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Special Attention to Special Needs – Central Bank Focuses on Regional Development

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Central banks are not supposed to engage in economic activities directly in view of unfavourable monetary implications of such interventions. However, due to practical reasons, in many emerging economies, central banks have undertaken a pivotal role in the developmental activities at different degrees in order to meet the requirements arisen at different stages of the economic development process. The Central Bank of Sri Lanka (CBSL) has also adopted a similar policy by paying special attention to ensure a regular flow of financial facilities towards regional development activities under different programmes and credit lines that are exclusively designed for meeting the development needs of different sectors and regions. Such attempts substantially promoted financial deepening in the country on the one hand while contributing to the growth of the regions on the other. "In the conceptual framework of financial deepening, it has been accepted that financial deepening promotes economic growth." [1]

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1 W.M. Hemachandra (2005), Page 1.

Delivery of Development Credit

Given the preponderance of the agriculture sector in the economy, the CBSL since its inception has provided leadership and direction in evaluating the problems and enhancing the availability of credit to this sector.[2]

The CBSL was requested to enter into the development credit disbursement process subsequent to the withdrawal of government Departments from credit delivery scenario in the rural sector in late 1960s. During the first two decades of the post independence era, a viable rural credit system was not in existence in the country, and in the absence of such a rural banking network, government departments were requested to undertake the credit disbursement function in the rural sector. Accordingly, since independence, credit disbursement in the regions was carried out by the Departments of Food and Agriculture, and Agrarian Services in collaboration with the cooperative movement in the country. Due to improper delivery systems and inherent weaknesses of the programmes, recovery of loans became a serious issue during this period.

In response to the high rates of loan defaults by the borrowers, a new scheme known as the New Agricultural Credit Scheme (NACS) was introduced in 1967. "This was a pioneering effort to transfer rural credit operations from government departments to the banking sector."[3] NACS was introduced by the CBSL in collaboration with the government with a view to granting production credit for the farmers through People's Bank which was established in 1961 for the sole purpose of expansion of banking facilities to the regions. The new credit scheme was supported by 100 per cent refinance from the CBSL and a 75 per cent Credit Guarantee from the government, under which the government agreed to compensate up to 75 per cent of any losses incurred by the bank under NACS. Initially loans were granted mainly for cultivation of paddy, but later in 1973, the scope of the scheme was extended further to cover paddy and other field crops (OFCs) and also implemented through broader participation of financial institutions, admitting Bank of Ceylon (BOC) and Hatton National Bank (HNB) as Participating Credit Institutions (PCIs) under the scheme. Subsequently in 1986, the scheme was further modified, introducing innovative features to ensure smooth and cost effective operations for mutual benefits to both lenders and borrowers.

Interest Subsidy Mechanism

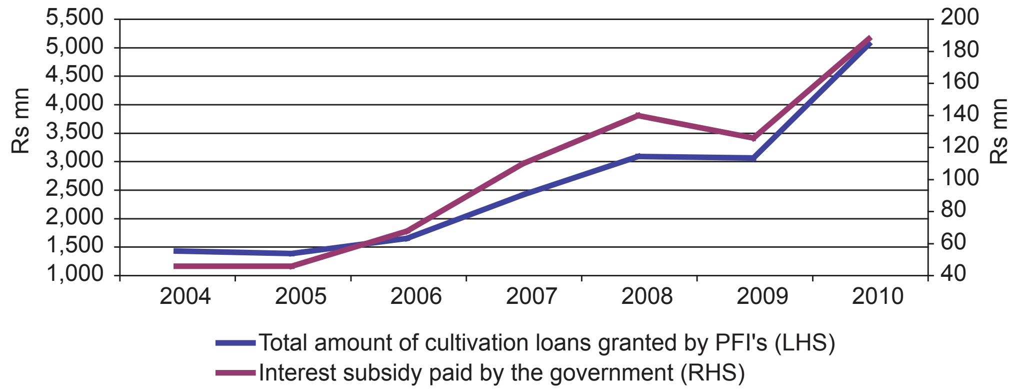
In view of adverse monetary implications, the CBSL terminated the provision of refinance out of the CBSL funds in 1994, and the government has undertaken the liability in respect of concessionary lending to agriculture to be met out of the budget. Accordingly, the scheme was modified to continue with the government interest subsidy. The Participating Financial Institutions (PFIs) were requested to grant loans at concessionary terms out of their own resources and the interest loss to the PFI has been compensated by paying an interest subsidy out of the government

2 Central Bank of Sri Lanka (1986), Page 189.

3 Central Bank of Sri Lanka (1986), Page 194.

Chart 19.1

Progress of Loan Disbursements to the Domestic Agricultural Sector with the support of Interest Subsidy by the Government



budget. As shown in Chart 19.1, this has been proved a very successful mechanism to ensure flow of bank credit to the domestic agriculture sector. This shows that a small amount of less than Rs.3/- spent on interest by the government is enough to motivate the PFIs to release Rs. 100 out of their own resources to the domestic agricultural sector, which was earlier considered as one of the most risky areas for financing.

Building a Viable Rural Credit Structure

At the inception, the CBSL had five main objectives as specified in Section 5 of the Monetary Law Act (MLA) No.58 of 1949. Among the five, two objectives were directly related to development purposes specified as the promotion and maintenance of a high level of production, employment and real income and the encouragement and promotion of the full development of the productive resources of Sri Lanka. Accordingly, the Bank established two separate departments namely (a) Development Finance Department in 1976 for the evaluation and facilitation of medium and long term development projects in the tourism industry and export sector and (b) Rural Credit Department in 1980 for promoting agricultural finance in the country.

However, in the initial period, the CBSL involvement was confined only to facilitate the delivery of rural credit mainly for cultivation purposes as the government policy was also directed towards achieving self sufficiency in food, particularly in rice. However, with the emerging demand for credit from different segments of the rural population, the CBSL has also been requested to play a vital role in delivery of diversified financial facilities for a wider range of regional based economic activities since early 1970s. In a developing economy, a sound rural credit system has a definite role to play in the area of economic and social upliftment of the people in the regions. When drafting the MLA, John Exter also believed that a country could not be fully developed without a flow of uninterrupted credit.[4] Similar to other neighbouring countries, Sri Lanka too has identified multiple benefits of a sound rural credit system to be operative in the regions.

Primarily, the government is responsible for development of such a viable rural credit system for regional development in a country. In Sri Lanka, the CBSL, as the apex institution in the banking sector, has gradually undertaken this responsibility on behalf of the government. Since early 1970s, the CBSL has been playing a proactive role as a promoter of development oriented credit schemes on the one hand and a principal credit disbursement agency for the regions on the other. The objective of the CBSL involvement in credit disbursement in the regions is, therefore, basically to facilitate the government policy towards development in the regions more effectively.

The CBSL has been engaged continuously in credit disbursement through PFIs for a wider range of regional specific economic activities covering cultivation of short term food crops, perennial crops, farm power machinery, pre and post cultivation requirements, marketing of agricultural produce, promotion of agro based rural industries, fisheries, animal husbandry activities, self employment, small trade, and also promotion of income generating activities among low income people for poverty reduction.

Formal Sector Credit Expansion

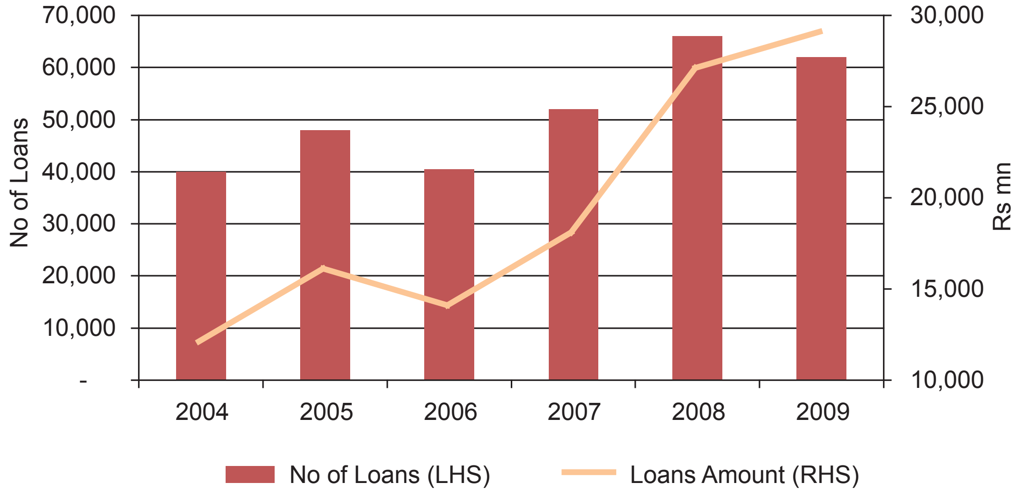
With the successful and effective participation of the CBSL in the delivery of development credit in the regions, it has been observed that a remarkable improvement has taken place in the formal sector credit expansion in the rural sector. According to consumer finance surveys, the share of formal sector credit has increased from 25 per cent in late 1960s to 40 per cent of the total credit requirement in mid 1980s. The corresponding figure reported in the latest consumer finances survey conducted in 2003/04 was 64 per cent. As the agent of the government to promote government policy objectives towards rural finance, the CBSL has been able to guide the formal institutional sources effectively in the regions as key suppliers of a variety of financial services to the regions. Due to direct intervention of the CBSL, the financial sector capability in respect of development financing has also been improved remarkably. Chart 19.2 shows the expansion of development credit in the regions under the programmes implemented by the CBSL.

As observed by the CBSL, state banks play a much involved role in expanding access to finance in the regions. “Evidence suggests that if state banks are made to operate in an economically viable way, there are opportunities to increase outreach and expand financial access particularly in rural and agricultural areas where private sector penetration might be

4 D.S. Wijesinghe (2009), Page 46.

Chart 19.2

Expansion of Development Credit - 2004 - 2010



limited."[5] In this sector, the government policy objective is also very clear under which the government recognises that the agriculture sector contributes to regionally equitable economic growth, rural livelihood improvement and food security through efficient production of commodities for consumption, for agro based industries, and for exporting competitively to the world market.[6]

Medium and Long Term Credit Fund (MLTCF)

In the context of the overall success in the expansion of rural finance over the years, a common understanding has been established among the stakeholders that the Central Bank should promote further economic activities by taking the leading role among the formal financial institutions in the delivery of development credit and other financial services through PFIs into the regions. In recognition of the need for intervention in the area of regional development, the CBSL has taken measures to create the appropriate environment within the Bank. Accordingly, the MLA was amended in 1963 to introduce "Part IIIA – Medium and Long Term Credit Operations with Credit Institutions" under which the Medium and Long Term Credit Fund (MLTCF), a special fund for provision of refinance facilities to PFIs, was established in 1964. Though many development projects in the agriculture and industry sectors usually require a long gestation period for success,

5 Alliance for Financial Inclusiveness (2009), Page 16.

6 Mahinda Chinthana Vision for a New Sri Lanka (2006), Page 3.

banking institutions are somewhat reluctant to grant medium and long term loans out of their own resources, since the bulk of their funds is mobilised through short term deposits and demand deposits. With the establishment of the MLTCF, the CBSL was in a position to provide long term financial facilities of up to 15 years to PFIs with respect to the loans granted by them for any productive purpose in agriculture, industry, tourism, trade and commerce as defined by the Monetary Board for the purpose of MLTCF. It has been observed that with the availability of refinance support from the CBSL, PFIs have also changed their stand towards granting facilities for development projects that require longer gestation/repayment period.

Credit Guarantee System

Although Small and Medium Scale Enterprises (SMEs) play a vital role in the economic development process, they continue to experience constraints when accessing formal sector finance. The four factors that cause market failure in the credit market for SMEs are high administrative costs for small scale lending, asymmetric information, high risk perception on small firms and lack of collateral. This market failure justifies government intervention.[7]

The CBSL intervention was also sought to provide a solution to the collateral issue as commercial banks mainly depend on collateral in making their credit decisions. Due to the inability to provide bankable security, many talented new entrepreneurs who possessed viable project proposals, particularly in the regions, were deprived of obtaining facilities from the formal banking sector even under the refinance schemes. Under these circumstances, the CBSL has taken significant efforts to change the attitudes of bankers, i.e. reorientation of traditional practices by introducing the concept of project based lending in which the lenders were requested to consider the cash flow and the viability of the project as collateral. In order to strengthen the efforts of the CBSL further in this area, the MLA was amended in 1974 to introduce the Credit Guarantee mechanism under Section 108(A) by which the CBSL was empowered to issue guarantees to PFIs on account of loans and advances granted by them for development oriented economic activities in the country.

Training of Rural Bankers

Further, in order to enhance the capacity and effectiveness of rural bankers in the field of development credit, the CBSL established the Rural Banking and Staff Training College (RB & STC) in 1979, for conducting training programmes mainly on techniques relating to project oriented lending. The objective of such training programmes was to develop a set of bank personnel within the system equipped with innovative methods, appraisal techniques and delivery

7 A.S. de Alwis (2009).

systems to undertake the challenging task of disbursement of development credit in the regions. Subsequently, the name of the College was changed as Centre for Banking Studies (CBS) with the expansion of its scope for training.

Further, the CBSL has taken steps to strengthen its developmental role by establishing its own Provincial Offices in Matara (1980), Anuradhapura (1982), Matale (1985) and recently in Jaffna (2010), and Trincomalee (2010) to coordinate, promote and implement development activities in the respective provinces. Provincial Offices are continuously engaged in training of bankers in rural finance.

Development of Financial Institutions

In addition to the above, from the early period, the CBSL has been engaged in a wider range of activities relating to institutional building and system development appropriate for the promotion of development credit in the regions.

In recognising the need for provisioning long term capital for development projects undertaken by the private sector in the fields of agriculture, industry and commerce, the CBSL assisted the government to establish the Development Finance Corporation of Ceylon (DFCC) in 1955.

On a proposal made by the CBSL to promote agricultural credit in the regions, the People's Bank was established by the government in 1961 under the People's Bank Act No.29 of 1961.

Later, in 1979, the CBSL contributed to the capital in the formation of the National Development Bank (NDB) which was established under the National Development Bank of Sri Lanka Act No.2 of 1979, for the sole purpose of provisioning medium and long term finance for development activities, particularly in the regions.[8]

The CBSL, going deeper into the regional development objective, has taken initiative to establish district based Regional Rural Development Banks (RRDBs) in 1985 with 100 per cent capital ownership. The RRDBs were encouraged to deviate from centuries old lending policies and practices of commercial banks and to adopt innovative methods as much as possible in credit delivery for development activities in the regions. The CBSL established 17 such RRDBs in 17 districts of the country, and subsequently they were merged on provincial basis to set up 6 Regional Development Banks (RDBs) under the Regional Development Banks Act in 1997. Later, the share ownership held by the CBSL in RDBs was divested to the government. Subsequently, the government restructured the RDBs by amalgamating them into one national bank under the name of Regional Development Bank (RDB) in 2010.

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8 Central Bank of Sri Lanka (1990).

Promotion of Microfinance among Low Income Segment of the Population

Central banks in emerging economies are in a position to play a key role in the development of microfinance through appropriate policies, systems and tools that enable the financial system to penetrate the microfinance markets. However, the general tendency is that in the absence of a conducive environment, the formal financial system is somewhat reluctant to reach the low income households. Under similar circumstances, the CBSL adopted a supportive policy for promoting financial systems to reach the microfinance market on a sustainable basis. As a supportive and supplementary measure, the CBSL has undertaken the responsibility of implementation of microfinance programmes through PFIs on behalf of the Government of Sri Lanka (GOSL). Small Farmers and Landless Credit Project (SFLCP), the first microfinance project of this nature implemented by the CBSL, was introduced in four districts in the country with the support of the International Fund for Agriculture Development (IFAD) and the GOSL in 1989. The project was titled as 'ISURU' and the CBSL adopted credit plus approach in the implementation of the project in association with Regional Rural Development Banks (RRDBs). The project was instrumental to make the rural bankers aware of many low cost innovative approaches developed in line with Grameen model (Bangladesh) Self Help Group (SHG) methodology. ISURU has become a popular rural finance programme of the relevant RRDBs during 1990s and was able to provide financial assistance to over 250,000 beneficiaries in the 4 districts.

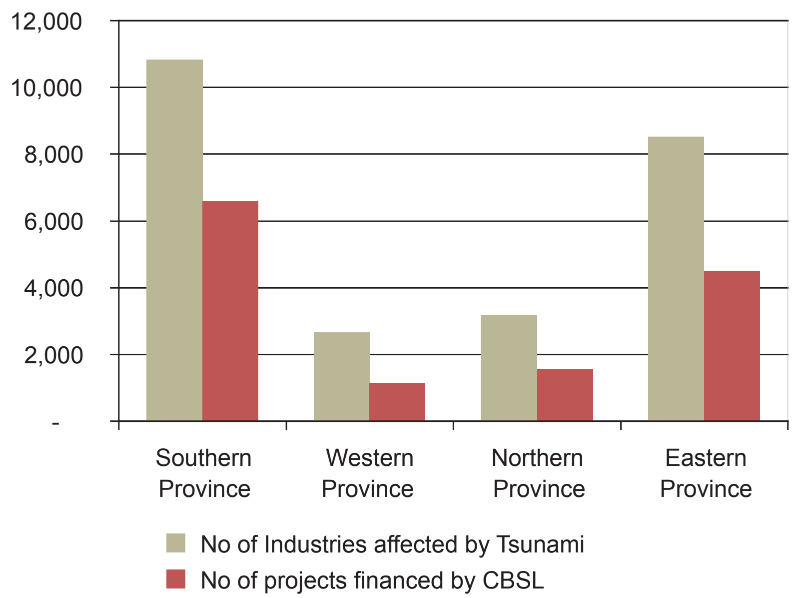
In late 1990s, the government entered into a Loan agreement with Japan Bank for International Cooperation (JBIC) to receive funds for implementation of similar microfinance project in other six districts and authorised the CBSL, as an executing agency, for the implementation of the project. Accordingly, Poverty Alleviation Microfinance Project (PAMP) commenced operations in 2000. PAMP I assisted approximately 200,000 low income families to obtain financial facilities from RDBs for improvement of their income generating activities (IGAs) in the six districts. Subsequent to the conclusion of PAMP Phase I, JBIC and the GOSL entered into an agreement for expansion of microfinance in the conflict affected Northern and Eastern regions in particular. Accordingly, PAMP Phase II has been commenced operations in 14 districts including all 8 districts in the North and East in 2009. At the same time, the CBSL, as an executing agency of several other projects, supported by IFAD, has engaged in promotion of microfinance through formal financial sector institutions in different parts of the country. In microfinance delivery under the projects, target beneficiaries were organised under SHG methodology and they were provided with credit for commencement of Income Generating Activities (IGAs) along with a package of necessary services including training/awareness on financial literacy, entrepreneurship development and required skills. Further, provision of market linkages for their produce has also been arranged where necessary. The CBSL was able to bring approximately 600,000 low income families into the formal financial sector under the microfinance poverty alleviation programmes, during last two decades, and impact evaluation studies have confirmed that 65 percent of beneficiaries under microfinance programmes were able to cross the poverty line within 3–5 year period.[9]

Special Programmes to Meet Urgent Requirements

As the apex financial institution in the country, the CBSL has clearly demonstrated its commitment towards the development of regional economic activities by introducing a concessionary credit line with 100 per cent refinance support from the CBSL to facilitate the affected enterprises by the Tsunami disaster which destroyed the entire coastal economy in 2004. The CBSL announced its own relief credit package under the name of 'SUSAHANA' within two weeks of the disaster, allocating Rs.3,000 million for refinance to PFIs that grant facilities to directly affected SMEs in the coastal areas. Thereafter, in association with the Ministry of Finance and Planning, carried out a series of negotiations with the Japan Bank for International Cooperation (JBIC), United Nations Development Fund (UNDP), French Development Association (AFD) and European Investment Bank (EIB) for borrowing funds for utilisation under refinance loan schemes. Accordingly the Regional Development Department of the CBSL was able to disburse a total amount of Rs.8,500 million among 13,596 SMEs under 5 special credit lines during 2005-2007 (Chart 19.3). Over 56 per cent of affected SMEs have been financed by PFIs, facilitating them for resumption of their business activities under the above programmes (Chart 19.4).

Chart 19.3

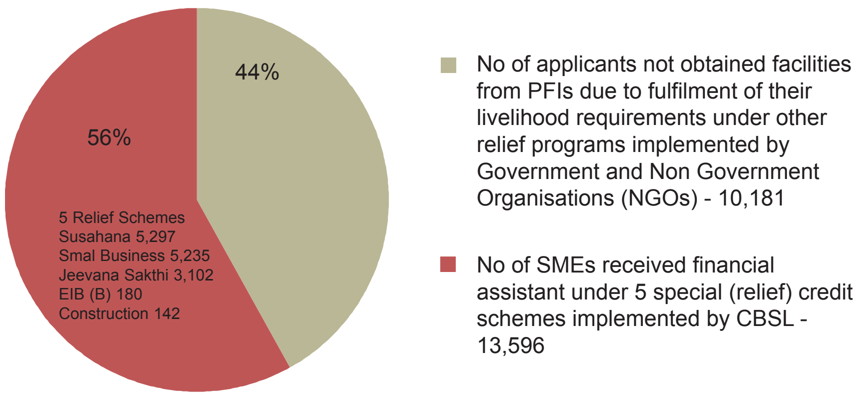
Resumption of SMEs in the Tsunami-affected Provinces



9 Impact Assessment Survey of the Small Farmers and the Landless Credit Project - 2005

Chart 19.4

Resumption of Tsunami-affected SMEs under 5 special (relief) credit schemes implemented by CBSL



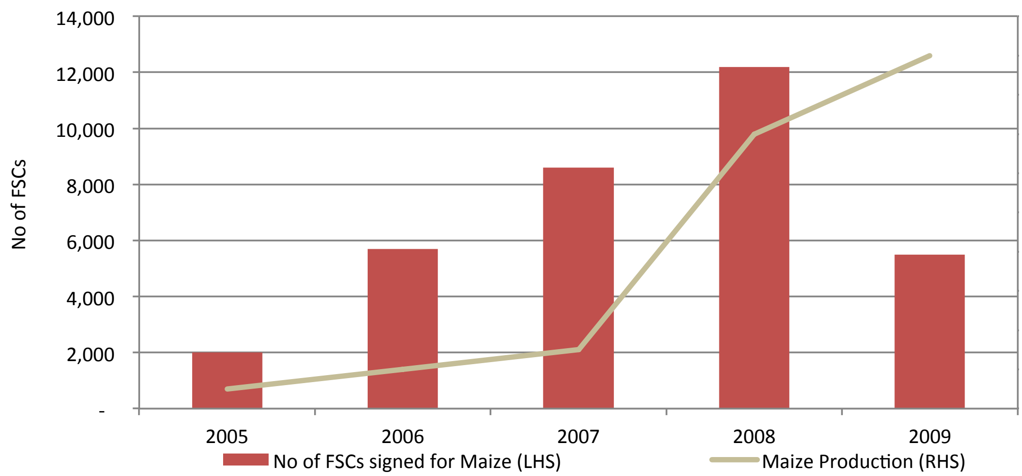
Further, just after the end of the conflict in the North and East, the CBSL has introduced two loan schemes with 100 per cent refinance from the CBSL, i.e. special credit line for the development of the East (2007) and "The Awakening North" for the resumption of economic activities in the North in 2009. This shows the timely involvement of the Bank at the time of disasters to rebuild the economy in the affected regions.

Balanced Regional Development

Despite the efforts made by successive governments to enhance the regional economic conditions during the past, regional economic disparities still remain to be balanced in favour of the 70 per cent of the total population living in the regions outside the Western Province of the country. In terms of the composition of GDP, Western Province has emerged as the principal contributor representing over 45 per cent of the GDP while other 8 provinces are sharing the balance. This indicates the disparities prevailing in the distribution of benefits of economic growth among the regions. The ultimate objective of all national development programmes would be the enhancement of the quality of life of all citizens living in the country.

This policy objective is clearly visible and emphasised in the 'Mahinda Chinthana' policy statement of the government. In order to achieve its regional development objectives, the government has accelerated the public investments in infrastructure development, undertaking several mega projects to be completed in the regions by 2016. Further, development in the agriculture sector has been given utmost priority in the policy agenda to ensure food security for all

Chart 19.5
Expansion of Maize Production 2005 - 2009



while contributing to rural poverty reduction. At the same time, rebuilding of economic and social life of the people in the conflict affected Northern and Eastern provinces has also become another priority area in the government's development policy agenda.

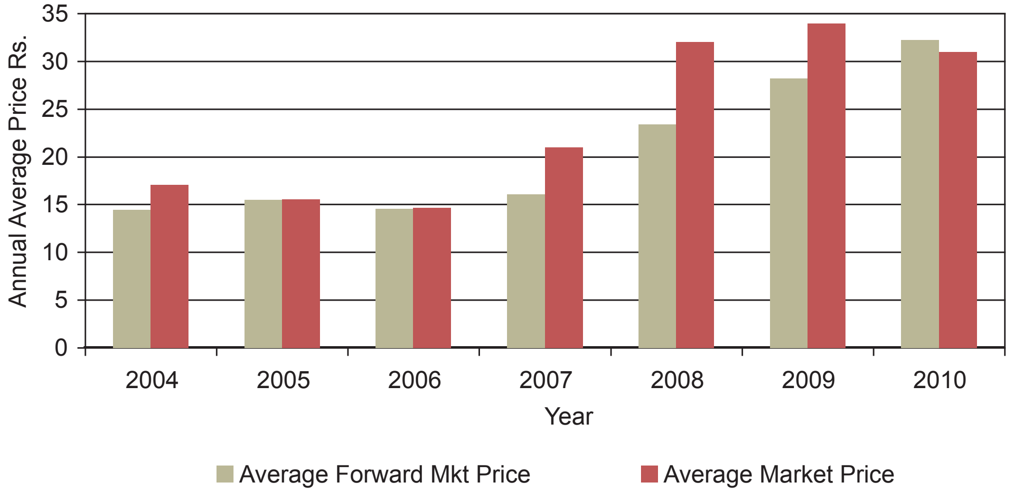
In line with the government's policy objectives, the CBSL has launched several special programmes complementary to the government development initiatives in the regions. Accordingly, credit delivery in the agriculture sector was intensified in order to attain self sufficiency in several food crops and liquid milk production in the country by 2016. In this effort, the government has extended the facilities already available for the farming community under the New Comprehensive Rural Credit Scheme (NCRCS) to cover more crops and activities related to agriculture.[10] The CBSL stepped in 1998 to introduce a Forward Sales Contract (FSC) system to ensure an agreed price for the major agricultural crops produced by the farmer community.[11] The CBSL promoted the FSC system among the farmers and commodity buyers in the country. Since FSC assures price and market for several food crops, PFIs were able to disburse more credit to the farming community with confidence of loan recoveries. Chart 19.5 shows that even a single crop could also be promoted under FSC coupled with disbursement of credit for cultivation.

One of the objectives of the promotion of FSCs among the farming community was to stabilise the market prices of agricultural commodities in the market. Chart 19.6 shows that current market prices of paddy have mostly been determined around Forward price decided at the beginning of each cultivation season.

10 Mahinda Chinthana Vision for a New Sri Lanka (2006), Page 7.

11 W.A. Wijewardena, (2009), Page 10.

Chart 19.6
Forward and Actual Market Prices of Paddy (2004-2010)



Recent Developments

Regional Development Department continues to implement the schemes discussed above, providing PFIs with 100 per cent refinance from the CBSL for the resumption of economic activities in agriculture, industry and commerce in the conflict affected Northern and Eastern regions. In addition, another credit line (Saubagya) supported by refinance from the CBSL has also been introduced recently for the benefit of new entrepreneurs and affected enterprises in the Small and Medium Scale Enterprises (SME) sector in the country. Concurrently, a new Credit Guarantee Scheme has also been introduced to encourage the PFIs, particularly in the SME sector lending facilitating the demand from such new economic activities expected to be generated through public investments programmes in the regions. At the same time, the CBSL has been engaged in a massive programme to eradicate poverty by adopting Self Help Group (SHG) mechanism in 14 selected districts including all 8 districts in the Northern and Eastern provinces on behalf of the government. "Expansion of microfinance programmes under SHG mechanism could help to alleviate the problem with regard to collateral to a certain extent as beneficiaries could then make use of inter se guarantee."[12] The SHG mechanism has been adopted by the CBSL under the ongoing poverty eradication programmes with a view to promoting financial inclusiveness and thereby reduce the incidence of poverty below 5 per cent by 2016. In addition, the CBSL has designed a special programme to conduct a series of training programmes to facilitate bankers and the entrepreneurs to meet the emerging challenges of SMEs and the middle level business community in the country.

12 A.S. de Alwis (2009), Page 65.

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