Chapter 7

Enhancing Credit Delivery in the Rural Sector

In the past four decades, the Central Bank has increasingly devoted its energies and resources to seek solutions to the problems in the rural sector. The process started in the 1960s. However, it was intensified only towards the latter half of the 1970s. Section 5 of the Monetary Law Act (MLA) which specifies the powers, functions and objectives of the Bank lays down "the encouragement and promotion of the full development of the productive resources of Sri Lanka" as one of the objectives of the Bank.

The Bank has, from its inception, performed its traditional central banking functions more fully than the developmental role assigned to it. Two distinct phases can be discerned from an examination of the performance of the Bank in the last four decades. In the first phase, lasting about 20 years from its inception, the Bank's energies were devoted in a large measure towards the achievement of objectives connected with traditional central banking functions. In the early years, the traditional functions of central banking such as the issue of currency, the performance of its functions as banker to the government, and banker to commercial banks, the regulation of the supply, availability and cost of money, and the maintenance of the par value of the Sri Lanka rupee engaged the attention of the Bank. During this phase, the Bank has made a positive contribution towards the development of the economy indirectly, through its involvement in the creation of new institutions to expand and modernise the banking system in the country. During the second phase, which commenced around 1978-80, the Bank's role has undergone a major change. It now seeks to play a more active and vigorous role in enhancing the flow of credit to the rural sector.

Role in the First Phase

In the first phase, the Bank contributed to the planning and setting up of several key financial institutions, which play a significant role in the economic development of Sri Lanka. The Bank was closely associated with the creation of institutions such as the Development Finance Corporation of Ceylon in 1956, the People's Bank in 1961, the National Savings Bank in 1971, the National Development Bank and the Sri Lanka Export Credit Insurance Corporation in 1979. These institutions were planned and established to fill gaps in the existing institutional framework in the banking system without which the banking system remained ineffective in fulfilling its developmental role. In many of these cases, a great deal of the preparatory work connected with the establishment of these institutions was undertaken by the Bank. In almost all instances, the legislation for their establishment was prepared in the Bank while in some cases the Bank has contributed greatly towards the evolution of the basic policies of these institutions. In a few cases the Bank has had a hand in the planning and the execution of operations. Apart from these, the Bank was also responsible for the amalgamation of the State Mortgage Bank with the Agricultural Investment and Credit Corporation in 1979, the two specialised credit institutions established in Sri Lanka in 1939 and 1943, respectively. Though it is not widely known, the Bank also played a vital role in the creation of the Hatton National Bank and the Commercial Bank of Ceylon which operate in Sri Lanka as private sector banks.

The Bank's involvement in rural credit and the problems concerning the rural sector began about 15 - 20 years after its inception. This marks the commencement of the second phase. This delay on the part of the Bank in becoming involved in rural sector activity may be largely due to certain shortcomings in the legislation that created it. The MLA, which was passed in Parliament in 1949, did not entrust the Bank with specific functions relating to the rural sector nor did it invest the Bank with the powers and the instruments to play a role in the advancement of the rural economy. Though the MLA recognised the encouragement and promotion of the full development of productive resources in the country as one of the principal objectives of the Bank, it failed to equip the Bank to fulfil this role from the beginning.

For example, the MLA made specific provisions for the establishment of the Department of Bank Supervision and the Department of Economic Research in the Central Bank, leaving the creation of the other departments to the wisdom of the management of the Bank. Promoters who established the Bank recognised the importance of supervision of the commercial banking system in the country and the conduct of economic research - an area which was not adequately taken care of by government departments or by the single university Sri Lanka had in the early 1950s. However, they failed to make statutory provisions for the setting up of a department of agricultural credit or rural credit in the Bank. In India for example, recognition accorded to the rural sector in the economy found expression through provisions relating to the establishment, powers and functions of the Agricultural Credit Department in the Act incorporating the Reserve Bank of India. In Sri Lanka, the Department of Rural Credit came into existence as a fully fledged department only in December, 1981, over thirty years after the establishment of the Bank. Statutory provisions in the MLA for the establishment of a department have certain distinct advantages. When powers and functions are detailed in the MLA and its role clearly defined, the recognition necessary within and without the Bank to carry out the allotted functions of the department is provided. This is greatly beneficial, especially at the commencement of operations. When the Rural Credit Department came into operation in 1980, there were several government departments and financial institutions already engaged in activities connected with rural credit and rural development, with a decade or more of accumulated experience behind them. In a situation like that, it becomes difficult for the newly created department to establish its credentials, gain acceptance among institutions performing similar functions and carve out for itself its powers, functions and area of activity. During the first few years in the life of the new department, a great deal of effort had to be expended to establish it on firm foundations.

Over a decade after its establishment, the Bank commenced equipping itself with the powers and instruments necessary for playing a direct role in the full development of economic resources. As originally envisaged, the Bank could influence development through the effective use of tools for monetary management. Through effective management of the economy, it was expected that the Bank could make a significant contribution towards the development of the economy.

Medium and Long Term Credit Operations

It was soon realised, that with the underdeveloped banking structure which existed in the two decades after the Bank's establishment, it was not possible to make a significant contribution towards the development of the economy unless the Bank was prepared to adopt a more direct approach. Certain statutory provisions incorporated in the MLA in the 1960s and 1970s were directly the results of this realisation. In 1963, the MLA was amended to enable the Bank to encourage commercial banks and credit institutions to undertake medium and long term lending operations. Medium and long term credit is a vital requirement for agricultural and industrial development. Though there were several specialised credit institutions catering to the medium and long term credit requirements in the economy, their resources and their scale of operations were hardly sufficient to meet the growing requirements of the economy. The Central Bank was therefore anxious to encourage the commercial banks to undertake medium and long term lending.

The commercial banking system which controls the largest share of financial resources in the banking system devoted only a very small share of those resources for medium and long term lending. In the 1950s and 1960s, the bulk of the portfolio of the commercial banking system was concentrated in short term advances of less than one year. Three years was about the maximum period for which bank credit was available. A 5-year term for a loan was very rare and such facilities were enjoyed by a select few who were considered good customers. The reluctance of the banking system to make medium and long term loans arises from the fact that banks draw the bulk of their resources from short term deposits and demand deposits from the public. Banks are naturally cautious when it comes to lending over long periods with a deposit base consisting mostly of demand and short term deposits. The desire of the banking system to remain liquid and the weight of banking tradition which favoured short term lending for trade and commerce confined a large volume of bank resources to a portfolio which consisted mainly of short term loans.

This imbalance in the portfolio had to be corrected to promote economic development. The Central Bank, therefore, amended the MLA, incorporating Section 88 which provides the Bank with the powers to undertake refinance operations directed towards encouraging commercial banks and credit institutions to devote a larger portion of their financial resources to advances with longer repayment periods. The efforts made by the Bank in the 1970s have borne fruit. The banking system has a sizeable portfolio of medium and long term lending for agriculture and industry with repayment periods extending to between 5 and 7 years. A 5-7 year term for a loan from the banking system is not a rarity today. As the Bank's refinance support is available mostly for agricultural and industrial projects on very attractive terms, the commercial banks in particular have changed their attitude towards projects with fairly long gestation lags requiring financial accommodation over long periods. The Bank's efforts are now directed towards encouraging the banking system to extend repayment periods upto about 10 years, so as to accommodate the financial requirements of many agricultural crops which require a long period to come into bearing. Longer repayment periods must always be accompanied by longer grace periods to make the facilities offered by the banking system match the requirements of the investors in agricultural crops. Many crops cultivated in Sri Lanka on a commercial scale such as tea, rubber and a variety of other crops, have a cropping cycle, from the stage of planting to the stage of bearing, spread over 3 to 7 years. Such crops cannot be assisted through bank credit unless the banking system is willing to lend long, while at the same time extending grace periods on the loan to match the requirements of the crop indicated by the cropping cycle.

Credit Guarantee Operations

Many commercial banks in Sri Lanka are extremely conservative in making credit decisions and tend to attach great importance to the security offered by a creditor. Unfortunately, this acts as a major deterrent towards expanding the volume of credit in the economy, especially to the priority areas of investment in the rural sector. The problem is a general one affecting all sectors of the economy. However, in the rural sector, consisting mostly of poor, landless and marginal farmers, the problem seems more acute. The insistence on bankable security, very often outside the project undertaken, restricts the benefit of bank credit to a rich and prosperous clientele. The banking system as a tool for promoting development in the economy has limited meaning and applicability in the face of archaic lending policies practised by Sri Lankan banks. This is, therefore, an area in which some direct intervention by the Central Bank has become necessary to ensure that an adequate volume of credit flows to all sectors of the economy in keeping with their requirements.

All commercial banks set up prior to the liberalisation of the economy in 1978 have evolved their lending policies on the British pattern, under which the available security looms large in the decision to grant a loan. Since bankable security is not available freely in the Sri Lankan economy, it is very difficult for a borrower to raise the capital necessary for investment from a bank. The degree of difficulty increases if the borrower happens to be a new entrepreneur setting out to undertake a new project. In general, it may be said that the degree of difficulty is even greater if the borrower is a rural borrower and happens to undertake an agricultural project with a long gestation lag, requiring financial assistance spread over a long period.

Lending policies of banks have changed very slowly over the last four decades. The pervasive nature of the problem spread throughout the banking system, including even some of the newly established banks, may be attributed to the fact that the staff in many of these institutions started their banking career in British banks in the country or in the two state banks. For many of them, these banks formed the nursery where they learned the first principles of banking and which moulded their "banking character".

The Central Bank in the last 10 to 15 years has been striving very hard to wean commercial banks from their security oriented approach and make them attach greater importance to the viability of the project that is seeking assistance. The Bank's efforts have been directed towards persuading banks to desist from the earlier practice of basing their credit decisions on valuation reports of properties, income tax and wealth tax declarations of borrowers, legal reports on title deeds of properties of the borrowers and on the financial status of guarantors. Its efforts have been directed towards shifting the emphasis from the above considerations to the financial and economic merits of the project under consideration to determine whether the project proposed could form a bankable project.

Project oriented lending requires that the Bank Manager should be conversant with project financing, should be able to use modern techniques of project appraisal and above all, should be able to spend time in the field examining and assessing a wide array of information relating to the project proposal. Since a wide variety of projects comes up for financing, a banker must possess a sound knowledge and a variety of skills or at least be able to procure such information as is necessary for making the credit decision. The credit decision depends on many factors affecting the project. Evaluation of a project is more complex and a more serious exercise than evaluating the security offered. It is not simple or straight forward and requires a talent for anticipating future trends in prices, marketability of products, assessing the relative merits of technology available and assessing the entrepreneurial capacity of sponsors. These skills are not available in abundance in the banking industry in Sri Lanka. Good ideas, and good project proposals with backing from sponsors with sound entrepreneurial talents very often fail to reach the stage of investment for lack of support from the banks. Accurate records on the rate of mortality of project proposals are not available for the banking industry in Sri Lanka. But, one might surmise that for each one that successfully reaches the stage of investment, at least 4 to 5 other proposals may fail to gain acceptance from banks and therefore, are never implemented. Not all of them deserve the fate they receive at the hands of banks.

The Central Bank has made significant efforts in the past to bring about a reorientation of the principles and policies which govern lending operations of commercial banks. The Bank's views on modernisation of the banking system place heavy emphasis on changing the attitudes of banker's lending criteria, policies and principles. Modernisation, in terms of the introduction of electronic devices, has little relevance and limited applicability if there are no major changes in lending policies and principles to accommodate the pressing demands of the economy. The Bank's concern in this area has been given expression through the operation of the credit guarantee schemes applicable to the agricultural and industrial sector. In 1974, the MLA was amended by the introduction of Section 108(A) to enable the Bank to issue guarantees for loans and advances or other accommodations granted to small scale enterprises by commercial banks and credit institutions operating in Sri Lanka.

The Central Bank's first involvement in such a scheme occurred in April 1978 when it introduced a credit guarantee scheme for small scale industry approved by the Industrial Development Board. The loans for these projects were made available through the People's Bank, Bank of Ceylon and the Development Finance Corporation of Ceylon. Each loan under this scheme was guaranteed upto 75 per cent of the loan. This same programme of guarantees was expanded in 1979 to support the Small and Medium Industries Programme of the National Development Bank funded by the World Bank. The rapid expansion in the small and medium industry sector can be attributed, to a significant extent, to the support given by the Central Bank through the Small and Medium Industry (SMI) guarantee scheme.

Development of an Appropriate Institutional Framework

Over the years, the Central Bank has become more and more conscious of the special role that it is required to play in the area of rural credit. This greater awareness has resulted in a thorough examination of the existing rural credit structure. Around 1978 - 1980, the Bank recognized the fact that the existing structure was inadequate to service the short term credit requirements of farmers and that with regard to the provision of medium and long term credit to farmers for agricultural development, the banking system had made only a beginning.

The Bank recognised the need to have a sound structure of rural credit in which it could play a pivotal role. The structure which prevailed upto about 1980 was considered loose, unco-ordinated and weak. At the same time, the Bank also expected the demand for rural credit to increase in the wake of large investment programmes for infrastructure development undertaken under the Accelerated Mahaweli Development Programme. These concerns found expression in several measures designed to strengthen the rural credit structure in the country in the period 1980 to 1985. The measures were:

(i) the creation of the Rural Credit Advisory Board (RCAB) to lay down appropriate rural credit policies;

(ii) the establishment of a separate Rural Credit Department (RCD) to look after functions relating to rural credit;

(iii) the establishment of several Regional Offices of the Bank in provincial towns;

(iv) the establishment of the Rural Banking and Staff Training College (RB&STC); and

(v) the establishment of Regional Rural Development Banks (RRDBs) at the district level to supplement and support the existing institutions in the banking system involved in rural credit.

In regard to policy formulation, the Bank found that there were many agencies which were responsible for laying down policy on rural credit and rural development. A mission from the Food and Agriculture Organisation (FAO) Investment Centre reported in 1978 that there was a serious lack of co-ordination in laying down policy on rural credit. Various government ministries were responsible for laying down policy and very often these were in the nature of ad hoc responses to emerging situations.

The RCAB was set up by the Ministry of Finance and Planning in 1980 for the purpose of formulating national policy guidelines for rural credit operations in Sri Lanka. The functions within the purview of the Board include:

(i) organization of an appropriate and sound rural credit structure in the country;

(ii) determination of the linkages and operational relationship between the various agencies handling rural credit and rural development;

(iii) laying down of national policy guidelines on rural credit;

(iv) examination of the terms and conditions of refinance and other support from the Bank in respect of lending to agriculture and allied sectors;

(v) determination of the manner in which and agencies through which small and marginal farmers may be financed;

(vi) examination of measure required for ensuring adequate flow of credit to small farmers; and

(vii) periodic review of various credit schemes under implementation, consideration of factors inhibiting their progress according to schedule and suggestion of suitable measures for overcoming the obstacles.

From the beginning, the Board concerned itself with major issues affecting this sector. In the early 1980s, one problem that affected the rural credit system was the problem of recoveries, which seriously affected the profitability of banks participating in rural credit and also contributed to serious reduction in the flow of credit to the rural sector from the banking system because of denial of facilities to a large number of defaulters. The RCAB in its first few meetings, therefore,considered proposals for rehabilitating defaulters of loans through rescheduling schemes. These schemes offered a measure of relief to farmers who were considered non-wilful defaulters, i.e. those who failed to repay their loans because of natural calamity and through no fault of their own. Along with this measure, several proposals were considered to strengthen the profitability of rural banking operations of the banking system. The Board, being an advisory body, always attempted to reach a consensus on the issues raised and prevailed on the banking institutions participating in rural credit to implement the decisions of the Board.

The RCD came into existence as a separate department in December, 1981, with responsibilities for activities which include:

(1) the operation of the Medium and Long Term Credit Fund (MLCF) in regard to loans given for agriculture and fisheries under schemes approved by various ministries with Central Bank refinance support;

(2) the implementation of rural credit schemes and integrated rural development programmes funded with assistance from international finance institutions and other donor agencies;

(3) the study and report on a framework of national policy guidelines on rural credit and review of same on a continuous basis in the light of the feed-back received through the inspection of branches of commercial banks and other lending agencies undertaken by the Department;

(4) the co-ordination and monitoring of the operations of banks and other credit agencies connected with rural credit; and

(5) the examination of credit gaps in the system, design and promotion of credit schemes to fill the existing gaps.

The Department, from its inception, has made a significant contribution towards promoting new credit schemes to fill the identified gaps in the credit structure. One of the first schemes to be introduced by the Department was the New Comprehensive Rural Credit Scheme (NCRCS). Under this scheme, banks are encouraged to lend to the food crop sector, consisting of over thirty crops including paddy, pulses, chillies, onions, potatoes, vegetables and a variety of subsidiary crops. In designing the scheme, several new features and new approaches to lending in rural areas for agriculture have been incorporated with a view to bringing down the transaction cost to the small borrowers as well as to the lending bank. Instead of requiring farmers to negotiate a crop specific loan for a specific season at the beginning of each season, a line of credit for 3 years or 6 successive cropping seasons is granted under the Scheme. Since the credit granted under the Scheme is a "homogeneous package", i.e. similar in all respects irrespective of whether it comes through the People's Bank, the Bank of Ceylon or the Hatton National Bank, banks have been encouraged to adopt an area approach whereby, through discussions and agreement among themselves, they were encouraged to restrict operations to selected areas without competing for business in the same area. This approach facilitates concentration of lending by a bank in a selected area, which helps effective disbursement and recovery of loan and extension of additional services to the borrowers, such as provision of inputs and marketing services, while keeping the administrative cost of lending at a low level. The Scheme also provides scope for participation of Thrift and Credit Co-operative Societies (TCCSs) on the basis of a relationship between the lending banks and the Society, which ensures the utilisation of the resources of the Society upto an agreed extent, thereby ensuring a more disciplined approach to lending by the Society. The Scheme also includes a facility to rehabilitate farmers affected by natural calamity. In the food crop sector, a significant number of farmers are affected by floods, droughts or pests in each season. The Scheme recognizes the occurrence of such events and has provided for rehabilitation of affected farmers through a scheme of rescheduling over a longer period loans granted to them. Finally, the Scheme has also simplified procedures for applying for refinance and the Central Bank guarantees to reduce the administrative cost of the Scheme to participating banks. The Department has successfully computerised operations of this scheme, which is the largest credit scheme in operation. Under this scheme nearly Rs.400 million is disbursed during the Yala and Maha seasons to borrowers, numbering over 60,000 farmers, all over the country (Table 7.1)

The Department has also introduced several other schemes in an effort to open the services of banks, in the form of medium and long term loans, to small borrowers engaged in farming and other rural activities. The All Island Farm Machinery Scheme which commenced in 1986, is today a very popular credit scheme under which tractors, threshers, water pumps and a wide variety of other farm implements are financed by the banking system for the benefit of small borrowers in rural areas. The Department also operates an All Island Dairy Development Scheme under which loans are made available to small investors in the dairy industry in rural areas. Progress has not been satisfactory, mainly due to factors external to the banking system. Good quality dairy animals for financing under this credit scheme are not available in abundance in many parts of the country. Many prospective borrowers for whom bank facilities have been sanctioned, fail to locate animals in good health and in the right age group to be acceptable for bank financing. The self-employment programme designed to promote employment opportunities for unemployed youth in the country, which was originally introduced through Regional Offices of the Bank at Matara and Anuradhapura, has now been expanded to cover all districts in which RRDBs operate.

All schemes under the MLCF for the small borrowers in the rural sector commenced after 1979. Before 1979, MLCF resources were exclusively devoted to the benefit of large scale investors in agriculture and industry. The provisions in the law governing the operation of the MLCF have been designed with large scale investments, particularly in the field of industry, in mind, so that when it comes to servicing the requirements of small investors, some of the legal provisions can cause serious problems in the implementation of credit schemes. Considerable flexibility is required to respond effectively to the requirements and problems of rural lending. These difficulties and shortcomings are quite natural and only to be expected. The Bank in the last decade has attempted to perform the functions of an agricultural development bank within the legal framework of a central bank.

Table 7.1
Short Term Cultivation Loans
Loans Disbursed under the New Comprehensive Rural Credit Scheme

(Rs.'000)

Name of Bank	1986 No.	1986 Amount	1987 No.	1987 Amount	1988 No.	1988 Amount	1989 No.	1989 Amount
1. Bank of Ceylon	27,601	137,781	28,363	150,307	18,920	102,254	20,145	220,279
2. People's Bank								
(a)Direct	33,333	179,087	24,328	118,970	13,749	64,473	13,885	126,569
(b)Co-operative Rural Banks	-	-	4,331	23,309	667	64,678	697	9,107
(c) Thrift & Credit Co-op. Societies	-	6	27	40	-	-	-	-
3. Hatton National Bank	2,147	12,305	2,011	7,956	995	4,644	1,166	16,952
4. Regional Rural Dev. Banks	2,000	4,604	3,932	21,509	4,198	11,788	8,328	51,995
5. Indian Overseas Bank	247	213	-	-	-	-	-	-
All Banks	65,328	333,990	62,992	322,091	38,529	187,837	44,221	424,902

* Includes 1989/90 Maha season only.

Performance, judged in terms of the rate of disbursement of refinance allocation under various schemes, is mixed. While in some schemes there has been a rapid draw down of funds, in many others utilisation has been slow and has fallen far short of expectations (Table 7.2).

At beginning of the Bank's involvement in credit schemes, it permitted sponsoring agencies - ministries, departments or international funding agencies - to determine parameters of the credit scheme. Today, the Bank with its accumulated experience is in a position to influence the shape and dimension of credit schemes. It is no longer willing to accommodate requests for financing unless it is proven that there is a real need for supporting that activity with credit and the parameters of the proposal receive its approval.

The Bank also operates several credit guarantee schemes designed to support rural lending. In 1986, under Section 108(A) of the MLA, a credit guarantee scheme was introduced to support the lending of commercial banks under the NCRCS. The coverage under this scheme was restricted to 50 per cent of the amount of loss. The guarantee is given automatically on application by the lending bank. No examination is undertaken by the Bank at the time of application. Complete reliance is placed on the lending banks. All cultivation loans granted under the NCRCS are required to be covered by the guarantee. The Scheme commenced in 1986 Yala and its performance upto 1987/88 Maha is available (Table 7.3)

Indemnity payments under the Scheme are made in two instalments,the first being paid as soon as the claim for indemnity is lodged with the Bank, while the second is paid only after a period of six months, during which time the lending bank has to take legal steps for recovery. The experience of 1986 Yala and 1986/87 Maha shows that recoveries after the first instalment of the indemnity payment is made are substantial. The actual indemnity payment as a percentage of the amount granted is almost halved from the position at the time claim is first lodged. The experience under the Scheme suggests that a properly administered credit guaranteee scheme with proper safeguards to prevent indiscriminate and indisciplined lending can lead to an expansion in lending while maintaining satisfactory levels of recovery.

Table 7.2
Medium and Long Term Credit Fund Loan Schemes Approved for Refinance under Category I

(Rs.Mn.)

Name of Credit Scheme	Refinance Allocation	Total Utilised upto 1988
A. CREDIT SCHEMES TERMINATED/CANCELLED AT THE END OF 1988		
1. Credit Scheme for Orchid Cultivation Sponsored by Ceylon Tobacco Co. Ltd.	4.50	3.49
2. Tank Irrigation Modernization Project	7.69	7.69
3. Dairy Development Project in Sammanathurai Electorate (Pilot Project)	.12	-
4. Credit Scheme for Cultivation of Orchids Sponsored by Sarvodaya and Lakmalsala	3.00	0.23
5. Credit Scheme for Financing the Construction of Windmills	2.56	1.05
6 .ADB/Sri Lanka Rural Credit Project	137.00	82.31
7. Credit Scheme for the Construction of Seed-potato Stores	1.00	-
8. Vavuniya/Mannar Integrated Rural Development Project	32.00	0.43
9. Sri Lanka/ADB Coconut Development Project Inter-Cropping Programme in Rambukkana Area	8.00	0.06
10. Special Credit Scheme to Assist Estate Sector Women in Income Generating Activities	1.00	0.31
11. Credit Scheme to assist Settlers in Minipe Scheme for the Installation of Bio-gas Plants	.40	-
12. Farm Machinery Loan Scheme under the Kurunegala Integrated Rural Development Project	76.50	71.59
13. Credit Scheme to Assist Settlers in Mahaweli Project Area for the Purchase of Tractors	55.00	6.62
14. Loan Scheme for Dairy Development in Nuwara Eliya District	10.00	9.32
TOTAL	338.77	183.10

Table 7.2 (Contd..)

(Rs.Mn.)

Name of Credit Scheme	Refinance Allocation	Total Utilised 1985 - 1989
B.. CREDIT SCHEMES AT THE END OF 1989		
1. Coconut Fertilizer Credit Scheme	65.00	19.27
2. Fisheries Sector Bank Financing Scheme	140.00	44.47
3. Credit Scheme for the Construction of Fertilizer Stores by MPCSs	14.00	0.33
4. Credit Scheme for Fishermen's Co-operative Societies	42.00	1.28
5. Matale-Puttalam District Integrated Rural Development Project	54.79	36.89
6. Youth Self-employment and Village Adoption Scheme in Matara District	18.20	15.72
7. Fertilizer Credit Scheme for Tea Small Holders	7.50	1.44
8. Credit Scheme for Financing the Purchase of Draught Animals in Districts not Covered under the Sri Lanka Rural Credit Project	5.60	-
9. Credit Scheme for financing the Projects Identified under Village Adoption and Self-employment Programme in Anuradhapura District	12.00	10.33
10. Badulla District Integrated Rural Development Project	7.00	4.22
11. Credit Scheme for Madel Fishing (Beach Seining)	5.00	0.97
12. Credit Scheme for Settlers for the Cultivation of Sugarcane under the Pelwatte Sugar Project	66.00	41.70
13. Credit Scheme to Assist Small Farmers for Cultivation of Sugarcane in Sevanagala., Hingurana and Kantalai Sugar Projects	120.60	52.50
14. All Island Farm Machinery Loan Scheme	106.99	90.88
15. Credit Scheme for the Cultivation of Chinese Ginger, Pineapple and Passion Fruit in the Kurunegala, Colombo and Gampaha Districts	32.00	4.64
16. Anuradhapura Dry Zone Agricultural Project Loan Scheme	22.30	3.24
17. Sri Lanka/ADB Livestock Development Project	91.72	5.36
18. Scheme for Financing Self-employment and Other Medium Term Projects in the districts of Kandy,Kegalle, Matale & Nuwara Eliya	16.00	11.98
19. Credit Scheme for Dairy Development	20.60	5.98
20. Credit Scheme to Promote Self-employment in Kalutara and Kurunegala Districts	35.00	22.49
21. Credit Scheme for Tube Wells for Lift Irrigation Purposes	1.10	0.17
22. Kegalle District Integrated Rural Development Project	50.00	7.40
23. Credit Scheme for Outgrowers for the Cultivation of Sugarcane under the Pelwatte Sugar Project	39.30	2.75
24. Kirindioya Irrigation & Settlement Project	37.82	2.27
TOTAL	1010.52	386.28
C. CREDIT SCHEMES APPROVED DURING THE YEAR 1990		
1. Agriculture Rehabilitation Project Credit Scheme	537.20	-
2. Tea Small-holder Development Project Credit Scheme	764.00	-
3. Mid-country Perennial Crops Development Project Credit Scheme	444.00	-
4. Small Farmers and Landless Project Credit Scheme	264.20	-
5. Sri Lanka/ADB Aquaculture Development Project	30.00	-
Total	2041.40	-
GRAND TOTAL	3390.69	569.38

Table 7. 3
Credit Guarantee Scheme under the NCRCS
(Position as at 30th September, 1989)

(Rs. Mn.)

Season	Amount Granted	Estimated Maximum Indemnity Payment* 1st Instalment	2nd Instalment	Total Estimated Indemnity Payment	Estimated Maximum Indemnity Payment as a Percentage of Amount Granted	Recoveries after Indemnity Payment (Refunds)	Net Indemnity Payment	Net Total Indemnity Payment as a Percentage of Amount Granted
86/Yala	150,859,000	6,234,175	6,234,175	12,468,350	8.26	4,978,392	7,489,958	4.97
86/87 Maha	256,978,000	8,490,607	8,490,607	16,981,214	6.61	6,844,509	10,136,705	3.95
87 Yala	123,592,000	2,640,790	2,640,790	5,281,580	4.27	4,081	5,277,499	4.27
87/88 Maha	275,354,000	6,589,958	6,589,958	13,179,916	4.79	-	13,179,916	4.79

* Total indemnity is paid in two instalments, 50% in each

* Second instalment of indemnity has not been paid for seasons of 87 Yala and 87/88 Maha.

The Bank also runs several credit guarantee schemes to support term financing for dairy as well as for plantation crops such as tea, rubber, coconut and minor export crops. The scheme for term finance has not been extensively used. Except for the scheme for the dairy sector, all other schemes came into operation in the latter half of 1989. Lending under the Tea Small Holder Development Project (TSHDP) and the Perennial Crops Development Project (PCDP) has just commenced. Therefore, an assessment of the progress of the Scheme can only be undertaken in 2 to 3 years from now. Lack of progress in the dairy scheme is mainly due to factors mentioned earlier, which have militated against speedy utilisation of refinance.

The Bank's promotional role in the area of rural credit and rural development has been strengthened through the establishment of Regional Offices. With their establishment, the Bank has sought a more direct and close involvement in the developmental process that is taking place in the country, especially in agriculture, small industry and other rural investment activities. The Regional Offices perform a variety of functions but the greatest importance has been attached to the developmental role that they play. Efforts are now being made to focus on poverty in the varied activities that the Regional Offices perform by enlisting their participation in the poverty alleviation programmes that are being implemented by various agencies.

The Central Bank has also made a significant contribution towards training bank personnel for undertaking rural credit. Rural credit is a specialised area for which special skills are required . The Bank has, therefore, assumed special responsibility for training and equipping personnel in the banking system to undertake this work. The RB&STC runs a wide range of courses for bank personnel and others engaged in rural credit and rural development. These training programmes lay heavy emphasis on project oriented lending, thus equipping bank personnel to adopt modern techniques of appraisal of projects and new approaches to lending for rural activity, while encouraging them to discard age-old principles relating to security which have governed their lending in the past. Lending for agriculture and to the rural poor is a theme that runs across many of the programmes conducted by the RB&STC in recent years, indicating the importance it attaches to equipping personnel in the banking system to handle credit for the neglected areas in the economy.

Early in 1982, the Bank focussed its attention on the existing network of Rural Banks in the country to determine whether they could be strengthened to take over a larger share in the provision of rural credit. It was also decided to examine the operations and the experience of the Regional Rural Banks (RRBs) in India to see whether such a scheme would be useful for Sri Lanka. In May 1982, the RCAB considered a paper on the progress made by the RRBs in India and it was decided, having considered the limitations of the existing rural banks in the country and the difficulty of revitalising them, to examine the feasibility of establishing a network of new institutions to supplement the role played by the existing commercial banks. The first four regional level banks were established in the latter half of 1985, bringing to a climax the wide ranging changes instituted during the period 1980 to 1985 in the institutional framework for provision of rural credit. The establishment of Regional Offices of the Central Bank and the establishment of district level banks under its sponsorship gave clear notice of the Bank's intentions in regard to participation in the development effort in rural areas in a more direct and forceful manner.

The RRDBs have been established as a result of the realisation that rapid progress in the economy depends largely on the rural sector and that the existing institutions such as the People's Bank, the Bank of Ceylon and other commercial banks are not adequate to fulfil the requirements. These institutions are commercial banks operating at the national level with their responsibility extending over a broad area of activity covering many sectors. The Bank was of the view that they are unable to give undivided attention to the process of rural development. The Bank was also convinced that the work of promoting rural development requires effective participation of people themselves, and that could be achieved only through the creation of rural level institutions sufficiently small to admit their participation but with sufficiently large resource bases to deal effectively with their problems.

There are eleven RRDBs in operation in eleven districts and a few more are on the drawing board for several other districts. Eventually all the districts in the island will have a RRDB, giving them the opportunity to build up a banking institution, with access to considerable resources available at the national level, and with the capacity to address the problems of development peculiar to their respective areas.

Criticism of Central Bank Policy

In recent years, the policy pursued by the Central Bank has come in for some criticism. The Bank in its refinance policy has tried to accommodate both growth and equity objectives. It recognizes that a policy which emphasizes a higher rate of growth, to the exclusion of other considerations in the economy, may lead to further impoverishment of the landless, small and medium farmers and accentuate further the inequality in incomes. Therefore,the Bank's policy on rural credit and rural development, while keeping both objectives in view, laid emphasis on poverty alleviation and creation of employment for the unemployed disadvantaged in the rural community. The focus of regional office schemes was on the disadvantaged groups in the community. Generation of off-farm incomes through small investments, exploiting the skills and simple technology available in rural areas was an important objective in many credit schemes designed for the rural poor.

Despite all the efforts made by the Bank, institutional sources have failed to make a substantial contribution in quantitative terms to the needs of the rural economy. In quantitative terms the achievement of the banking system does not look impressive at all, in comparison with the achievements of banking systems in countries in the region such as India. During the period 1982 to 1987, total advances from the banking system as a percentage of total GDP fluctuated between 25 and 27 per cent. Advances for agriculture and rural activities, excluding those for large scale agriculture, as a percentage of agricultural GDP was below 1 per cent throughout this period. The share of rural credit disbursement in total advances was also below 1 per cent during the same period. This is in sharp contrast to the experience of several countries in the South Asian Region which have registered levels of disbursement ranging between 6 and 12 per cent of agricultural GDP. Despite the impressive growth of the branch network of commercial banks in the last two decades and the measures introduced by the Bank to enhance credit delivery in the rural sector, there has been very slow growth in the volume of credit flowing through institutional sources to the rural sector.

There may be several factors responsible for the slow growth in rural advances in the banking system in the country. Many of these institutions have been troubled by low recovery rates, high administrative costs and low profitability of rural credit operations. The FAO study on Rural

Credit in Sri Lanka (1988) blames the existing policy of the Bank on interest rates and refinance for the poor performance of the banking system in regard to rural credit. It recognizes the low level of profitability as the main reason for the slow growth of the rural credit portfolio and the lack of enthusiasm and initiative on the part of formal credit institutions to undertake rural lending on a larger scale. The margin of profitability after taking into consideration the high incidence of defaults and the high administrative cost of lending do not leave a net spread to the lending institutions to make it worthwhile for them to engage in lending in the rural sector. The report therefore recommended strengthening the profitability of rural lending programmes and proposed a more market oriented credit structure to promote expansion in rural lending. The report was critical of the Bank's role in setting refinance rates, interest rates and margins which are considered as unnecessary interventions in the operation of the banking system. The basic policy reform required to encourage the banking system to lend more to the rural sector consists of strengthening the profitability of rural lending operations through adjustments in interest rates and refinance rates.

In early 1989, the Bank's recognized the need for adjustments in the refinance and sub loan interest rates under credit programmes. In 1990, it raised the lending rates for agriculture from 9 to 12 per cent while the rates for all medium and long term loans under various schemes was raised from 12 1/2 to 14 per cent. At the same time, the refinance rate was adjusted upwards in the case of short term agricultural loans from 1 1/2 to 4 1/2 per cent, leaving the margin on these loans undisturbed at 7 1/2 per cent while the refinance rate applicable to medium and long term loans was revised from 8 1/2 to 7 per cent - a downward adjustment to give the lending institutions a spread of 7 per cent. These adjustments in sub loan interest rates and refinance rates were introduced to strengthen the profitability of banking operations in the area of rural credit.

Lack of market orientation in lending rates has also been pointed out as a reason for the slow growth of rural lending and for many of the ills affecting rural lending. The Bank's initiatives in the provision of refinance has been faulted for lack of progress. It is true that the Bank in its refinance policy has tried to accommodate both growth and equity objectives. It has consciously adopted a policy of concessional interest rates on sub loans under refinance schemes, as the activities supported through the Bank's refinance are considered priority areas for investment.

The criticism levelled at the Central Bank's policy on refinancing is based on the assumption that commercial banks are compelled under the Bank's regulations to confine their energies only to those schemes supported by the Bank. The Central Bank has no such power and there is no compulsion. The banks are free to use their own resources, lend on their own terms and conditions and at rates which ensure a satisfactory return to the banks. This freedom has always been available but banks have not shown any inclination to exploit this freedom to their advantage. The simple explanation is that there are other competing claims for their resources. Resources tend to flow in those directions. If the Bank were to dismantle its refinance schemes and the credit guarantee support for rural lending, contrary to the expectations of those supporting complete market orientation in rural lending, there will certainly be a shrinkage in the volume of rural lending from the banking system. There are many other factors which influence bank lending and where the resources flow. The rural sector and the rural poor cannot compete on equal terms with other, more developed, commercial sectors in the economy for resources. Some kind of assistance and support will have to continue to be extended from the Bank to ensure that resources flow through the banking system to rural areas. In the present context of development in the country, when equity objectives should also play a significant role in the strategy for development, a policy of complete market orientation in rural lending may not be desirable.

However, in the recent past, the Bank, while strengthening the profitability of credit schemes supported with refinance, has chosen to leave some schemes to the lending banks' own initiative. The Naya Niyamaka Scheme which is variously described by several banks participating in the Scheme, is one such credit scheme. All the banks participating in this scheme, without exception, sought both refinance on concessional terms and guarantees from the Bank in support of this scheme. However, the Bank decided not to support this scheme but to leave it to the banks operating the scheme to develop it on their own initiative, using their own resources. As a result, there is complete market orientation in approach, interest rates and in all other aspects. Already, there are questions being asked about its relevance for tackling rural indebtedness. Resources of the banking system channelled through this scheme appear to flow not to the rural poor - the intended beneficiaries - but to others at interest rates well above that stipulated under the Scheme.

The Bank will, therefore, continue to play a role in this field. In fact, legislation is under consideration to convert the RCAB to a statutory body with broader powers and functions to get the banking system to devote a larger share of its resources to the rural sector. It is expected that this piece of legislation will be in the statute books soon and that the RCAB will be converted into a statutory body called the Rural Credit Board with powers to take decisions which will be binding on the banks participating in rural lending.

Further reforms to the institutional framework are also under consideration. The Bank is actively examining the feasibility of establishing a Credit Guarantee Corporation to undertake the credit guarantee operations of the Bank on a broader scale, to assist lending by the banking system to priority areas. Its limited operations in the past decade have shown that well administered credit guarantee schemes can achieve an increase in the portfolio of priority sector lending.

The efforts of the MLCF in the 1990s would be directed towards strengthening the operations of this Fund to match the requirements of a large variety of crops that are cultivated in Sri Lanka on a commercial scale. A start has already been made in this direction through the Tea Small Holders Development Project and through the Perennial Crops Development Project launched by the Bank last year. Under both these schemes, investors in tea replanting or in other perennial crops will be given long term loans with a long grace period which matches the cropping cycle of the crop financed.

At present, the operations of finance houses and finance companies remain restricted to the urban sector. The Bank recognizes that these institutions have accumulated experience in dealing with clients who do not gain access to the commercial banking system in the country. Small operators in the transport sector have all been accommodated by finance houses in the country. The Bank will examine ways and means of exploiting the special skill and experience that these finance houses possess to enlarge the flow of credit to the rural sector.

An area in which the Bank has already made a start and which is likely to expand in this decade is poverty alleviation. Under the Small Farmers and Landless Credit Project now in operation in the Puttalam and Kandy districts, the poorest segments in the community will be assisted with credit to create for themselves some means of livelihood. This is a special scheme which the banking sector in general may not be in a position to tackle. Therefore, the Bank has decided to enlist the support of Non- Governmental Organizations (NGOs) in the country to carry through this programme of poverty alleviation. The programme will shortly be expanded to cover the Galle and Matara districts. A frontal assault on poverty is a must if the social system is to survive, free of conflict and turmoil. In this effort, the Bank has a special responsibility to ensure that the banking system plays an effective role in finding solutions. The Small Farmers and Landless Credit Project is one such experiment which the Bank has launched. Its progress will be keenly watched to see whether it provides an effective instrument to the banking system to undertake the alleviation of poverty. The Bank will operate this scheme all over the island if, after the experimental stage, progress on the Scheme appears satisfactory.