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ETHICAL PRACTICES AND TECHNOLOGY IN FINANCIAL INSTITUTIONS OF SRI LANKA

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ABSTRACT

Ethical practices in Financial Institutes require constant improvement along with the rapid growth of technology. Conducting your business activities following ethical principles and facing advancements of technology are difficult matters to handle for financial institutes in Sri Lanka. Nevertheless it is important for the financial institutes to ensure that the new technologies operate in an ethically sound manner. This research paper intends to look at the connection between business ethics, policy-making, and technology and will investigate the relationship between ethical practices and performance of firms with the focus on financial institutions. The study started with investigation of ethical practices as a concept and, the literature on ethical practices and different theories and empirical evidence in the area were critically reviewed. In summary the outcomes of this paper will identify that there is a relationship between ethical practices and the performance of financial institutions of Sri Lanka, that there are potential impacts and challenges of digital technology in these financial institutes and that there is a link between ethical practices and the firm performance.

Key Words: Ethics, Digital Technology, Financial Institutions, Sri Lanka

BACKGROUND

Advancement of technology and introduction of new knowledge has always improved production and consumption. As per history there are three distinct periods of technical progress, or in lay-term, industrial revolutions. Initial revolution started with the invention of steam power which was followed by the second revolution of electrification and the internal combustion engine, and the third revolution was information technology. Schwab (2016) speaks of a fourth industrial revolution, created through the development of digital technologies. These revolutions created changes which were adopted over time as capital is replaced, new skills are acquired, and consumer preferences change. Nevertheless, some technologies which were adopted as a part of a revolution created a 'disruptive' change; which is changing the way the economy and society operates during a short space of time. A significant difference seen in a countries' corporate governance system is the difference in the ownership and control of firms. Various types of corporate governance systems can be identified according to the level of ownership and control, and recognizing the controlling shareholders. As per Diacon and O'Sullivan (1995) "while some systems are characterised by wide dispersed ownership (outsider systems), others tend to be characterised by concentrated ownership or control (insider systems)". In the outsider systems, the strong managers and widely-dispersed weak shareholders create a conflict of interest. In the insider

systems, it is within the controlling shareholders and weak minority shareholders. The policy makers need to develop a good corporate governance framework which can secure the benefits associated with controlling shareholders acting as direct superiors. This framework must also ensure that they do not impinge upon the Development of the country. The government of Sri Lanka establishes the legal and regulatory systems that govern the operation of the economy and provides key inputs into the economy by educating the labour force and providing public infrastructure and services. Government also negotiates through democratic processes and maintains through social expenditure and justice. Disruptive technologies may cause interruptions for each of these roles. Thus, this study focuses on the role of Corporate Governance in the face of potentially disruptive technological change in the financial institutes of Sri Lanka.

Research Problem

The study will first investigate critical reviews found in the literature to identify the strengths and weaknesses of the previous work in this area and identify the gap in the literature and then conduct an empirical research. The data used for the empirical part of the study consists of published data on corporate governance of Sri Lankan banks and other financial institutes, and the information on financial operations of these institutes abstracted from the central-bank database. There are no specifically published datasets on the state of corporate governance in all the Sri Lankan financial institutes. A survey was therefore organized by the author to explore the compliance of these banks with Corporate Governance Principles. The data was supplemented with the financial information of individual banks obtained from their annual reports. This study will investigate the specificities of corporate governance of financial institutions that separate this industry from others.

Aim

The aim of this study is to investigate corporate governance practices of financial institutions in Sri Lanka and their impact on the performance. This study will first address the corporate governance and its effect on corporate performance and economic performance. This study will then explore the potential impacts and challenges of digital technology in the said financial institutes. The study anticipates digital technologies will continue and likely accelerate changes in Sri Lanka's economy. The study aims to provide a survey of empirical evidence on the link between corporate governance, firm performance and economic growth. Finally, several policy implications will be recommended.

Objectives

- To identify the corporate governance practices of financial institutions in Sri Lanka.
- To recognise the potential impacts and challenges of digital technology in these financial institutes.
- To affirm that there is a link between corporate governance and firm performance.

LITERATURE REVIEW

Corporate Governance

Rezaee (2009) states that "Corporate governance is not merely the governing of a certain form of organization". As per Diacon and O'Sullivan (1995) "A series of unexpected corporate failures in the 1990s brought to attention the importance of the corporate governance system". Corporate governance is a widely discussed topic and researchers such as Shleifer and Vishny (1997) or Becht et al. (2002) have produced studies of the existing knowledge in this field. Shleifer and Vishny (1997) states "Corporate

governance deals with the ways suppliers of finance to corporations assure themselves of getting a return on their investment". Corporate governance refers to "the design of institutions that induce or force management to internalize the welfare of stakeholders" (Tirole 2001). La Porta et al. (2000) states "Corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by insiders". Gillan and Stark (1998) states "corporate governance is defined as the system of laws, rules, and factors that control operations at a company". "Defined broadly, corporate governance refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs on one hand, and those who invest resources in corporations, on the other" (Oman 2001). "The term 'corporate governance' essentially refers to the relationships among management, the board of directors, shareholders, and other stakeholders in a company. These relationships provide a framework within which corporate objectives are set and monitored" (Mehran 2003). A more comprehensive definition where corporate governance is looked at as "the process affected by a set of legislative, regulatory, legal, market mechanisms, listing standards, best practices, and efforts of all corporate governance participants, including the company's directors, officers, auditors, legal counsel, and financial advisors, which creates a system with the goal of creating and enhancing enduring and sustainable shareholder value, while protecting the interests of other stakeholders" (Rezaee 2009).

Corporate Governance of Financial Institutions

The role of financial institutions is to provide financing to enterprises, facilitate various transactions and other services which makes their position integral to the economy at large. Good governance practiced by these financial institutions will have a great effect on the enterprises it lends to. For example by having a proper system for evaluating every loan, possible 'unethical' projects will not be funded. This should prevent firms with corrupt ideas, which will ensure a positive selection process followed by an economy with more successful enterprises. However, the complex nature of finance means that the concepts and daily activities of financial institutions may not easily be observed by the general public (Mullineux, 2006).

Alexander (2006) states that "there is a large enough distinction between corporate governance of financial institutions themselves let alone in comparison to other firms, and that corporate governance of each type of financial institution should be studied separately". However, there are others who suggest that there are no differences between the corporate governance of financial institutions and other firms (Flannery et al. 2002) and that they are all subject to the same core corporate governance principles.

Disruptive Technology

Disruptive technology has different meanings. Schumpeter (1942) used the term 'creative destruction', but is well known for his observation that capitalist systems progress by creating new structures while destroying existing ones. Christensen (1997) promoted the words 'disruptive technology' and his definition of disruption is a relatively narrow concept whereby technology evolves through quality improvements to inferior but low-priced products. As per (Lepore 2014) "a general and more policy-relevant characterisation of disruptive technologies is that they are developments that drive substantial change across the economy for many firms, households or workers, with

impacts that impose significant costs of adjustment as they make capital obsolete and leave some workers significantly under-utilised for some time". The expansion of disruptive technologies is both unescapable and unavoidable. Governments may try to restrict such growths by forming various regulations. A positive stance for any government is to focus on making the best of the benefits of these technological changes to the community.

METHODOLOGY

The study was done mainly with secondary data obtained from materials from research done previously by other distinguished authors, the Central Bank of Sri Lanka, and material such as Annual Reports and articles obtained from the Banks and other financial institutes of Sri Lanka. Data obtained from a previous research done by the author was also extracted and analyzed for the purpose of this study. Out of that data-base population consisting ninety (90) interviews and case studies, thirty five (35) were chosen from convenience sampling. Convenience sampling is useful where it is otherwise difficult to elicit a sufficient level of response (Bell and Bryman, 2007). These selected participants were stakeholders from respective financial institutes of Sri Lanka who represented the key characteristics and attributes of the total sample group. They were interviewed face to face at a location of their convenience with similar questions that were raised in the data base interview. They elaborated the responses given in previously, to provide a wider understanding to the author. All the participants interviewed and included in the database, have been stakeholders of various financial institutes of Sri Lanka.

Validity and Reliability

Results were also presented for the respondents to see if the answers have been interpreted correctly. Furthermore, the validity of the result has been discussed with the senior colleagues, academic consultants, experts of the industry with valuable feedback. Cross checking of the information was done with the aid of industry experts and professional bodies. In terms of reliability measurement, repetition of the study was conducted. Randomly selected few respondents were asked to do the interviews again with a third person. This was done in order to see if the same results were to be obtained. Because of the lack of time, it was not possible to conduct the study more than once for all the respondents. But the chosen sample reiterated that the findings or the answers were more or less identical.

KEY FINDINGS

In the past decade corporate governance has been recognized for the proper functioning of capital markets and ensuring investor confidence. As per Demb and Neubauer (1992), the 'shareholder value maximisation approach' is one approach to corporate governance, whereby the owners are concerned with preventing management from diverting company profits for their own private benefit. However, another approach is that the company is not a body consisting of only two entities, shareholders and managers, but there are other interested parties such as employees, suppliers, customers and so on, otherwise known as stakeholders who affect or are affected in some form by the achievement of company's objectives (Freeman,1984). This is considered as the 'stakeholder approach' to corporate governance. Many studies have explored the relationship between corporate governance and the performance of financial institutes. Gompers et al. (2003) found that firms with better corporate governance practices that provide shareholder protection, as

measured by an index constructed by them, outperform firms where managers had strongest rights. Van den Berghe and Levrau (2003) found evidence that firm-level corporate governance provisions matter more in countries with weaker legal systems. The very first thing that can be noticed is that there are only few studies which look at this relationship (Caprio et al., 2007). With the relationship between corporate governance and performance of financial institutes empirically documented, the focus of this study was to investigate whether such a relationship also holds, for financial institutions in Sri Lanka. With the data obtained from the survey results as well as from previous literature, this study confirmed a relationship between corporate governance and the performance of the financial institutes.

Corporate Governance and Economic Implications

Corporate governance systems can be distinguished according to the degree of ownership concentration and the identity of controlling shareholders. Shleifer and Vishny (1997) states that while some systems are characterised by wide dispersed ownership, others tend to be characterised by concentrated ownership where the controlling shareholder may be one person, family holding, or financial institution and other corporations acting through a holding company. Differences in the systems of corporate governance with respect to ownership concentration, the identity of owners, and the regulatory and legislative framework, all have important implications for both firm performance and economic performance (Becht, 1997). If in case the corporate governance has no impact on the performance of financial institutes, then the policy makers need not concern themselves with this area. However, the available empirical evidence suggests that the corporate governance does affect performance of financial institutes and is therefore an important framework condition for the industrial competitiveness.

Corporate Governance and Performance of Financial Institutions

With the growing significance of corporate governance, it is automatically assumed that good performance of financial institutions is related to good corporate governance. However it is not an easy task to identify which element of corporate governance will improve the performance of a given financial institution.

Spong and Sullivan (2007) states that "by comparing the combined cost efficiency and revenue tests, the difference between the 'most efficient' and the 'least efficient' community banks in terms of board size, average age of directors, and length of tenure is not very significant". However, they find that "the directors of more efficient banks have higher median net worth, a greater ownership stake in their banks, and are less likely to be outside directors. The more efficient banks also feature more frequent meetings, have better attendance rates and higher director fees". These findings advocate that directors with higher financial stake are more actively involved in those bank's affairs and in monitoring the performance of management, which in turn bring better overall bank performance.

Gugler (1999) suggests that as per financial theory a similar argument, holds for officers that are also major stakeholders. Their incentives to control costs and improve performance of the financial institute start from the fact that they will directly benefit through improved stock returns. Spong and Sullivan (2007) report that an ownership stake held by managers of financial institutes is likely to improve the average profit efficiency significantly. Trayler (2007) uses key governance variables "which are based on board characteristics such as number of directors, percentage of

inside directors, independent chairperson, statement from the board on corporate governance, statement from the risk direction board, and the existence of a risk committee to evaluate return on assets and on equity, equity to assets, and provision for loan losses to loans". He argues that a lower proportion of internal directors will improve the performance of the financial institute. Using the data on financial institutes in Argentine in 1990s Berger et al. (2005) test the effects of governance on their performance. In the model, they include the "static, selection, and dynamic effects of: domestic ownership, foreign ownership, state ownership, events like: domestic mergers and acquisitions, foreign acquisitions, privatizations, state restructurings, on the performance of the financial institute. Findings in terms of static effects of financial institutes' ownership on performance suggest that ones' which are state-owned have poorer long-term performance than domestically- and foreign-owned financial institutes".

The participants of the survey conducted by the author, also agreed upon the above findings and added their own views to the study. To sum it all up, the relationships between corporate governance and the performance of financial institutions are present but in most cases the evidence is related to specific types of businesses and is not applicable to all financial institutions. What emerges as a significant relationship in one study seems to change in another. The inconsistency of methodology and variables used by different researchers to estimate the relationship of corporate governance and performance of financial institutes, which varies across studies, seems to contribute to this situation.

Digital Technology in Financial Institutes

While many digital technologies have been able to expand by using existing infrastructure, investment in infrastructure is important to support adoption of some digital technologies by financial institutes of Sri Lanka. Broadband communication is critical, but so are sensor and communication systems that support interoperability of technologies. The digital technologies can boost competition but control over networks and data can pose a barrier to entry for new financial institutes. However, access to networks and data can also allow existing firms to compete in new product markets. Digital platforms support distributed production, including through the so-called sharing economy, which brings household and other non-market resources into the market economy. This increases the utilisation of assets, improving the overall efficiency of the economy but undermining some traditional markets. Social media and aggregator websites are increasing consumer access to information on the quality of the services and other factors of the financial institutes. This enhances their ability to impose market discipline on poor performers, reducing the need for regulatory approaches to consumer protection. Some regulation to ensure information quality may be required.

ANALYSIS

When dealing with a challenge it is required to better coordinate ideas, resources, information, and planning. Technology experts must work alongside business and government leaders to make better, more ethical decisions. Good, effective governance of emerging technologies requires all relevant stakeholders which include industry, consumers, businesses, governments, academia, and society, to work together in a collaborative, decentralized way. Multi-stakeholder approaches will achieve the greatest economic and technological benefits. It will also bring out broadest range of social benefits. In the future, collaboration may in fact become a

necessity as regulatory frameworks become global to align with the advancement of technology, data, and information. Good communication among all the stakeholders can also allow financial institutes to play a key role in helping the government as they develop laws and standards that increase the reliability of emerging technologies. Academics, researchers, and technology experts should make their findings more accessible to business and government leaders as well as the broader public, so that informed decisions can be made and policies and guidelines established.

CONCLUSION

Corporate governance affects the development and functioning of the economy of any country and therefore, Sri Lanka is no exception. With the effects of globalisation, it has also become an important framework condition affecting the industrial competitiveness. This study was conducted in order to develop the understanding of corporate governance and its effect on corporate performance and economic performance of financial institutes of Sri Lanka. In doing so, it addresses some of the underlying factors that promote efficient corporate governance, and examines some of the economic implications associated with corporate governance systems. It also provided empirical evidence on the link between corporate governance, performance of the financial institutes and economic growth, identifying areas in which a consensus view appears to have emerged in the literature and areas in which further research is still needed. The lack of sufficient research in the field, and the absence of the impact of corporate governance in the financial institutions in Sri Lanka, was the main motivations for this study. The purpose of the survey study conducted by the author, were to obtain a snap shot picture of the corporate governance situation in the surveyed financial institutes in Sri Lanka. In order to get a better understanding of the corporate governance environment, additional interviews were conducted with other stakeholders such as the Central Bank and the chamber of commerce. The findings suggested that better legal frameworks induce better corporate governance practices of financial institutes. The findings also indicate that there are aspects of corporate governance that need to be better regulated by law or regulations such as the equitable treatment of shareholders, and the role of stakeholders. The responses to the survey questionnaire enabled to construct a measure of corporate governance practice, for each financial institute. Even though the survey was limited to a few banks and financial institutes of the country, this methodology which can be extended to all the financial institutes in Sri Lanka, where the corporate governance rating is still unavailable, constitutes another contribution to knowledge of this study.

Recommendations

Given that this study has provided evidence of a relationship between corporate governance and the performance of financial institutions, it can be expected that it should recommend some policy implications. These recommendations should be interesting to regulatory and supervisory bodies dealing with corporate governance as well as financial institutes and their respective boards. The relationship between corporate governance and performance of financial institutes implies that regulatory and supervisor bodies of Sri Lanka should ensure that good corporate governance is observed and implemented and, when possible, improved. Regulators and other relevant bodies dealing with corporate governance should make sure that current laws, regulations, and rules on corporate governance are observed and implemented fully by the financial institutions. When

shortcomings of these rules and regulations are identified, then they should be amended and improved by taking into consideration best practices from developed economies. Shleifer and Vishny (1997) and La Porta et al. (2000), agree that dispersed ownership requires good legal protection, thus the regulators should insist on observance of laws and regulations by all financial institutes.

Limitations of the Research

The survey study conducted by the author encountered a number of unexpected problems and became subject to a number of limitations. The main limitation was that stakeholders of only a handful of financial institutes participated in the study. Also, given the central role of the banks in the economy, it would have helped if banks and financial institutions of developed economies are included in the sample for comparison. In terms of the financial institutions chosen, the main problem (and limitation) was the unwillingness of these institutions in to participate in the survey. The non-inclusion of all the possible financial institutions in the sample is another limitation of this study.

Further Research

There are several ways in which this research can be expanded. Including financial institutes from other countries for comparison could perhaps benefit from investigating which countries apply better corporate governance systems thus using this information to guide policymakers in other countries during the process of designing or implementing corporate governance related policies. In addition, the sample can be enriched with all other financial institutions and explore what are the implications of certain laws or regulations for banking and other non-banking financial institutions.

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