard is widely used in the euro area, including in retail payments, as the required format for SEPA payment messages under the SEPA Regulation. The standard is also an enabler, improving cross-border transactions. For large-value payments systems, the older SWIFT Net FIN (MT) is still used, but the migration for the industry as a whole is envisaged to come by the end of 2025. In the euro area, TARGET-2 and EURO-1 are planning to adopt fully in end 2024. Currently the Euro system has been carefully monitoring the migration plans, testing and contingency planning being developed by the operators.

Recent Developments of Financial Market Infrastructures in Euro System

The retail payments landscape in the Euro area is subject to modernization with innovative retail payment mechanisms entering the industry. This modernization process is supported by the growth in mobile phone penetration including smartphones and the increasing e-commerce activities and time spent online. As a result, mobile payments, e-commerce payment solutions, virtual currencies and instant payments have been widely discussed as retail payment ecosystem.

Even though e-commerce payment solutions are being developed with the growth of usage of online payment infrastructure. There are only a few solutions that are efficient, safe, and reliable. The payment initiation services can be recognized as e-commerce payment solutions. Mobile payments can be defined as a payment device in which a payer uses his/her mobile device to make a payment. Virtual currencies are also being largely discussed as an innovative retail

payment solution. Further, virtual currency can be described as a digital representation of value, not issued by a central bank, credit institution or e-money institution. In some circumstances, can be used as an alternative for money. Instant payments methods ensure the real time or near real time fund availability for the payee. Real-time payments are instant payments that are processed immediately and continuously, 24/7. Unlike traditional payment systems, which can take hours or even days to complete transactions, RTP systems immediately transfer funds from one bank account to another. However central banks are required to be proactive in their catalyst role regarding recent developments in the retail payments. Retail payments can involve in setting appropriate payments security requirements and offering secure and modern settlement for innovative retail payment solutions. Further, it is required to ensure that harmonization and integration requirements are taken into consideration when adopting innovative retail payment solutions in the Euro region.

Conclusion

The information on payment, clearing and settlement infrastructure in the Euro region and how the ECB discharges its responsibilities as an operator, an overseer and a catalyst in practice are important in the payment landscape.

It is importance to identify areas for improvement in the Sri Lankan payment landscape, especially regarding the Central Bank's role in payment, clearing and settlement systems. Although the regulatory actions and initiatives for the improvement of the payment, clearing and settlement systems in the Euro region cannot be directly applied to Sri Lanka due to the integrated nature of systems in the Euro region and variations that exist in terms of payment needs, there are many things that we can learn from their experiences to improve our systems, processes and practices.

Being the operator and the overseer of the Real Time Gross Settlement Systems (RTGS), the only system in the country that facilitates large value and time critical payments, the Central Bank of Sri Lanka (CBSL) requires to further strengthen its role as the overseer. Further, ECB in practice compiles and analyzes data on the TARGET 2 system to assess risks associated with the system. This will provide important insights to broaden the scope of CBSL's oversight activities related to the all payment instruments and mechanism.

The retail payments, the experiences in the Euro region in promoting electronic payments (especially credit transfers, direct debits and payment cards) and addressing risks associated with retail payments will also be useful for CBSL in its short, medium and long-term planning process about payment system development and regulatory action.

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The Future of Banking Industry with Automation and Artificial Intelligence (AI)

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Introduction

Financial technology and artificial intelligence are the innovations trying to tackle the gaps between what financial institutions offer and clients' expectations. It is one of the most exciting developments in financial technology today. Furthermore, technology-driven financial services help achieve financial inclusion, which aims to provide financial products and services at an affordable cost to every segment of society. Including women, youth, and SMEs (Small and Medium-sized Enterprises), to meet their basic needs regardless of their income, through providing them with financial services such as payments, savings, loans, and insurance.

The banking industry is undergoing a rapid transformation due to the emergence of automation and artificial intelligence. Automation and AI are revolutionizing the way banks operate, from customer service to risk management. Currently, banks can provide faster, more efficient, and more productive services to their customers, while also reducing costs and improving security.

Moreover, the banking sector is one of the most heavily regulated industries in the world. As such, banking sector regulators must ensure that banks comply with all applicable laws and regulations within their regulatory framework. In recent years, the banking sector has seen an increase in the use of automation and artificial intelligence technologies to improve efficiency, reduce costs and mitigate risks. This has led to clear questions about how the regulators should regulate these technologies.

Innovative technologies have been adopted in the financial sector, especially for banks, many years ago. For instance: "Digitalizing finance is not new, and it began many years ago; in 1967, the first ATM (Automated Teller Machine) was introduced by Barclays Bank in the UK. This machine was a kind of innovation and allowed an enormous transformation of how people could get their money quicker than basic transactions with the aid of a branch representative or teller. In the 1970s, banks began to introduce card-based payments, while online banking was widely accepted starting from the year 2000, and by 2010s mobile-based "on-the-go banking" became popular" (amf.org.ae 2021) [1].

Importance of Automation and AI

Automation is the process of using technology to program manual tasks. Streamlining processes,

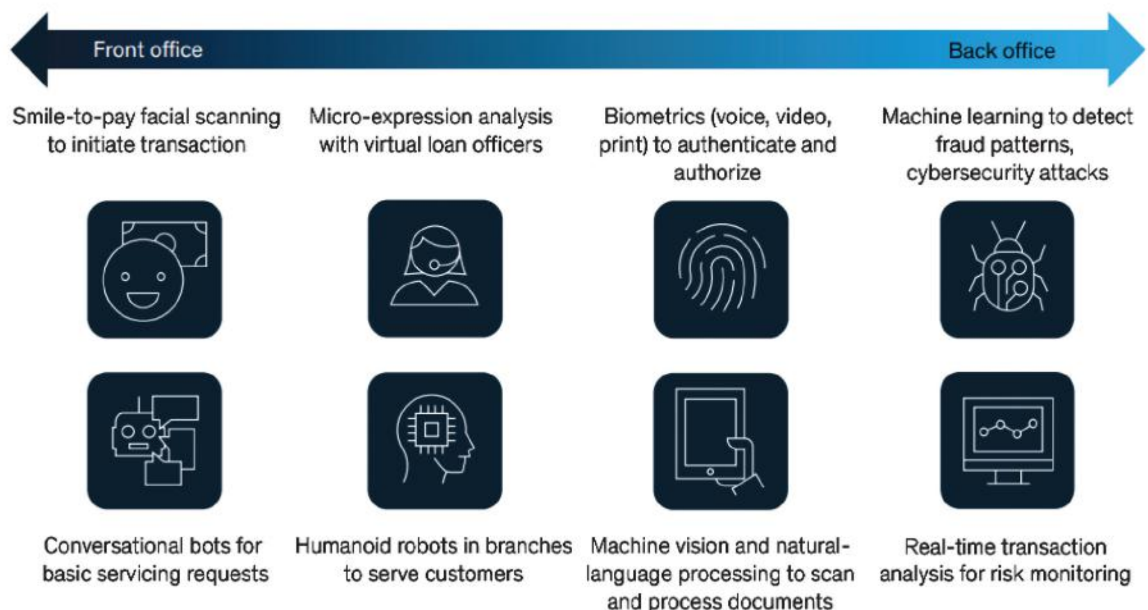
reducing errors, and improving customer service are the common benefits of the above. It can also be used to reduce costs by eliminating the need for manual labor and associated resources. Mechanizing customer service tasks such as account opening, account maintenance, customer support, back-office tasks such as loan processing, risk management, and compliance are further benefits of automation.

AI is the use of computer algorithms to mimic human intelligence. It can be used to automate tasks such as customer service, risk management, and compliance, analyze customer data to provide better customer service and detect fraud. Processes such as loan processing and risk management can also use AI to automate them (Deloitte 2021) [2].

In addition, automation and AI can be used in a variety of ways in the banking sector, from automating customer service processes to providing more accurate credit scoring and fraud detection. Streamline the compliance process, allowing banks to meet their regulatory requirements more quickly and accurately are further benefits of such services.

However, the use of automation and AI in the banking sector also raises noticeable regulatory concerns. For example, regulators must ensure that banks are using these technologies responsibly and in a manner that does not put customers at risk. Additionally, regulators must ensure that banks are using these technologies in a way that does not violate any laws or regulations.

To address these concerns, banking sector regulators have begun to develop guidelines and regulations for the use of automation and AI in the banking sector. These guidelines and regulations are designed to ensure that banks are using these technologies in a responsible manner and in compliance with all applicable laws and regulations.



Source: McKinsey & Company (2021). Building the AI bank of the future. [3]

In addition to developing guidelines and regulations, banking sector regulators are also working to ensure that banks are using these technologies in a way that is beneficial to customers. For example, regulators are encouraging banks to use automation and AI to improve customer service and provide more accurate and timely credit scoring and fraud detection.

Overall, automation and AI are becoming increasingly important in the banking sector. As such, banking sector regulators must ensure that banks are using these technologies responsibly and in a manner that does not put customers at risk. By developing guidelines and regulations, as well as encouraging banks to use these technologies in a way that is beneficial to customers, banking sector regulators can help ensure that banks are using these technologies in a safe and responsible manner.

Benefits of Automation and AI for Financial Institutions and Regulators

This section has discussed the benefits of automation and AI for financial institutions and regulators in detail under separate subtopics.

Automated Fraud Detection

Automated fraud detection is a process that uses computer algorithms to detect fraudulent activity in financial transactions. It is used to identify and prevent fraudulent activities such as identity theft, money laundering, and credit card fraud. Automated fraud detection systems use a variety of techniques to detect suspicious activity, including pattern recognition, data mining, and machine learning. These systems can detect anomalies in data that may indicate fraudulent activity and alert the appropriate personnel. Detecting suspicious activity in customer accounts, such as unusual transactions or large transfers are additional benefits of the system. Detect suspicious activity in online banking, such as phishing attempts are also possible with automated fraud detection systems.

Automated Credit Scoring

Automated credit scoring is a process that uses computer algorithms to assess a person's creditworthiness. The algorithms consider a variety of factors, such as credit history, income statements, debt-to-income ratio, and other financial information. The algorithms then assign

1. Automated Fraud Detection
2. Automated Credit Scoring
3. Automated Customer Segmentation
4. Automated Risk Analysis
5. Automated Loan Approval
6. Automated Investment Advice
7. Automated Customer Support
8. Automated Personalized Marketing
9. Automated Financial Planning
10. Automated Portfolio Management

Financial Institute

1. Automated Transaction Monitoring
2. Automated Risk Assessments
3. Automated Compliance Checks
4. Automated Customer Profiling
5. Automated Reporting

Regulator

a score to the individual based on the data, which lenders use to determine whether to extend credit. Lenders assess potential borrowers and make decisions about extending credit quickly and accurately using automated credit scoring systems.

Automated Customer Segmentation

Automated customer segmentation is the process of using data-driven algorithms to group customers into distinct segments based on their shared characteristics. This process can be used to identify and target customers with tailored marketing messages, products, and services. Automated customer segmentation can be used to identify customer needs, preferences, and behaviors, as well as to create personalized experiences for customers. Automated customer segmentation can also be used to identify opportunities for cross-selling and upselling, as well as to identify potential customer churn.

Automated Risk Analysis

Automated risk analysis in banking is the use of technology to analyze financial data and identify potential risks. This technology can be used to detect fraud, assess creditworthiness, and identify potential money laundering activities. Automated risk analysis can also be used to monitor customer accounts for suspicious activity and to detect patterns of behavior that could indicate a risk. Automated analysis can help banks reduce their risk exposure and improve their compliance with regulations.

Automated Loan Approval

Automated loan approval is a process that uses technology to streamline the loan approval process. It involves the use of algorithms to analyze a borrower's credit history, income, and other financial information to determine if they are eligible for a loan. Banks, credit unions, and other lenders assess a borrower's creditworthiness and decide on whether to approve or deny a loan quickly and accurately, by using automated loan approval processes. Automated loan approval can also help lenders reduce costs associated with manual loan processing and reduce the time it takes to approve a loan.

Automated Investment Advice

Automated investment advice, also known as robo-advice, is a type of financial advice that is provided by computer algorithms. Providing investors with personalized investment advice based on their individual financial goals and risk tolerance is another advantage of these algorithms. Robo-advisors typically provide advice on asset allocation, portfolio rebalancing, and tax-loss harvesting. They can also provide automated portfolio management services, such as automatic deposits, automatic rebalancing, and automatic withdrawals. Robo-advisors are becoming increasingly popular as they are more cost-effective than traditional financial advisors.

Automated Customer Support

Automated customer support is a type of customer service that uses automated systems to provide customer service. Through a website, mobile app, chatbot, or other automated systems provides this type of customer service by simulating human operators. Automated customer support can provide customers with quick and efficient service, as well as help to reduce customer service costs. Automated customer support can also provide customers with personalized service, as the system can be programmed to recognize customer preferences and provide tailored responses.

Automated Personalized Marketing

Automated personalized marketing is a type of marketing strategy that uses technology to

customize marketing messages and content for individual customers. Tailored to the individual customer's needs and interests, this type of marketing uses customer data to create personalized messages. Also, to increase customer engagement, loyalty, and sales, nowadays it is common to use automated personalized marketing systems. Email campaigns, website content, and social media posts are the common campaign media for automated personalized marketing.

Automated Financial Planning

Automated financial planning is a type of software that helps individuals plan their finances. It can provide advice on budgeting, saving, investing, retirement planning, and more. The software typically uses algorithms to analyze a user's financial situation and provide tailored advice. Automated financial planning can be used to help individuals make better decisions about their money, as well as to provide an easier way to manage their finances.

Automated Portfolio Management

Automated portfolio management is a type of investment management that uses computer algorithms to create and manage a portfolio of assets. It is a form of passive investing, where the computer algorithms make decisions about which assets to buy and sell, and when to do so. To manage a variety of investments, including stocks, bonds, mutual funds, ETFs, and other financial instruments use automated portfolio management to various extent. Automated portfolio management can help investors save time and money by reducing the need for manual portfolio management. It can also help investors diversify their portfolios and reduce risk by automatically rebalancing portfolios as market conditions change.

Automated Transaction Monitoring

Automated transaction monitoring is a type of financial technology that uses software to detect suspicious or fraudulent transactions. To analyze enormous amounts of data quickly and accurately, flagging any transactions that are out of the ordinary, it is common to use specially designed software. Detect money laundering, terrorist financing, detect suspicious activity such as credit card fraud, identity theft, and other types of financial fraud and other financial crimes are additional usage of automated transaction monitoring systems. Automated transaction monitoring is becoming increasingly popular as financial institutions look for ways to protect themselves from financial crime.

Automated Risk Assessments

Automated risk assessments in banking are a form of risk management that uses computer algorithms to analyze data and identify potential risks. This process is used to identify areas of risk and to help banks make informed decisions about their investments and lending practices. Automated risk assessments can help banks identify potential risks associated with lending, investments, and other banking activities. They can also help banks identify areas of potential fraud or money laundering. Automated risk assessments can be used to evaluate the creditworthiness of potential borrowers, as well as to monitor existing customers for changes in risk profile. Automated risk assessments can also help banks identify areas of potential market risk, such as changes in interest rates or currency values.

Automated Compliance Checks

Automated compliance checks are to ensure that all transactions are compliant with applicable regulations and laws. Automated compliance checks in banking involve the use of software to monitor and detect any suspicious activity or transactions

that may be indicative of money laundering or other financial crimes. By detecting any suspicious patterns or activities that may be indicative of criminal activity, the software executes the compliance checks. The software is also capable of analyzing substantial amounts of data and flagging any suspicious activity for further investigation. Automated compliance checks can help banks to identify and prevent money laundering and other financial crimes.

Automated Customer Profiling

Automated customer profiling systems can be used to identify customers who may pose a higher risk and alert supervisors to potential risks. Automated customer profiling in banking is a process that uses data and analytics to create a profile of a customer's banking behavior. This profile can be used to better understand customer needs and preferences, and to provide more tailored services and products. It can also help banks to identify potential fraud and money laundering activity. Automated customer profiling can be used to identify customers who may be more likely to respond to certain offers or products, or to identify customers who may be at risk of defaulting on loans. Additionally, it can help banks to better understand customer segmentation and target marketing campaigns.

Automated Reporting

Automated reporting in banking is a process that uses automated software to generate reports on banking activities. This process can be used to track customer activity, monitor financial transactions, and identify potential fraud. To programmatically generate reports on customer service, compliance, and other areas of banking operations, the ideal tool is automated reporting tools. This can help banks improve efficiency and accuracy, reduce costs, and provide better customer service.

Challenges of Implementing Automation and AI in Banking

The banking industry is one of the most rapidly changing sectors in the world and with the introduction of automation and AI the way banks operate is transforming. Automation and AI have the potential to revolutionize the banking industry, but there are also challenges that must be addressed for these technologies to be successfully implemented. Cost, Complexity and Customer acceptance are the factors that any organization consider before implementing such technologies.

1. Cost

One of the biggest challenges of implementing automation and AI in banking is the cost. Automation and AI require significant investments in technology, personnel, and training, which can be prohibitively expensive for banks. Additionally, the cost of maintaining these systems can be high, as banks must continually update and upgrade their systems to keep up with the latest technology.

2. Complexity

Another challenge is the complexity of the banking systems. Automation and AI require a deep understanding of the banking industry and its processes, which can be difficult to achieve. Additionally, banks must ensure that their systems are secure and compliant with industry regulations. This can be a daunting task, as the banking system is constantly changing and evolving.

3. Customer acceptance

Finally, there is the challenge of customer acceptance. These technologies are intrusive and impersonal, which can lead to customer dissatisfaction. Banks must ensure that their customers are comfortable with the use of automation and AI, and that they understand the benefits that these technologies can bring.

Despite these challenges, automation and AI are becoming increasingly important in the banking industry. Banks are investing heavily in these technologies to remain competitive and to provide their customers with the best possible service. By addressing the challenges outlined above, banks can ensure that their automation and AI systems are successful and beneficial for both the bank and its customers.

The Impact of Automation and AI on Banking Security

The banking industry is one of the most heavily regulated industries in the world, and security is a top priority for banks. As technology advances, banks are increasingly turning to automation and artificial intelligence to improve their security systems and protect their customers from fraud and other malicious activities. Automation and AI can help banks detect and prevent financial crimes, protect customer data, and improve customer service.

To detect and prevent financial crimes today heavily use AI based tools. Banks can use AI-based algorithms to detect suspicious activities and alert the appropriate authorities. AI can also be used to analyze customer data to identify patterns that may indicate fraudulent activity. Banks can also use automation to automate the process of verifying customer identities, which can help reduce the risk of identity theft.

Protecting customer data is one of the major advantages of these systems. Banks can use AI-based algorithms to detect and prevent data breaches and unauthorized access to customer data. Banks can also use automation tools to automate the process of encrypting customer data to prevent unauthorized access, which can help protect customer data.

Finally, automation and AI can be used to improve customer service and use of AI-based algorithms to analyze customer data, provide personalized recommendations to customers, and automate the process of responding to customer inquiries, which can help reduce customer wait times.

These technologies can help banks detect and prevent financial crimes, protect customer data, and improve customer service. As technology continues to advance, banks will continue to rely on automation and AI to ensure the security of their customers and their financial systems.

How Automation and AI are Affecting Banking Jobs

The banking industry is one of the oldest and most established industries in the world. With the rise of automation and artificial intelligence, however, banking jobs are being affected in a variety of ways. Automation and AI are changing the way banks operate, and they are having a significant impact on the banking workforce.

Automation is the process of using machines and software to computerize tasks that would otherwise be manually done. Automation can be used to streamline processes, reduce costs, and improve efficiency. Automated mundane tasks such as data entry, customer service, and back-office operations are common usage in the banking industry. This has resulted in a decrease in the number of banking jobs that require manual labor.

AI, on the other hand, is a form of technology that is used to simulate human intelligence. AI can be used to analyze enormous amounts of data and make decisions based on that data, automate customer service, fraud detection, and loan approval processes…etc. more accurately in less time. This has resulted in a decrease in the number of banking jobs that require human decision-making.

The impact of automation and AI on banking jobs is significant. As more tasks are automated, fewer jobs are available for human workers. This has

resulted in a decrease in the number of banking jobs available, as well as a decrease in the wages of those jobs that remain. Additionally, automation and AI are changing the skills that are required for banking jobs. As more tasks are automated, the skills required for banking jobs are shifting away from manual labor and towards technology and data analysis.

The banking industry is undergoing a transformation due to automation and AI. Banking jobs are being affected in a variety of ways, and the impact is likely to continue in the future. As automation and AI become more prevalent, the banking industry will continue to evolve and the number of banking jobs available will continue to decrease. As a result, it is important for those in the banking industry to stay up to date on the latest trends and technologies to remain competitive.

The Role of Regulators in Automation and AI in Banking

The banking industry is undergoing a major transformation due to the rise of automation and AI. These technologies are transforming the way banks operate, from customer service to risk management. As these technologies become more prevalent, regulators have a significant role to play in ensuring that banks are using them responsibly and safely.

Regulators are responsible for overseeing the banking industry and ensuring that banks are following the rules and regulations set forth by the government. With the rise of automation and AI, regulators must ensure that banks are using these technologies in a responsible and ethical manner. This includes ensuring that banks are using AI and automation to improve customer service, reduce risk, and comply with regulations.

Regulators must also ensure that banks are using automation and AI in a way that is transparent and fair. Banks must be able to explain how their AI and automation systems work and how they are using them to make decisions. Regulators must also ensure that banks are not using AI and automation to discriminate against customers or to manipulate markets. [4]

Finally, regulators must ensure that banks are using automation and AI in a secure and safe manner. Banks must be able to protect customer data and ensure that their systems are not vulnerable to cyber-attacks.

In conclusion, regulators have a vital role to play in ensuring that banks are using automation and AI responsibly and safely. Regulators must ensure that banks are using these technologies in a transparent and fair manner, and that they are protecting customer data and not using AI and automation to take advantage of customers or manipulate markets. By doing so, regulators can help ensure that banks are using these technologies to improve customer service, reduce risk, and comply with regulations.

The Potential of Automation and AI in Financial Inclusion

The potential of automation and AI in financial inclusion is immense. Automation and AI can help to reduce the cost of financial services, increase access to financial services, and improve the quality of financial services. Automation services can also help to reduce the risk of fraud and money laundering, as well as improve the accuracy and speed of financial transactions.

Similar technologies can be used to streamline the process of providing financial services, program the process of customer onboarding, which can reduce the cost of providing financial services, automate the process of loan origination, which can reduce the time it takes to process a loan application and automate the process of loan servicing, which can reduce the cost of servicing a loan.

Improving the accuracy and speed of financial transactions, detecting fraud and money laundering, as well as improving the accuracy of credit scoring are direct advantages of using AI. AI can also be used to improve customer service and provide personalized advice to customers, as well as to provide automated customer service.

Automation and AI can help to reduce the cost of financial services, increase access to financial services, and improve the quality of financial services. It can also help to reduce the risk of fraud and money laundering, as well as improve the accuracy and speed of financial transactions. Automation and AI can be used to streamline the process of providing financial services and to improve customer service and it can help to make financial services more accessible and more affordable, which can help to reduce poverty and inequality. [5]

Conclusion

In conclusion, automation and AI have the potential to revolutionize the banking industry. Automation can reduce the time and cost of manual processes, while AI can help banks make smarter decisions and better serve their customers. As technology continues to evolve, banks should continue to explore the possibilities of automation and AI to improve their operations and customer service.

The implementation of regulations for automation and AI in banking is essential for the safety and security of customers and financial institutions. However, it is important to ensure that responsibly and ethically use these technologies. By establishing clear regulations, banks can ensure that they are using these technologies in a way that is beneficial to customers and the industry. With the proper regulations in place, banks can take advantage of the potential of automation and AI while also protecting their customers.

However, these technologies also present evident challenges, including the need for significant investments in infrastructure, the potential for job losses, and the need to address ethical and legal considerations. Banks must carefully consider the potential benefits and challenges of automation and AI before investing in these technologies. With the right strategies in place, banks can leverage the power of automation and AI to improve their operations and better serve their customers.

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Importance of Strong Governance, Risk and Compliance Function for Banking Sector

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Effective governance, risk and compliance (GRC) covers integration of disciplines, activities across risk categories and departments, activities in business process while providing a single version of the truth. There may be complexities in the process due to clients, market sectors and jurisdictions, all of which raise distinct challenges to the achievement of the targets. At present, banks are taking many efforts to improve a good GRC framework of their institutions since this is an important element to effectively manage any challenging task. GRC strategies support towards managing any challenge which are broadly segmented into banking businesses and regulatory challenges. It is difficult to find a static bank, a firm or an organization from the financial sector due to evolving nature of this sector. Historically, these businesses were become more complex, and the sector is exploring an important role. Therefore, its exposure to the external environment is evolving and changing in response to increased regulation and legislation. The article attempts to identify the importance of holding a comprehensive GRC framework for a bank. The findings of the study revealed that there are important positive influencing factors can be achieved when initiating and continuing a good GRC framework within a bank.

1. Introduction

GRC is an important component in any organization in the world which is the main mechanism where firms are both directed and controlled through the strategic thinking and actions and thereby guide the management to find out what is happening in the firm on a daily basis. One of the main risks faced by any business is the risk of regulatory non-compliance, which makes understanding the broader regulated environment essentially. To comply with regulation and legislation, banks need to manage and direct regulatory compliances in an effective manner. Therefore, governance is an important element for this task. Governance in practice involves having the necessary mechanisms to identify risks and the ability to respond to risks by devising compliant solutions. Hence, governance, risk and compliance are interlinked, leading to GRC having significant

importance in the management of control within and the direction of the business. Lack of an effective GRC mechanism will lead to the serious risk of regulatory breach and non-compliance with the requirements of legislation. For an effective GRC, it is required a pre-requisite programme that can be included the ability to change and adapt to remain effective and fit for purpose of the organization while providing flexibility and dynamism.

GRC has been defined as "the capacity or integrated collection of capabilities that enables an organization to reliably achieve objectives, address uncertainty and act with integrity; including the governance, assurance and management of performance, risk and compliance."[1] According to the definition published by the Open Compliance and Ethics Group (OCEG), GRC has been identified as a system of people, processes and technology that enables an organization to achieve its business objectives such as enhance organizational culture, increase stakeholder confidence, prepare and protect the organization, prevent, detect and reduce adversity, motivate and inspire the desired conduct, improve responsiveness and efficiency, optimize social and economic value, etc.

1.1 Main Components of GRC

There are three main components of GRC i.e., governance, risk and compliance. Figure 1 highlighted those components in briefly.

Governance: Most of the time governance refers to the financial sector which is called corporate governance. This consists of the processes, policies, internal laws and accepted ways of doing business and how these factors affect the way a firm is controlled. It further includes the relationship among the stakeholders and the business goals where such firms seek to achieve in doing businesses. In the banking sector, main

Figure 1: Components of the GRC

Source: Author constructed based on the literature

stakeholders are the customers (depositors and lenders), investors, shareholders, management and other employees and the regulators (central bank and other regulating authorities like Stock Exchange, Deposit Insurance etc) who regulate and supervise the banks.

Risk: The Institute of Risk Management (IRM)[2] highlighted that there is a need for firms to understand the risks that they take while continuing works towards achieving their objectives. When it considers the banking sector, the management and the board of directors need to understand the level of risk that are inherent in their activities and the process that are followed within those activities. Therefore, it is important if banks can identify the most significant risks and also prioritize their actions to reflect those risks. In the banking sector, risk may affect in various time frames such as short, medium and long term versions and the timeframes can link with risks to the bank's operational activities

1 OCEG, Governance, Risk and Compliance (GRC)': https://www.oceg.org/about/what-is-grc/

2 Institute of Risk Management, 'About Risk Management': https://www.theirm.org/the-risk profession/risk-management.aspx

(short term risks), business tactics (medium term risks) and overall bank strategic decision making process (long term risks). Therefore, the board of directors and senior management need to have a comprehensive understanding of the levels of different risk severity and the timescale over which they may affect to the business to be able to manage the bank effectively.

Compliance: Compliance confirms rules, laws, policies and standards and the regulatory compliances that have been achieved when conducting business activities according to the regulatory framework. There are several fundamental components in relation to compliance such as creating policies and procedures to follow the rule; developing internal controls; having a management framework that makes accountabilities and responsibilities clearly; monitoring, testing and auditing; training and development; advising and guiding the business; robust record-keeping standards.

1.2 Importance of Having an Effective GRC for a Bank

GRC requires corporate integrity that requires for establishing and maintaining robust and high-quality management of the business i.e., a bank is more able to effectively manage itself, its activities, employees, agents and resources. Quality and comprehensive governance framework provides guidelines for a comprehensive business structures and frameworks needed for a board of directors to manage the bank in an effective manner. Risk analysis and management controls enables decisions to be made in an informed manner. Compliance management means that banks are engaged in compliance of legal, regulatory and other external standards or obligations that are enforced on the industry. GRC has become a vital feature within the overall complex system of the banking sector which regulates the functions and activities of the bank. Huwlyer (2011) argues that a robust GRC culture influences management and employees' decisions. All staff of a bank need to ensure that whatever it takes, attitude to get results does not affect stakeholders' interests. Employees should understand that GRC rules apply for all the bank when they continue to achieve banks' goals.

In the GRC framework, it is difficult to ignore the culture in relation to GRC because any organization depends on good cultural values. GRC culture divided into three main categories i.e., governance culture, risk culture and compliance culture. A healthy governance culture creates a reputational advantage among the external stakeholders while a strong risk culture is part of a good business-wide risk management practice. Compliance culture involves strategic planning, effective control points, careful audit traceability and documentation, proper disclosure and internal procedures that are familiar to the employees. Therefore, creating a strong GRC culture is a consistent and long-term process which is based on effective communication on ethics and practices and also on rewarding through proper actions that comply with the GRC strategy.

2. Relationship Between GRC, Banks and the Regulators

GRC has been designed for creation of a better mechanisms to be followed by banks or any firm or both directed and controlled. The strategic thinking and actions may be created at the part of directed while at the controlled part covers the management of what is happening in the bank on a day today basis. When it considers the regulatory environment in relation to the banking sector, it is important to understand the diversity of activities which are subject to the regulations. Regulations are operated by different levels and these levels may be subdivided into many times. Each country maintains their own regulatory environment for the

banking sector and these industry serves different market segments and consumer categories while providing various services and products to the customers as per their models.

Regulatory environment consists of laws and regulations set by each country in order to exert control over business practices. However, in the financial sector business, when setting the regulations, regulators consider the international dimensions, significance of the industry as a contributor to the economy and other agencies/ authorities' laws and enforcement and finally create a complex regulated environment.

The banking industry plays a crucial role in the present context mainly targeting the economic wellbeing. A well-maintained economy is closely related to the soundness of its banking sector which mostly covers the financial system of any economy. Therefore, GRC covers an essential part of the banking sector and pays more attention in the world-wide. In any country, the banking sector plays an important role and consider as the backbone of any economy due to any economic crisis can be prevented through the banking sector. Therefore, GRC is an important element for the banking sector which maximize the wealth of this sector. At present, the financial sector mainly the banking sector is facing lot of problems with regard to managing risks and complying with strict regulatory requirements. For complying the effective GRC, the banking sector requires to pay biggest attention as this sector has to face many challenges such as access to credit and capital, increased regulatory overhead, economic uncertainty, cost factors, protection of depositors and customer transparency, new technological innovations and international standards etc. Accordingly, the financial sector including banking sector need to set up their models and systems to actively face any regulatory challenges, corporate governance expectations and evolving risks at any time. Accordingly, good GRC maintains well organized banking system which means regulatory concerns are minimized and easy for regulators to monitor and supervise the banks in a timely manner.

2.1 Key Influences on the Regulated Environment

There are many factors that affect regulated environment, and such factors are evolving from time to time. Among those factors, regulated, politics, economics factors, environmental aspects i.e., consumers and media, and factors due to globalization may influence to the regulators in the banking sector.

The banks play as an intermediary role which meet both servers and borrowers in the financial market. Accordingly, banks are the contact point for the depositors, lenders, and other parties, and as financial intermediators, they can understand their demand and particular requirements at any time. Often, this knowledge is essential in helping the regulator to develop effective policies and procedures by providing reasoned evidence of the potential impacts of proposed changes or developments of the customers.

Further, the financial market is an evolving market and therefore, regulators need to be strengthened and regulatory process need to be covered many aspects more than in the past. There are many reasons for globalization of the financial sector due this sector become more and more globalized as technology developments, economic developments, political alliances, the growth of multinational corporations, increased consumer awareness and greater demand for products and services from the global marketplace. At present, Basel regulations have been implemented worldwide for the financial sector especially for

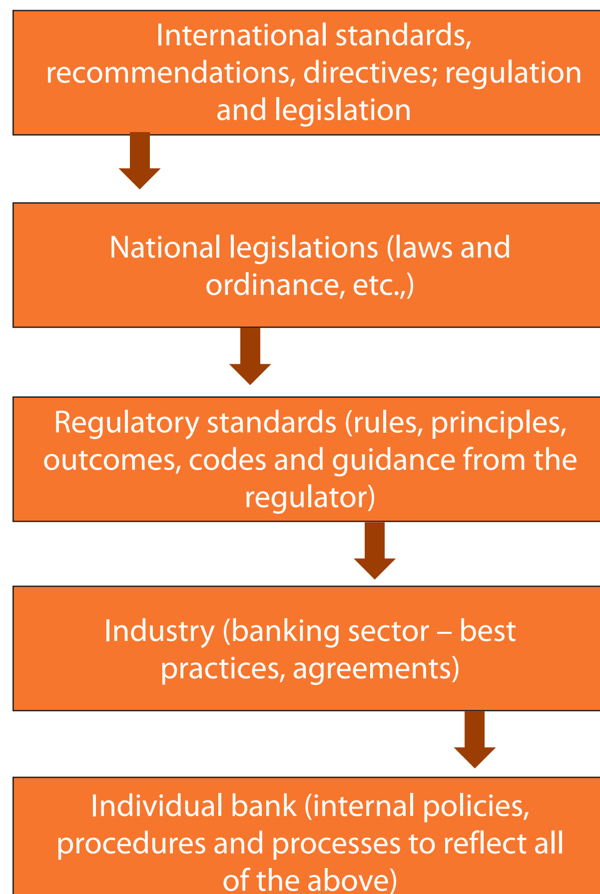
the banking sector to safeguard and to strengthen the various risks including regulatory risk. It formulates best practices for supervisory standards and guidelines which are implemented through the regulators i.e., the central bank, to ensure the financial sector stability. After the financial crisis happened in 2007, Basel Committee announced that it is required substantial attention to strengthen the mechanisms for the existing capital and liquidity requirements while strengthening the regulatory and supervisory role and managing the risks of the banking sector in an effective way. However, some countries have been adopted these standards fully or partially, considering respective country's perspectives, policies and mechanisms that have established a scheduled timeframe for complying with these standards.

2.2 Current Trends in Regulatory Environment

Constant Change (the volume of regulatory change): There are many criticisms to the regulators regarding the limited transparency in the marketplace and therefore, now regulators are being publishing new and updated rules, requests for comment, guidance, frequently asked questions, notices, enforcement and disciplinary actions and letters. However, expansion of the regulations is resulted to increase the complexity and hence challenging factor to the regulators. Some of the challenging and developing factors are the changing marketplaces, technological initiatives and developments, evolving factors due to globalization, and different products and services offered by the banks. Therefore, strong culture and values are essential for both regulators and banking sector industries.

The hierarchy of the regulation: Legislation and regulation follow of a hierarchy with one level feeding down into the next level are given in Figure 2 below.

Figure 2: Hierarchy of legislation and regulations



Source: Author created based on the literature

2.3 The Legal or the Structural Basis of Regulation

In relation to the financial sector services, it mainly uses the terms of obligations, fiduciary duties and consumer or the financial protection. Contracts or the operation of the law has taken into consideration of obligations in this regard. A contract refers to an agreement between two parties where a one party breaches the terms of the agreement, it is straightforward for another party to take actions in terms of the laws. A fiduciary duty is a legal or the ethical relationship of confidence or the trust between the parties and as per financial sector services, the duty generally arises in relation to the expectations over the management of money or property between two or more parties but can apply for an advisory relationship. Consumer

protection may refer to additional legal or statutory rights governing the quality of products that are reaching to the customers.

3. Governance and Culture

Corporate governance is a framework and a system that control the system when making decisions. It fundamentally provides the structure, accountabilities and responsibilities of each party and lines of communication for the effective and efficient flow of information within the banking businesses to allow decisions to be made. The compliance function has to be played a key role towards ensuring the systems and controls that have been in place and comply with the regulatory requirements. Further, compliance function can contribute positively to the overall success of the bank by ensuring that the governance methodologies are in place for working properly and improving the quality decision making process.

Corporate governance is a central mechanism for the effective and efficient process of the banking business. It shapes everything from short-run to long-run with better directions towards the banks for handling everyday operations and playing an important function in its success or failure. Regulators have been identified governance as a key drive for achieving the regulatory outcomes and as a key measurement of a bank's compliance culture.

Ethics, integrity and values of a bank are important elements in a GRC framework. Further, it is essential to understand how they are applied due many reasons. Some of the important factors are highlighted as following.

- Internationally, regulators are moving towards more principle-based regulations, both in the rules and regulations that they set and, in their application.
- Compliance functions will be more effective if a broad-based compliance culture is developed throughout a bank.
- External expectations are changing because of politicians, non-governmental organizations, shareholders, employees and customers increasingly make decisions and hence choices are based on their perception of a bank's values, trustworthiness and ethical reputation.
- At a time when consumer confidence in the financial services of banks is low, demonstrating a commitment to ethics and values that are clearly visible for the customers are essential factor in order to re-establish the trust.

3.1 Common Principles of Good Governance

Considering many factors leadership, independence, competence and taking challenges are important principles in the good governance framework. The brief description of those principles is given below.

Leadership: Leadership mainly divided into two parts i.e., individual leadership and collective leadership. The Chairman of a bank leads the board, collectively the board leads the bank and the management turns that leadership, demonstrably, into operations. The board's primary role is to provide leadership towards banking business enabling it to meet its strategic objectives and fulfill its responsibilities to all stakeholders. The leadership should be cleared and run through out all layers of the bank, and it should be supported and provided clear structure with proper lines of responsibilities, reporting and accountabilities.

Independence: None of the individual and important decision should be influenced inappropriately, and no individual person or group or interested party influenced the bank disproportionately.

Independence is also protected and promoted in the financial sector by other structural safeguards such as division of responsibility, a majority or significant proportion of the board to be non-executives, nomination, selection and election of board directors, regular re-election of directors and chairman, maximum limit of shareholdings, transparency records, appointment of senior independent director when the chairman is non-independent etc.

Competence: The board of directors of a bank needs the necessary balance of expertise and up-to-date experience to contribute effectively for any action or policy decision in a bank. The competency may include technical expertise and knowledge suited to the banking business and regulations. Some directors may be selected to the board such as lawyers, compliance experts and accountants which contain relevant qualifications and experience to carry out the professionalism of the bank. The core competences of all board members of a bank need to be covered strategic vision and an understanding of the existing role, ethics and values, leadership, business knowledge, regulatory and legal understanding, and analysis and understanding of the banking business.

Challenges: Building upon the requirement of independence, the board of directors of the bank, especially non-executive directors should offer constructive and effective challenges within the culture. This is a part of a function of individual's competence and confidence, but also the environment set by the chairman in accepting and fostering open and honest debate but not recorded in the minutes. However, key differences need to be in the minute, so that any honest differences of opinion can be identified later, and the bank may show that these challenges were raised, and a conclusion reached through a process of debate and resolution.

3.2 Implementing a Good Corporate Governance Structure in a Bank

Corporate governance is fundamentally a system for the effective flow of information within a bank. Accordingly, effective implementation of required systems and controls are critical, and the benefits require to be realized in an appropriate manner. When implementing a good corporate governance framework in a bank, the factors that are required to be considered are highlighted in the below.

Responsibility for controlling the systems: The board of directors require to demonstrate that they are taking the responsibilities of their bank's activities and arrangements. In this regard, it is required to investigate the sound policies approved by the board and good information flow so that the board of directors may ensure that these policies are being implemented properly.

Understanding what is needed for the bank: The bank can use GRC for self-assessment purposes, under the heading of risk assessment, control environment and control activities, information, and monitoring. Therefore, understanding of such requirements are important when implementing a good GRC structure within the bank.

Control and review: The board's operation in most jurisdictions is supported by specific board committees. When terminologies are changing, these changes are usually referred to the audit committee, the remuneration committee, the nomination committee, the risk committee and a financial management committee. The nominated person for such committees and audit committee provides the main checks and balances on the performance of the board. Accordingly, better control and review process may safeguard the good implementation of the GRC framework in a bank.

External audit: Revisions to the guidelines on audit committees generally have included

comments on selecting external auditors. Accordingly, the audit committee should have primary responsibility for the appointment of the auditor, the selection procedure for the appointment of audit firms and annually assess and report to the board on the qualification, expertise, resources and independence of the external auditors and also report the effectiveness of the audit process.

3.3 The Management of Good Governance

In common with all systems, once implemented, effective management must be sustained as the next stage to ensure the best possible benefits are gained from the corporate governance framework. Hence, the following key areas are important to be considered in this regard.

Evaluation, reporting and accountability: Evaluation principles apply for both day-to-day monitoring of the bank and the annual appraisal in the lead-up to the external reporting cycle. All boards need to be evaluated by themselves but ideally by external parties. Most jurisdictions have a maximum time period, and it is ideally beneficial if a bank may assess it at least every three years period.

Effective Management Information (MI): Any annual evaluation and continuing supervision function depends on the quality of MI. Therefore, MI should be accurate, timely manner, relevant and consistent while following a good mechanism by a bank.

Forward focus: This means that the boundary conditions need to be reviewed at least annually by the risk committee.

External evaluation: It is generally considered as beneficial if an external evaluation of the board avail on a regular basis, i.e., ideally at least every three years. Such an evaluation mechanism allows observations to be de-personalized and to have more credibility outside the bank. Further, this will highly beneficial if an independent second opinion on the board competent and the processes is available, however, the evaluators have given the appropriate resources and access to do their job properly. Then their observations and findings are acted upon properly.

Comply or explain: Satisfactory engagement between the boards of a bank and stakeholders is crucial to the healthy corporate governance framework. Banks and stakeholders both have responsibility to ensure the 'comply or explain' remains an effective alternative to a rules-based system.

4. Benefits of Having an Effective GRC

The 'culture' of a bank can be defined as being a single overview of its values, attitudes, and beliefs. It may include the way in which those within the business perceive what it stands for and the way they understand the environment in which it operates. Although the regulators around the world have constructed a framework of principles, rules, and guidance, it is unclear whether the ethos on which they are built is fully understood or applied consistently by those in the financial services industry. The spirit on which regulatory frameworks are based is on the ethical values and the integrity of those who have applied them. If a bank moves towards its culture with ethical or integrity concerns, the board objectives on regulation will not be addressed. There are some benefits that have been identified as a result of robust GRC and a strong ethical culture as follows.

- ❖ All risks will be managed effectively, mainly the compliance risk, regulatory risk and thereby, reputational risk. With the right culture and attitude is in place, breaches are less likely to occur.
- ❖ Decision making based on clear understanding

of the facts and associated risks will be improved.

- ❖ Investors, customers, and other stakeholders will be increased their trust towards the bank which lead to increase the business performance.
- ❖ Banks can maintain a better relationship with the regulators. If something goes wrong, a sound base exists and will be worked together constructively to resolve it. If a bank build a good reputation with its supervisors, this will support for regulatory dividends which result in a less intrusive approach.
- ❖ Staff motivation is improved where employees care that the bank for which their work is ethical and well run. They can be a very effective way of engaging employees, who will see value in what they do. This will lead to lower the staff turnover and subsequently reduce the staff cost.
- ❖ Competitive advantages may receive because of having a good GRC for a bank. The efficiencies created by doing things 'right first time' can pay real commercial dividends later by reducing the cost-base.

5. Conclusion

The timely benefitting factor of any bank is the implementation of an effective GRC framework within the institution. Understanding the requirements and status of various GRC components of the bank, including bank's goals with respect to each of these GRC components will be supported for willingness of all sections of the bank. Accordingly, changes may happen, and it will make possible creation of a sound GRC framework. Further, assessment of perceived obstacles arising from each component need to be assessed and rolled out properly. This will help for obtaining a clear idea of how bank can achieve integrated and successful GRC. Maintaining a proper GRC framework for a bank will be beneficial for all stakeholders including the regulators.

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Enhancing Financial Consumer Protection: Building a Strong Financial Future in Sri Lanka

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1. Introduction

Nowadays, Financial Consumer Protection is a topic of great discussion around the world as which is reviewed of financial customer's rights to be protected from irresponsible and unfair financial business conducts. Within any nation's economy, the financial welfare of its populace holds undeniable significance. Financial institutions are the backbone of this economic endeavour, providing indispensable services such as banking, insurance, and investment opportunities. Nonetheless, the potential for unethical practices and misconduct in the financial sector underscores the urgent need to establish a resilient framework to protect financial consumers. This article delves into the pivotal role of bolstering Financial Consumer Protection within a country and offers insights into strategies for its enhancement.

2. The Importance of Financial Consumer Protection

In order to ensure fair and responsible treatment of financial consumers in their purchase and use of financial products and their dealings with financial services providers, Financial Consumer Protection is especially important. The following integral components can also be considered as importances of Financial Consumer Protection.

2.1 Safeguarding the Interests of Citizens:

Financial Consumer Protection stands as an indispensable pillar of a well-functioning financial system. It ensures that the interests of consumers remain protected, equipping them with the knowledge required to make informed decisions and guard against unfair practices. Central to this role is preventing predatory lending, concealing fees, and other exploitative tactics that can subject unwitting consumers to financial turmoil.

2.2 Encouraging Financial Inclusion:

A robust framework for consumer protection cultivates trust in financial institutions, a pivotal factor in fostering financial inclusion. When consumers feel secure, they are more inclined to engage with the formal financial sector,

subsequently reducing reliance on informal, unregulated financial services. Across the globe, financial inclusion emerges as a paramount policy objective, and by providing a secure environment for consumers to save, borrow, and invest, Financial Consumer Protection significantly contributes to reducing income inequality and stimulating economic growth.

2.3 Bolstering Economic Growth and Stability:

Financial consumer protection is not just about protecting individual consumers; it also plays a crucial role in maintaining the stability of the financial system and the broader economy. By preventing abuses, fraud, and unfair practices, it helps build and maintain trust in the financial system and contributes to economic growth and stability. The absence of consumer protection and accountability within the financial sector was a significant contributing factor to the global financial crisis of 2008. By studying such events and instituting more stringent regulations and safeguards, nations can lower the risk of future financial crises.

3. Globally Accepted Best Practices on Financial Consumer Protection

In order to achieve above mentioned strategies towards protecting the financial consumers' rights, internationally recognized and embraced standards for safeguarding financial consumers have evolved to ensure that individuals are treated with fairness, transparency, and responsibility by financial institutions. These principles aim to harmonize the promotion of financial inclusivity with the protection of consumer interests. Below are some of the fundamental best practices in Financial Consumer Protection which are globally accepted and enacted:

3.1 Regulatory Oversight and Frameworks:

Under this best practice, it is required to establish Independent Regulatory Bodies that are the establishment of regulatory authorities with autonomy to supervise and enforce consumer protection regulations. Further, Comprehensive Legal Frameworks are also needed to ensure that the enactment of comprehensive laws and regulations exclusively focusing on the protection of financial consumers are available in all jurisdictions.

3.2 Transparency and Disclosure:

The requirement of the Transparent Disclosure is providing clear and concise disclosure of terms, fees, and conditions associated with financial products and services to financial customers in order to empower consumers to make informed decisions. In this process, it would be better to follow the standardized terminology and formats for disclosures which would facilitate comparisons to financial customers.

3.3 Fair Treatment:

The enforcement of laws related to discrimination prohibition would ensure preventing discrimination based on factors such as gender, age, race, or socio-economic status. Further, in this practice, ethical debt collection practices are also focused as the regulation of debt collection practices is to prevent harassment and unfair collection methods.

3.4 Responsible Lending and Borrowing:

Responsible Lending Guidelines would provide for the promotion of responsible lending practices, including the assessment of borrowers' repayment capacity and the imposition of interest rate limits to combat predatory lending. Under this Financial Institutions are to provide financial education and counseling to guide borrowers in responsible borrowing decisions.

3.5 Consumer Data Protection:

The enactment of data protection and privacy laws secure consumer data and personal information from misuse or exposure to security breach and in which granting consumers control over their personal data, including the right to provide consent for its utilization and the right to request its deletion should be covered by such laws.

3.6 Complaint Handling and Redress:

Under this best practice, Financial Institutions are required to establish transparent and efficient mechanisms to address consumer complaints and compensation and redress mechanism should be there ensuring that consumers have access to compensation or redress avenues when they suffer harm due to misconduct by Financial Institutions.

3.7 Financial Literacy and Education:

This practice discusses promoting financial literacy that endorsement of programs and resources that enhance consumers' understanding of complex financial products and enable them to make well-informed choices. Further, consumer education initiatives would support the public and private initiatives dedicated to enhancing consumer knowledge and skills in financial matters.

3.8 Innovative Financial Products and Services:

Fintech Regulation is also considered as a best practice of Financial Consumer Protection and the adaptation of regulatory frameworks to accommodate and oversee emerging fintech products and services to ensure they adhere to consumer protection standards. In this the development of regulatory approaches to govern cryptocurrencies and digital assets, addressing risks and fraud prevention are also focused.

3.9 Global Cooperation and Information Sharing:

International Collaboration encourages cross-border cooperation among regulatory authorities to address challenges posed by global financial markets and international transactions. Under information sharing, it is expected to promote the exchange of information concerning emerging threats, scams, and best practices among regulators and financial institutions.

3.10 Continuous Evaluation and Adaptation:

In this best practice, it is necessary to conduct regular reviews such as periodic assessments of Financial Consumer Protection measures to accommodate evolving market dynamics and consumer requirements. The involvement of consumer advocacy groups, financial institutions, and other stakeholders in the process of shaping and enhancing consumer protection regulations should be in place.

In view of the above, globally acknowledged best practices of Financial Consumer Protection are crucial for upholding trust and integrity within financial systems, fostering financial inclusion, and ensuring consumers can access and utilize financial services with confidence and security. These practices strike a balance between **economic** growth and consumer welfare while mitigating risks tied to financial products and services.

Furthermore, in parallel with the best practices on Financial Consumer Protection discussed above, the following strategies have been globally recognized in order to enhance Financial Consumer Protection.

- **Fortify Regulations and Enforcement:** Governments must institute and enforce comprehensive financial regulations, covering

all financial services, from banking and lending to insurance and investment products. The existence of robust enforcement mechanisms, including penalties and stringent oversight, is imperative to ensure compliance on the part of institutions. This encompasses the establishment of clear limits on interest rates, the enforcement of equitable lending practices, and the regulation of complex financial product issuance.

- **Foster Clear and Transparent Communication:** Financial institutions should be committed to delivering transparent, comprehensible, and honest information to consumers regarding their products and services. This transparency extends to fees, terms, and conditions, enabling consumers to make well-informed decisions. This can be achieved through the implementation of standardized disclosure requirements and a commitment to employing plain language in financial documentation.

- **Promote Financial Education and Literacy:** Championing financial education and literacy programs is pivotal. These initiatives empower consumers to comprehend complex financial products, manage their finances, and discern potential pitfalls. Collaboration between governments, educational institutions, and financial organizations is instrumental in providing resources for financial education, ranging from personal budgeting workshops to educational materials on investing and retirement planning.

- **Establish Effective Complaint Resolution Mechanisms:** Governments and financial institutions should create efficient mechanisms for consumers to report grievances and secure resolution in a timely and equitable manner. Swiftly addressing consumer concerns and grievances is imperative to sustain trust in the financial system. This might entail the introduction of dedicated ombudsman services, online complaint platforms, or mediation processes.

- **Enhance Consumer Data Protection:** Implement rigorous data protection regulations to shield consumers' financial information. Measures aimed at preventing data breaches and the misuse of personal information are indispensable. In our digital age, data security assumes paramount importance. Financial institutions must invest in robust cybersecurity measures and adhere to privacy laws to protect the sensitive financial data of their customers.

- **Empower Consumer Advocacy Groups:** Empowering consumer advocacy organizations is pivotal in the drive to educate consumers, provide legal support, and advocate for their rights. These groups wield significant influence in holding financial institutions accountable. By serving as a platform for consumer grievances and advocating for policies that are consumer-centric, advocacy groups represent a potent catalyst for change within the financial sector.

- **Conduct Regular Audits and Assessments:** It is essential to undertake periodic audits and assessments of financial institutions to ensure adherence to consumer protection laws. These evaluations unearth shortcomings and avenues for improvement. Regulatory bodies or independent audit firms can be engaged to perform these assessments, providing an impartial perspective on the conformity of financial institutions with consumer protection standards.

- **Institute Whistleblower Protections:** The establishment of robust whistleblower protection laws encourages individuals within financial institutions to report unethical or illegal activities. This inculcates a culture of accountability within the industry. Whistleblowers often play a critical role in exposing fraud and misconduct within financial institutions. Shielding them from retaliation is pivotal in maintaining the integrity of the financial system.

- **Foster International Cooperation:** Cross-border collaboration and information sharing pertaining to consumer protection should be encouraged. As financial transactions increasingly transcend national borders, international cooperation is vital for addressing emerging challenges effectively. Collaboration on sharing best practices, monitoring international financial institutions, and ensuring consumer protection on a global scale is essential in the current era of globalization.

4. Financial Consumer Protection Framework in Sri Lanka

The Central Bank of Sri Lanka (CBSL), commercial banks, finance companies, insurance companies, primary dealers for government securities, and other stakeholders of the capital market and money market are some of the key components in the current Sri Lankan financial system. The financial system for consumers offers facilities for savings, investments, borrowing and many other services. The consumers, who are the beneficiaries of those services, should not be misinterpreted as equals. They are a diversified group categorized into various demographic strata, including ethnicity, religion, gender, age, income, physical health, etc.

As the apex body, which is responsible for maintaining economic and price stability, and the financial system stability of Sri Lanka, the CBSL is keen on the protection of financial consumer rights. On the one hand, the good practices of Financial Consumer Protection provide a comprehensive diagnostic tool to help identify consumer protection issues in all parts of the financial sector, leading the responsible institutions to take corrective measures on time and manage the possible risks of financial system instability. On the other hand, monetary policy is implemented through the banking system to achieve economic and price stability objectives. Accordingly, the policy actions are transmitted to the economy through the activities of the financial consumers. Therefore, the protection of financial consumer rights is important in aligning their behaviour with policies and the conditions of financial markets. Meanwhile, international developments opened a new discussion on financial consumer rights protection.

Some measures taken by the CBSL so far have directly and indirectly contributed to enhancing the rights of these financial consumers. When considering laws relating to Financial Consumer Protection in Sri Lanka, the bylaws issued by CBSL, and other regulatory authorities can be listed as follows.

- Banking Act (Customer Charter of Licensed Banks) Direction No. 8 of 2011 issued by CBSL.

- Finance Companies Act (Financial Customer Protection Framework) Directions No. 1 of 2018 issued by CBSL.

- Finance Leasing Act (Financial Customer Protection Framework) Directions No. 1 of 2018 issued by CBSL.

- Mobile Payments Guidelines No. 1 of 2011, for the Bank-led Mobile Payment Services, issued by CBSL.
- Credit Card Guidelines No: 01 of 2010, issued by CBSL.
- Direction on Customer Charter for Primary Dealers and their Customers issued under Regulation 11 of the Local Treasury Bills (Primary Dealers) Regulation No. 01 of 2009, issued by CBSL.
- Code of Conducts for Primary Dealers issued by CBSL – 2003.
- Banking Act (Appointment of Agents of Licensed Banks) Direction No. 2 of 2018 issued by CBSL.
- Finance Companies Act (Outsourcing of Business Operations) Directions No. 1 of 2018 issued by CBSL.
- Guidelines on Complaint Handling by Insurers and Brokers (2016) issued by Insurance Board of Sri Lanka.
- Principles on Fair Treatment of Customers (2018) issued by Insurance Regulatory Commission of Sri Lanka.
- Ethical Framework and Best Practices in Professional Conduct issued by Security and Exchange Commission.

These laws cover transactions on savings, lending, and other customer-related financial activities as well. Furthermore, overall regulatory, and supervisory measures initiated by the CBSL, as a whole, have also supported ensuring financial system stability while improving financial consumer rights. Developing and maintaining payment infrastructure also enhances consumer rights. On the other hand, annual awareness programs conducted by the CBSL increase the financial literacy of consumers. However, these initiatives need to be revised to protect financial consumer rights due to recent developments such as digital financing, the micro-credit market and non-banking financial sector trends and the new normalcy followed by the economic crisis. Further, 2 under the World Bank-funded financial sector modernization project, it is required to establish a Financial Consumer Protection authority across all financial services under an independent authority. However, with a short to medium term objective it was proposed to set up a department within CBSL covering all the institutions regulated by CBSL. Thus, CBSL in 2020 established a new department known as the 'Financial Consumer Relations' opening a new way to address financial consumer issues in this backdrop.

Further, the Consumer Affairs Authority is also the apex government organization mandated to protect consumers' interests and ensure fair market competition in Sri Lanka established under the Consumer Affairs Authority Act No.09 of 2003 and they can be referred the matters on Financial Consumer Protection as financial agreements entered by financial customers with financial service providers can be considered as services. Moreover, there are Ombudsman schemes such as Financial Ombudsman scheme and Insurance Ombudsman scheme covering licensed banks, licensed finance companies, specialized leasing companies, primary dealers, and insurance companies.

5. Recent Developments on Financial Consumer Protection in Sri Lanka

In August 2023, the CBSL introduced fresh directives i.e., Regulations on Financial Consumer Protection No. 01 of 2023 pertaining to Financial

Consumer Protection. These guidelines encompass essential elements necessary for an efficient consumer protection framework for institutions under CBSL's regulatory purview, thereby granting CBSL the authority to oversee and supervise these provisions effectively.

i. Powers and Actions of CBSL

ii. Governance Regulations

iii. Fair and Equitable Treatment of Consumers

iv. Disclosure and Transparency

v. Responsible Business Conduct

vi. Complaints Handling and Redress Mechanism

vii. Protection of Consumer's Assets and Information

These regulations grant CBSL the authority to inspect the financial records, documentation, and activities of Financial Service Providers (FSPs), a power similar to that exercised by other regulatory bodies. Furthermore, they serve as the cornerstone of Market Conduct Supervision, enabling the Monetary Board of CBSL to take punitive action against FSPs that fail to comply with these regulations. Additionally, these rules streamline the complaint-handling process for both FSPs and CBSL, providing CBSL with the jurisdiction to make determinations regarding such grievances. In summary, these regulations enhance the Financial Consumer Protection frameworks outlined in the Banking Act Direction No. 08 of 2011, Finance Business Act Direction No. 01 of 2018, and Finance Leasing Act Direction No. 01 of 2018, aligning them with international standards.

6. Conclusion

The enhancement of Financial Consumer Protection transcends mere moral imperative; it represents the bedrock of a prosperous and inclusive economy. The financial system of a country can flourish when its citizens have unwavering trust in its financial institutions. By augmenting Financial Consumer Protection through rigorous regulations, transparency, financial education, and accountability, a nation paves the way for economic stability, financial inclusion, and the safeguarding of the financial well-being of its populace. Thus, when financial consumers are protected, it would create responsible financial inclusion in an economy.

Accordingly, it is clear why Financial Consumer Protection is needed and the path towards robust Financial Consumer Protection is a continuous journey necessitating vigilance and adaptability to address emerging challenges. Ultimately, the robustness of financial system of a country is intrinsically linked to the financial well-being of its citizens, rendering the improvement of consumer protection a pivotal goal for a resilient and prosperous society.

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A message from the Central Bank of Sri Lanka

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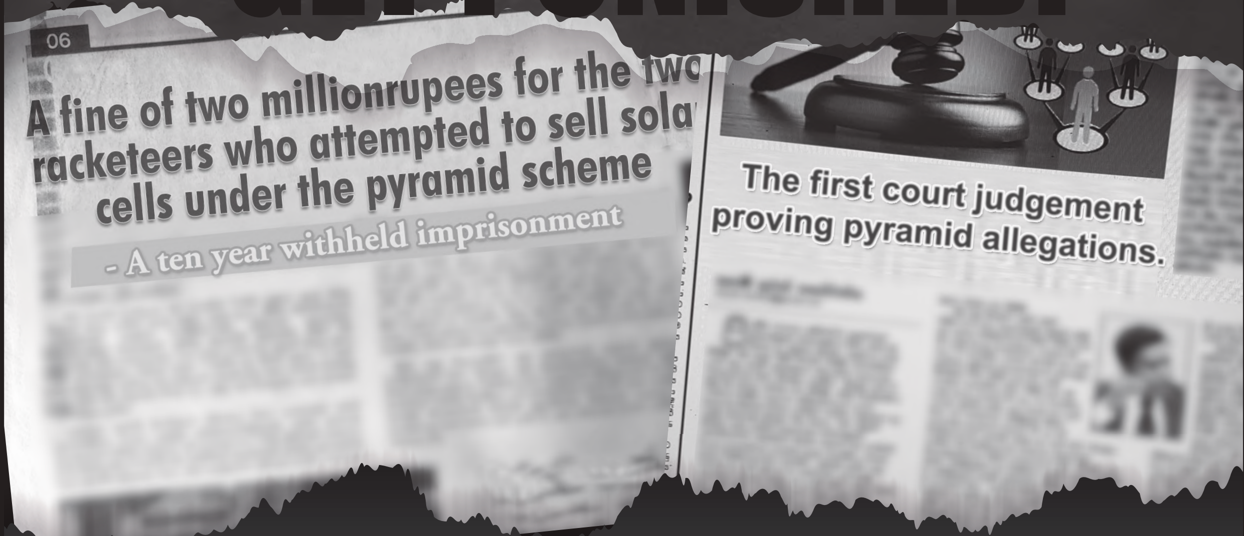

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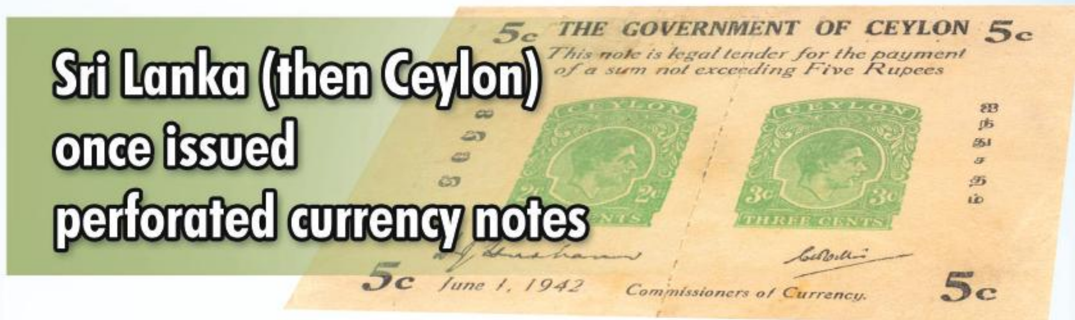

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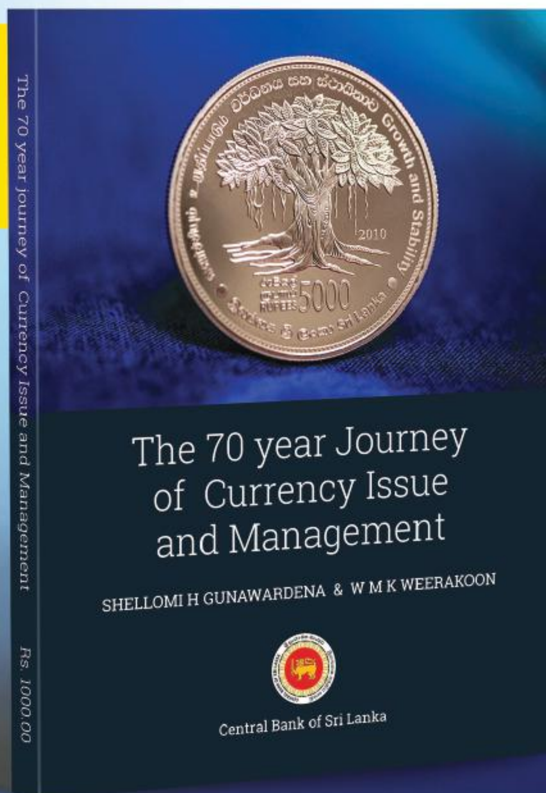

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