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USAID/SRI LANKA
HOUSING GUARANTY PROGRAM

389 HG-004

INCREASING PROGRAM UTILIZATION

Indefinite Quantity Contract No. PCE 1008-1-00-2069-00
Sri Lanka: HG-004 Program Delivery Plan

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I. SUMMARY AND RECOMMENDATIONS

This reports presents the findings of the ISTI team, Messrs. Bradford A. Warner, Jr. and Howard K. Gray, who visited Sri Lanka March 10 through April 5, 1993, as supplemented with certain updated information from the USAID/Sri Lanka Housing Advisor, Mr. Howard W. Kane, through May 20, 1993.

In the near term, the best means identified toward improving the rate of the Sri Lanka Housing Guaranty Program, 389 HG-004 (HG-004 Program) loan drawdowns is to support the initiatives of the Housing Development Finance Corporation of Sri Lanka (HDFC) acting either individually as a Sub-Apex/primary lender or in concert with selected Thrift and Credit Cooperative Societies (TCCSs) who would perform an originating/servicing role. On May 4, subsequent to our field visit, the Mission informed us that the HDFC had developed a backlog of more than 5,000 loan applications totalling approximately Rs. 250 million, of which 80 to 90 percent, or roughly Rs. 200 to 225 million, would fit the target profile. Assuming formalization by the Central Bank of Sri Lanka (CBSL) of HDFC's status as a Sub-Apex lender, this backlog could be converted into loans which would exhaust the unutilized HG-004 Fund balance, as of March 13, 1993, of Rs. 228.7 million (USD 4.8 million, based on the current exchange rate of Rs. 47.50 = USD 1.00) over the next three to four months. If the HDFC is able to operationally link up with the TCCSs, a substantial further increase in loan applications should be anticipated.

The HDFC was established in 1983 as a building society. Majority control is held by the Government of Sri Lanka (GOSL) with a minority interest shared by several thousand individual member shareholders. Management appears knowledgeable and aggressive with respect to making median to lower income residential loans on a commercial basis. It is slated for privatization by year-end 1994.

A. There appears to be significant demand for lower cost housing by the rural population in particular, which represents approximately 75 percent of the total population. The program, therefore, should target the rural as well as urban population groups. The best identification/delivery vehicle would be individual TCCSs as agents for the HDFC. Without a government guaranty, we feel it is unlikely that purely private-sector commercial banks will participate to any great extent in the HG-004 Program. Conversely, the HDFC, because of its familiarity with this type of lending and its government-sponsored, building society orientation, is prepared to act as an active Sub-Apex institution.

B. If the HDFC and TCCSs were successfully linked, the HDFC believes that up to 400 loans per month, averaging Rs. 50,000 per loan, or Rs. 20 million total per month, could be originated and processed in the near term. Thereafter, the HDFC projects that it could process up to 700 loans per month or approximately Rs. 30 to 35 million total per month. The current level of loan processing is approximately 200 per month. HDFC indicated strong professional interest and willingness in substantially increasing its volume of loans. Other HDFC activities in conjunction with the formal sector, such as CEYLINCO Housing and Real Estate Limited loans, may also be possible (see page 14). The recent agreement in principle with the Central Bank as to the HDFC's status as a Sub-Apex institution is critical in this process. Given the anticipated increased level of activity, efforts by the Mission should be directed toward the institutional strengthening of the HDFC, particularly in technical assistance and training.

C. To the degree that the commercial banks are prepared to serve as Sub-Apex lenders, a major disincentive is the alleged excessive turnaround time between a bank's disbursement to a mortgagor and reimbursement from the Central Bank. It would be helpful to the program if the turnaround interval could be shortened via automated record keeping and reliance upon certification by the Sub-Apex institutions.

   As Apex institution, the Central Bank is reviewing each individual loan application and is requiring excessive documentation and record keeping. So long as the credit risk lies with the HDFC or a private-sector commercial bank, the ISTI team feels that such reviews and documentation are unnecessary. USAID should assure the Central Bank that, for purposes of due diligence in the use of U.S. Government guaranteed loan funds, it is not necessary to review the documentation of each individual loan. Instead, the Central Bank should accept a certification or representation by an officer of the HDFC or a private-sector bank that loan documentation and approvals are complete and in order. In any case, shortcomings in documentation or defaults by mortgagors would be the responsibility of the HDFC or the private-sector bank that lent the funds. If the Bank of Ceylon (BOC) and People's Bank are privatized, then the same certification acceptance should apply to them and their participation in the program should be encouraged. For overall monitoring purposes, the USAID-funded computer equipment recently acquired by the Central Bank should substantially improve efficiency.

D. The mortgagor eligibility requirement to enable a Sub-Apex lender to be reimbursed by the Central Bank should be reoriented to embrace a maximum loan size affordable to a median income household rather than the current eligibility test of a maximum household income level not in excess of the median income. The linkage between affordable loan size and median income is established and discussed later in the report (see page 4). Assuming self-amortizing, level monthly payments, the maximum affordable loan size is approximately Rs. 75,000 for a 15-year obligation in the current interest rate environment. A minimum interest rate (MIR) of 20.5 percent is required under the HG-004 Program. We believe such a maximum loan size eligibility test should result in enhanced usage of the HG-004 Program since it removes a burden of proof by the borrower and the primary lender.

E. While rural villagers will pay very high rates of interest (40 to 60 percent per annum) over short periods, they will not do so over the longer term. This is particularly true if interest is being paid to creditors "outside" a TCCS membership, such as to HDFC or a commercial bank. Therefore, the MIR of 20.5 percent per annum probably cannot be increased much without curtailing demand. However, by eliminating layers of intermediaries between the Sub-Apex institution and the mortgagor, the full spread can be earned by the Sub-Apex institution. Thereby, the Sub-Apex would receive the earnings effect of higher interest rates without a corresponding increase in the cost of money. Also, it should be noted that the seasonal cash flow patterns of rural borrowers may justify semi-annual as well as monthly or quarterly loan repayments. Good lending practice would make use of such patterns to establish credit-worthiness through a required build-up of deposit balances prior to the granting of a loan. These balances could then be used as partial security or equity to support loans (see page 6).

Determining the feasibility of establishing secondary market operations for mortgage loans was the original principal objective of the scope of work for Task I. During discussions with the Mission's Housing Advisor, however, this objective was recognized as being less urgent than the need to develop the primary market for the HG-004 Program. This report contains a review of the development of the debt market, in general, and the steps necessary to build a secondary mortgage market in particular (see pages 18-23). The development of a secondary market in Treasury Bills and Government Bonds provides the platform upon which a secondary market for other debt instruments can be built. The beginnings of such a market for government securities are being developed now. Thereafter, it should be possible to foster a market for institutional participation in the debt securities of a specialized housing finance institution such as the HDFC. As the Abt Associates report, "Mobilizing Financial Support for Housing", November 28, 1989 points out, by purchasing the debt securities of the HDFC institutions will achieve one of the principal effects of a secondary mortgage market — the leveraging of a loan originator's balance sheet. In addition, assuming the HDFC and selected TCCs become operationally linked, there will occur a degree of integration between the formal and the informal financial sector as well as the housing finance sector with the overall financial system.

II. HG-004 PROGRAM

A. OBJECTIVES

As expressed in the Program Delivery Plan, the objectives of HG-004 Program include the following:

- Authorize loans — $25 million of which $10 million is currently under agreement, $6 million for loans and $4 million for grants. The lending agreement for HG-004 was executed in October, 1992;

- Improve the shelter conditions of urban and rural low-income households;

- Assist the GOSL in developing policies, programs and solutions to more effectively employ government resources to improve low-income household shelter conditions with specific reference to the 1.5 Million Houses Program[1] and to broaden the role of the private sector in providing shelter solutions;

- Increase private-sector lending activity by reimbursing loans initially funded with domestic resources, that are affordable (emphasis supplied) to below-median-income households and carrying market rates of interest; $6 million allocated;

- Deliver loans through the CBSL as Apex institution to public and private-sector financial institutions that will act as Sub-Apex or primary lenders;

- Subsidize housing in the form of direct grants, controlled by the GOSL budget process, to low income households — the poorest of the poor; $4 million allocated;

- Distribute housing grants through the National Housing Development Authority (NHDA) as administrator;

- Emphasize loan recoveries by requiring the private-sector institutions to repay reimbursements funded by the HG-004 Program without a GOSL guaranty.

- Supplement loan recoveries by instituting a credit guaranty scheme funded by participating financial institutions; and

- Recover grants through a separate GOSL credit guarantee funded by the NHDA.

As the program has evolved, the objectives that are at the center of USAID's focus and concern involve the loan component of the program, $6 million, and comprise: 1) stimulation of private-sector participation in the housing finance system on a self-sustaining basis; 2) integration of the informal sector (namely the TCCSs) with the formal sector; and 3) rationalization of government's role in housing as provider of grants to the poorest of the poor. This report concentrates on items 1) and 2) above.

Private-sector participation will be largely dependent on credit and return on investment considerations rather than on social objectives. However, the program is structured to place low-income housing credit risk on the Sub-Apex (and primary) lenders which are targeted to be from the private sector. Yet, the private sector, typically, does not find this type of lending activity attractive without a guaranty from a high-quality credit. Even then, servicing and collection problems can significantly erode profitability.

[1] This program is designed to assist 1.5 million households, primarily those below the median income, with loans and grants to upgrade shelter and related services.

B. PROGRAM PARAMETERS

1. Household Income Levels

The median income level for households, which has been established as a ceiling for eligible borrowers for the private-sector-led loan program, Rs. 4,600 per month, targets a low-income group in accordance with the stated objectives. As noted in Section I, specification of a household income level ceiling is significantly less flexible than establishing a maximum loan amount affordable to a median-income household. In fact Section 1.2 (a) (page 2) of the Program Delivery Plan speaks in terms of eligible expenditures including loans "affordable to below median income households." In actual practice, we understand that the band of eligible income levels reaches down to the third quartile level or a minimum income per household of around Rs. 2,000 per month. Below that level, the NHDA grant administered program comes into effect.

2. Market Interest Rate

The "market" interest rate has been established with reference to the Weighted Average Deposit Rate of 17 percent to which is added 3.5 percent to cover participating financial institutions (PFI) overhead (2 percent), risk (0.5 percent) and profit (1 percent), for an overall minimum interest rate of 20.5 percent. The table that follows sets forth the current range of interest rates for housing loans. The minimum interest rate of 20.5 percent appears to be within the range of current market interest rates although the term of the financing, up to 20 years, and the potential level of risk to the PFIs and the Sub-Apex lenders have not been taken into account in this comparison. If the term and risk factors were considered, it is likely that 20.5 percent would be considered a below-market interest rate.

The minimum interest rate provision is structured to allow a primary lender to increase the rate in accordance with market conditions, but we are not aware that PFIs have lent at above 20.5 percent under the program. The 20.5 percent per annum rate is a nominal rate which, if paid monthly, results is an effective annual rate of 22.5 percent.

The effect of very high interest rates over a 15-year term (the maximum maturity permitted by the CBSL to a Sub-Apex) is dramatic. For example, on a standard level payment mortgage in which the payment is calculated as a constant represented by a fixed percentage of the original principal amount, the aggregate interest payment totals 2.23 times the original amount borrowed at an interest rate of 20.5 percent per annum In contrast, an 8 percent interest rate results in aggregate interest payments of 0.72 times the original principal amount.

3. Individual Loan Amounts

The table on page 6 sets forth an illustrative range of maximum loan amounts affordable to a median income household (Rs. 4,600 per month) under the debt service ratios and repayment terms indicated at the MIR of 20.5 percent. Here, debt service ratio means the percentage of monthly household income represented by a mortgage payment calculated on a constant percentage of original principal basis to result in a self-amortizing, level payment loan. The affordable loan amount is a function of household income, the required debt service ratio, maturity, interest rate, repayment interval and whether the payment is due in arrears or advance. (See the footnotes to the table on page 6.)

INTEREST RATES ON HOUSING LOANS GRANTED BY LENDING INSTITUTIONS IN SRI LANKA AT JANUARY 1993

LOAN AMOUNT - Rupees	NSB %	HDFC %	SMIB %	Bank of Ceylon %	Peoples Bank %	TCCS %	NHDA %
Rural Housing Sub Program Rs. 20,000	-	-	-	-	-	-	20.5
Urban Housing Sub Program Rs. 25,000	-	-	-	-	-	-	20.5
CONSTRUCTION OF NEW HOUSES							
UP TO 200,000	18						
250,000 - 350,000	19	20.5	20.5	22	21	14-20	
400,000 - 1,500,000	21	22.5					
PURCHASES OF NEW HOUSES							
UP TO 150,000 - 200,000	19	20.5					
250,000 - 350,000	20	22.5	20.5	23	21	14-20	
400,000 - 500,000	22						
1,000,000 - 1,500,000	23						
CONSTRUCTION OF HOUSES & PROPERTY							
UP TO 200,000	19	20.5					
250,000 - 350,000	20	20.5	20.5	22	21	14-20	
400,000 - 500,000	22	22.5					
1,000,000	22	-					
1,500,000	23	-					
PURCHASES OF BUILDING SITES (LAND)							
UP TO 150,000	19						
250,000 - 300,000	20	-	20.5	-	21	14-20	
400,000 - 500,000	21						

Source: National Housing Development Authority

The Central Bank operating instructions issued in connection with the Housing Guarantee Low-Income Shelter Programme are flexible in respect to defined loan amounts, final maturity, and collateral requirements. However, the instructions require monthly or quarterly debt servicing which should be relaxed to include semi-annual repayments, at the option of the lender, to more closely fit the cash flow pattern of agricultural households in particular.

AFFORDABLE LOAN AMOUNTS
(monthly household income — Rs. 4,600; interest rate 20.5%)

	Debt Service Ratio - 25% Repayment Interval		Debt Service Ratio - 35% Repayment Interval	
Term (Years)	Monthly in Arrears*	Semi-Annually in Advance**	Monthly in Arrears*	Semi-Annually in Advance**
5	42,954	46,245	60,136	64,744
10	58,500	63,675	81,900	89,145
15	64,126	70,244	89,776	98,341
20	66,162	72,720	92,627	101,807

* Monthly in arrears is the standard repayment interval for fixed rate, residential mortgages requiring equal monthly payments of a combination of interest and principal to amortize the loan fully at maturity. The computation assumes payments occur at the end of each month.

** Semi-annually in advance is a repayment interval recommendation of this report for certain rural borrowers whose cash flow pattern is dictated by a two harvest per annum scenario for example. The computation assumes semi-annual payments at the beginning of each six-month period. Note that the loan amounts are higher for semi-annual payments in advance than for monthly in arrears. This is due principally to lending the borrower his first payment, which has been paid in advance so there is no risk or additional outlay of funds by the institution.

In all cases, good lending practice would suggest that the lender require a potential borrower to demonstrate his ability to repay the loan prior to disbursement. A convenient way to achieve this is to require monthly, quarterly or semi-annual payments into a deposit account. Prior to a loan being made until a minimum six months or one year repayment amount has accumulated. Thus, a borrower would first become a depositor for a six to twelve month period, for example. The deposit could be used as partial security for the loan, or as a partial replacement of the loan, or added to the loan, as in a payment in advance computation.

4. Central Bank Approval Procedure

The Central Bank's approval procedure requires the Sub-Apex (and primary) lenders to submit, in duplicate, forms containing all the details of each individual loan to be refinanced under the HG 004 program. Including originating, monitoring and the Sub-Apex note agreements, there are 13 separate forms to be completed by the Sub-Apex and primary lenders. We believe this documentation procedure is cumbersome and unnecessary, particularly since the Bank of Ceylon's program with the NHDA is no longer ongoing. As a result, only private-sector banks, and most recently the HDFC (see below), will be participating in the program. The private-sector banks are extremely concerned with the potential for repayment risk, as evidenced by the poor housing loan recovery performance of the Bank of Ceylon, and is pursuing an intrusive monitoring policy to create and maintain a sound loan portfolio.

5. Housing Loan Insurance Scheme

The spread (2 percent) between the rate of interest charged by the Treasury to the Central Bank (10.5 percent) and that charged by the Central Bank to the Sub-Apex lenders (12.5 percent) includes 1 percent for a Housing Loan Insurance Scheme (HLIS) sinking fund recovery program. At the current Treasury Bill interest rate level of 18.0 percent per annum, such a sinking fund paid semi-annually would amount to 168.9 percent of the original loan amount at maturity in 20 years. A yield on the sinking fund payments of approximately 14.0 percent per annum nominal payable semi-annually, or 14.5 percent effective, is required to equal 100 percent of the original loan amount.

Therefore, there is room for a substantial interest rate decline without jeopardizing the HLIS in terms of recovery of the principal amount. However, the earnings risk, interest foregone on defaulted loans, is more than twice as large as the principal risk on a future value basis. This risk is not covered by the HLIS.

C. PROGRAM IMPLEMENTATION TO DATE

As of March 1993, the HDFC arrangement had been agreed to in principle and the following participation agreements had been signed:

1992
- Hatton National Bank
- People's Bank (no longer considered active)
- Seylan Bank Limited
- State Mortgage & Investment Bank
- Bank of Ceylon (see below — problem)

1993
- Commercial Bank of Ceylon
- Regional Rural Development Banks
  - Badulla
  - Galle
  - Kandy
  - Kegalle
  - Kurunegala
  - Puttalam

March 1993 - Agreement in principle for HDFC to become a Sub-Apex Institution

LOAN FUND UTILIZATION AS AT MARCH 13, 1993

Institution	Amount Approved	Number of Loans	Average Loan Size
Bank of Ceylon	Rs 49.7m	7,536	Rs 6,600
SMIB	3.7	90	41,100
Hatton	2.3	130	17,700
Seylan	.6	7	90,000
Total	Rs 56.3m	7,763	---

(See Details on Page 9)

DISBURSEMENTS:	As of February 28, 1993 — Rs. 11.8 million
UTILIZATION:	Based on approvals as a percent of Original Loan Fund Allocation — 23.5 percent (that is, Rs. 56.3 million out of Rs. 240.0 million based on USD 1.00 = Rs. 40.00. As the rupee depreciates against the USD, the Loan Fund increases. At the current rate of exchange of Rs. 47.50 = USD 1.00, the total loan fund of USD 6 million would amount to Rs. 285.0 million).
PROBLEM:	The Bank of Ceylon participation is executed through NHDA and represents 88 percent of fund approvals to date. USAID has requested BOC to cease further loan originations due to poor loan recovery experience with NHDA administered funding in previous programs. Private-sector participation, represented to date by only Hatton and Seylan, is only 5 percent and moving slowly.

HOUSING GUARANTEE LOW-INCOME SHELTER PROGRAMME - APPROVALS (1)											DISBURSEMENTS (2)
District	BOC		SMIB		HNB		SB		TOTAL		Amount
	No. of loans	Amount	No. of loans	Amount	No. of loans	Amount	No. of loans	Amount	No. of loans	Amount	
Colombo City	379	4178000	-	-	-	-	-	-	379	4178000	
Colombo	-	-	42	1684700	5	95000	7	630000	54	2409700	
Gampaha	264	2267400	22	903000	1	20000	-	-	287	3190400	
Kalutara	252	1687600	11	424850	2	40000	-	-	265	2152450	
Kandy	398	2280900	3	147000	29	409000	-	-	430	836900	
Matale	506	3021800	-	-	-	-	-	-	506	3021800	
N'eliya	-	-	-	-	4	75000	-	-	4	75000	
Galle	277	1548200	4	170000	2	30000	-	-	283	1748200	
Matara	176	1064800	2	80000	-	-	-	-	178	1144800	
Hambantota	150	1035100	1	75000	-	-	-	-	151	1110100	Break down not available
Ampara	330	1728800	-	-	-	-	-	-	330	1728800	
Trincomalee	-	-	-	-	1	20000	-	-	1	20000	
Kurunegala	766	2627000	-	-	2	25000	-	-	768	2652000	
Puttalam	373	1681200	4	191000	-	-	-	-	377	1872200	
Anuradhapura	2766	21464900	-	-	18	350000	-	-	2784	21814900	
Polonnaruwa	88	483400	-	-	3	60000	-	-	91	543400	
Badulla	127	855100	-	-	8	137500	-	-	135	992600	
Moneragala	507	2848600	-	-	-	-	-	-	507	2848600	
Ratnapura	-	-	-	-	32	570000	-	-	32	570000	
Kegalle	173	868500	1	45000	4	80000	-	-	178	993500	
Vavuniya	4	48000	-	-	19	375000	-	-	23	423000	
TOTALS	7536	49689300	90	3220550	130	2286500	7	630000	7763	56326350	11,836,700

Source: Central Bank
(1) As of March 13, 1993
(2) As of February 28, 1993

III. SCOPE OF WORK

The original Scope of Work for technical assistance in support of the HG-004 Delivery Plan was completed in November 1992. Since then events have overtaken the assumptions underlying that Scope of Work, so that now the most urgent task at hand is to develop the means, in the short term, to address the obstacles that are constricting the flow of primary loans under the HG-004 Program. Once the primary loan program is operating efficiently, the issue of the secondary market will become more relevant.

A. ORIGINAL TASKS

Task I: Determine the feasibility of a viable secondary market for HG-004 funded housing loans.

Task II: Find ways to bridge the "credit risk gap" between the Sub-Apex lenders (the private-sector commercial banks) and the primary lenders, especially the TCCSs, so as to induce the Sub-Apex lenders to on-lend against TCCS-originated housing loans.

B. REDEFINED TASKS

Task I: Determine and define with greater specificity the actual policies, attitudes and constraints inhibiting the volume of HG-004-funded housing loans from being generated.

Assist in facilitating on-lending programs that will increase significantly the utilization of HG-004 funds.

Explore the feasibility of a viable secondary market for HG-004-funded low-income housing loans, assuming implementation of the primary loan program.

Task II: Develop a greater understanding of the functioning of the informal sector (especially the TCCSs), the formal sector, i.e., the Sub-Apex lenders (both commercial banks and the HDFC) and the targeted population for HG-004 loans (the TCCS membership is primarily low-income rural villagers), so as to streamline and enhance the process by which HG-004-funded loans are originated, serviced, and reimbursed.

C. FACT FINDING

The ISTI team conducted more than 25 meetings with representatives from the following institutions and individuals:

- The Ministry of Policy Planning & Implementation
- Central Bank of Sri Lanka
- Combined Sub-Apex Primary Lenders
- Primary Lenders
- USAID Housing Advisor
- HG-004 Consultant
- Asian Development Bank Housing Consultants (2)
- The National Housing Development Authority
- The Housing Development Finance Corporation

- State Mortgage & Investment Bank
- The Federation of Thrift and Credit Cooperative Societies
- Insurance companies, other financial institutions and the business community
- During the field trip:
  - Two regional Rural Development Banks, one participating and one not participating in the HG-004 Program
  - One District Thrift and Credit Cooperative Society
  - Three Primary Thrift and Credit Cooperative Societies

IV. PROGRAM REALITIES

The flow of funds under the HG-004 Program[2] bogs down with the Sub-Apex lenders. Other than the HDFC (newly approved in principle as a Sub-Apex lender by the CBSL) and the BOC, the remaining Sub-Apex lenders do not appear inclined to on-lend to the primary lenders. (Even the BOC is doing so reluctantly and only under instructions from the GOSL.) The private commercial banks, especially, continue to insist that without a GOSL guaranty such on-lending involves unacceptably high credit risks and excessive administrative expenses, neither of which, they feel, are adequately compensated for under the present interest rate spreads involved. Given the Rs. 4600 per month maximum household income eligibility requirement to qualify for a HG-004-funded housing loan, the banks consider the targeted low-income population group as approaching the "neediest of the needy" to which — again, in the absence of some sort of a GOSL guaranty — only "social lending" should be made available. Some social lending programs (under which most loans are de facto grants) are being implemented by the commercial banks. But the aggregate sums involved are relatively modest and, with minimal recoveries anticipated, are considered potential write-offs, thus justified only as a part of the institutions' charitable giving efforts.

Perceived excessive credit risk results from the banks classifying as unsecured any on-lending they might do to primary lenders. Since advances made represent reimbursements for housing loan funds disbursed, the underlying promissory notes are assigned but, in the judgement of the banks, are not adequately collateralized. Demarcated property ownership determinations are increasingly available in urban areas, but far less so in the rural areas where the bulk of the targeted low-income population lives. When such determinations can be obtained, much time and — for the typical borrower — great expense are involved.

As a possible way to get around the problem, we broached several private bankers with the concept of unsecured lending on a "participation" basis to primary lenders such as the TCCSs. Advances made would reimburse TCCSs only to the extent of, say, 80 percent of the underlying loan amounts, with the TCCSs relying on their own funds for the remaining 20 percent. The concept generated little interest. As a rule, the TCCSs appear to have calls on all their available funds for their traditional lending programs, such as short-term agricultural production loans, and would find it difficult to set aside funds for such participations.

The total interest spread (8 percent) built into the HG-004 Program between the Sub-Apex institutions and the primary lender has been structured to allow the Sub-Apex lenders to cover overhead costs, risk, profit and a 1 percent insurance premium (in addition to the HLIS discussed earlier). The spreads are as follows.

■ Treasury lends to CBSL at 10.5 percent	-
■ CBSL (Apex) on-lends to Sub-Apex lenders at 12.5 percent }	2 % spread
■ Sub-Apex lenders on-lend to primary lenders (e.g., TCCSs) at, say, 16.5 percent }	4 % spread
■ Primary lenders on-lend to housing loan borrowers at 20.5 percent minimum }	4 % spread

Given the inherent credit risks and the large administrative expense involved, the commercial banks, as Sub-Apex lenders, indicated that a 4 percent minimum spread with some sort of GOSL guaranty would be required before they might reconsider their willingness to participate to any degree in the HG-004 on-lending process. The officers of the four TCCSs whom we interviewed during the field trip indicated that a 2 percent spread was an absolute minimum. A spread of 3 to 4 percent was considered more appropriate.

The flow of HG-004 funds represents reimbursements to primary lenders for housing loans made. In order to show due diligence, and rather than accept the assurances about and blanket guarantees from the

[2] From the Treasury on-lent to the Apex lender (the CBSL); on-lent to the Sub-Apex lenders (the commercial banks and now the HDFC); on-lent again to the primary lenders (which could include the Sub-Apex lenders and the TCCSs); and on-lent finally to the ultimate housing loan borrowers.

Sub-Apex lenders regarding the underlying loans being submitted for reimbursement, the CBSL is conducting individual reviews of each and every housing loan reimbursed. To do so, it requires that full documentation — application forms, copies of promissory notes and details of the collateral, etc. — for each loan accompany reimbursement requests. According to the commercial banks, the administrative burden in ensuring that loan documentation packets are complete and accurate falls disproportionately on their shoulders as Sub-Apex lenders. This increases the already high administrative costs of the HG-004 Program resulting from the need to maintain (for loan repayment monitoring purposes) individual loan ledgers for each of the housing loans reimbursed.

Costs aside, a result of this repetitive housing loan review process (first by the primary lender, then by the Sub-Apex lender and finally by the Apex lender) is that, as far as the Sub-Apex lenders are concerned, loan reimbursement turnaround times are excessive. (One bank asserted that it had been waiting three months for one reimbursement in the amount over Rs. 2 million, resulting in its having to tie up its own funds for that period of time and a consequent loss of spread.) The CBSL refutes this strongly and showed us and the USAID housing officer its internal records that indicated one week average turnaround times from dates of receipt. This situation should be improved significantly when, using USAID-provided equipment, the loan documentation and accounting information is converted on to a computer database for joint use by Apex and Sub-Apex lenders.

The possibility of a recurrence of the 1988 GOSL loan forgiveness debacle seems to haunt some commercial bankers and conjures up visions of the same massive loan collection problems they experienced at that time by the TCCS. This apprehension is complemented by a certain lack of confidence in the TCCSs, born perhaps of a relative ignorance about their operations. While acknowledging that many TCCSs are undoubtedly well managed, that the government audits their books periodically for proper use of funds, and that extremely high loan repayment rates are said to be the rule rather than the exception, we encountered skepticism from commercial banks about the TCCSs' administrative capabilities, financial integrity, and loan origination and servicing capabilities.

As stated earlier, an objective of the HG-004 Program is to provide housing loans to low-income families (i.e., those whose incomes do not exceed the Rs. 4600 per month eligibility requirement). With some 75 percent of Sri Lanka's population living in the rural areas, most of whom would fall within the low income designation, it seems apparent that a substantial proportion of the targeted population for the HG-004 Program should be rural villagers, most of whom are involved with agriculture, fishing, trading and certain crafts. From conversations held and observations made during the field trip, the institution with the greatest access to, understanding of, and strong credibility with those rural villagers is the TCCSs. Some 7500 TCCSs representing 800,000 members are located all over Sri Lanka and are joined with the Federation of Thrift and Credit Cooperative Societies (FTCCS).

In their fund investment programs for and lending activities to their members, the TCCSs serve a valuable quasi-banking function. We were informed that officers of individual TCCSs, as local residents, are well known in their communities and thus are held accountable for their actions — as they are able to hold their members accountable for their actions, especially in maintaining very good loan repayment histories. This is due to a combination of peer, social and financial pressure. In effect, the members are lending each other their own money so that a default hurts the membership as a whole.

Yet it is an unfortunate anomaly that the very population group the HG-004 Program is intended to serve is not being served altogether because of the reluctance of the Sub-Apex lenders to on-lend HG-004 funds to the primary lenders, especially the TCCSs. Aside from possible questions by the Sub-Apex institutions as to the credit-worthiness of the TCCSs, the very existence of a primary lender other than the Sub-Apex itself implies a dilution of the spread to the Sub-Apex.

With the recent approval by the CBSL of HDFC as a Sub-Apex lender, matters may improve significantly. HDFC's on-going housing finance programs benefit target populations not dissimilar to that under the HG-004 Program. So the organization is both experienced at and comfortable with lending to such groups. As support for these loans, HDFC offers two services: (a) preparation of property determination reports that resolve ownership issues to the extent that loans can be secured at least in part by the underlying property, and (b) credit life insurance that, in the event of the death of the borrower, pays off the loan. If prospective borrowers find it difficult to pay for the cost of the property determination report and/or the credit life insurance, these expenses are added to the loan amount borrowed.

Using HG-004 funds, HDFC is proposing to initiate two new low-income housing finance schemes.

A. Utilizing the services of selected TCCSs[3] as both loan originators and loan servicing agents (for which the TCCSs would be paid a fee), a substantial number of new low-income housing loans (projected at approximately 400 per month initially, increasing thereafter to as many as 700 per month) would be originated. Based on a "guesstimated" average loan amount of Rs. 50,000, some Rs. 20- million per month in new loans would thus be generated, increasing thereafter to Rs. 30 to 35- million per month. Both HDFC's property ownership determination report service and credit life insurance would be made available in the TCCS programs. HDFC would not on-lend to the TCCSs but, instead, intends to make loans directly to individual borrowers, using the TCCSs selected to process, recommend and, if approved, service the resultant loans made. HDFC asserts that, by using its extensive field staff not to originate HG-004-eligible housing loans but instead to identify certain rural communities and their resident TCCSs for their potential in generating new loan volume, it has the capacity to absorb adequately a potential doubling of their current new loan origination rate of approximately 200 per month.

   Direct lending to eligible TCCS member borrowers and compensating the originating TCCS with originating and servicing fees avoid the involvement of the FTCCS and dilution of spread to the HDFC. The FTCCS Chairman, P.A. Kiriwandeniya, may raise objections to this since the FTCCS would lose some control over its membership.

B. An on-lending program to CEYLINCO Housing and Real Estate Limited, a subsidiary of a major private-sector financial institution, would involve two parallel activities, as follows:

   - On the basis, most likely, of the parent CEYLINCO Limited's blanket guaranty (details have not yet been worked out), advances would be made to the CEYLINCO Housing against HG-004-eligible low-income housing loans made to CEYLINCO Group's employees. CEYLINCO Housing's branch offices would originate, process, recommend and, if approved, service the resultant loans. If CEYLINCO desires, HDFC would provide property ownership determination reports and credit life insurance. The total number of loans anticipated to be originated under this facility would be approximately 400 to 600 total.

   - As proposed, on the basis of either assigned promissory notes that are supported by HDFC property determination reports and credit life insurance or the blanket guaranty of CEYLINCO Limited (again, details have not yet been worked out), advances would be made against HG-004-eligible low income housing loans originated by CEYLINCO Housing's branch offices. For a fee, those branch offices would process, recommend and — if approved — service the resultant loans for HDFC. Based on assertions made by CEYLINCO senior management, a substantial loan volume under this facility would be generated in a relatively short period of time.

Many of the borrowers under both the HDFC/TCCS and HDFC/CEYLINCO Housing schemes will be involved in rural agriculture. The income of these borrowers is likely to be very seasonal in nature. Thus, they would find monthly or quarterly loan repayment installments difficult to honor. For this type of borrower, a semi-annual in advance payment plan may be appropriate.

[3] Defined as those that have not been "blacklisted" by the credit bureau, whose books have been audited and found to be in proper order, and whose total administrative expenses are not excessive in relation to member fund balances.

V. CONCLUSIONS/RECOMMENDATIONS

A. CONCLUSIONS

1. Unless the volume of new low-income housing loans can be increased significantly (and thus additional USAID program funds obligated), the HG-004 Program may well be in jeopardy. Increasing the flow of primary loans takes precedence over determining the feasibility of a secondary market for low-income housing loans. Absent a viable primary market, there is little justification in trying to establish a secondary market.

2. The commercial banks, especially the private banks, remain in a "show me" attitude about their participating actively as Sub-Apex/primary lenders in the HG-004 Program. This position might change if a GOSL credit support — ideally its blanket guaranty — were forthcoming, if interest rate spreads were widened and if the loan reimbursement process was streamlined and thus speeded up. Simply raising interest rates is likely to curtail loan demand.

3. HDFC appears to be the one Sub-Apex lender that is prepared to become actively involved with the HG-004 Program, primarily as direct lender but also as on-lender (to CEYLINCO Housing). But the organization's ability to handle the increased loan volume involved has yet to be determined. Thus, as HDFC launches its new financing schemes, through the TCCSs and to the CEYLINCO organization, close monitoring and follow-up by USAID undoubtedly will be required.

4. The assertion by the commercial banks that on-lending HG-004 funds is unsecured in nature can be challenged up to a point. Properly documented, the resultant housing loans can be predicated, at least in part, on the value of the underlying land and improvements, and/or substitute collateral that is permitted under the program. But taking possession of such collateral, especially property, can be a politically explosive endeavor. So, knowing the borrowers and having the confidence that, failing an unforeseen crisis, they will repay their housing loans as agreed is of paramount importance. The TCCSs, HDFC field staff and CEYLINCO branch offices all should be able to make those value judgements adequately. HDFC has parate execution powers, and its experience has been that once a borrower has been put on notice that he is in default, the default is cured shortly thereafter.

5. It seems clear that rural villagers have compelling housing needs that can be addressed using the financing offered by the HG-004 Program. Numerically, they represent a significant segment of the low-income population in Sri Lanka. But, given their involvement with agriculture, fishing, small trading and crafts, their income is seasonal in nature, thus justifying consideration in setting up special repayment terms, particularly semi-annual repayments.

6. It is likely that the rural villagers will resist paying much over the 20.5 percent minimum interest rate mandated under the program. Although they borrow at substantially higher rates now (40 to 60 percent is not uncommon), it is for short periods and for income generation purposes, (e.g., crop production loans that generate cash income upon sale of the resultant crops). Considering the long term, they will balk when they realize the sizable amount of interest they will be paying over the life of the housing loan.

7. On balance, the program appears to have merit. It has the potential of addressing the housing needs of an important segment of Sri Lanka's population. Its structural shortcomings do not seem to be insurmountable and hopefully can be rectified. The recommendations that follow address those shortcomings.

B. RECOMMENDATIONS

1. USAID should concentrate its efforts regarding the HG-004 Program on increasing the volume of new and credit-worthy low-income housing loans by :

- Given the potential for HDFC becoming a major Sub-Apex on-lender and direct loan originator, identifying HDFC's loan generation and administrative shortcomings and providing such technical assistance as required to remedy those shortcomings (e.g., training HDFC loan officers in mortgage lending principles and practices);

- Seeking ways in which it can provide similar technical assistance in mortgage loan evaluation, documentation and administration to the staffs of selected TCCS members and CEYLINCO Housing field staff;

- Convincing the Central Bank to simplify its individual loan review process by (i) accepting the due diligence assurances and loan documentation representations made by private-sector Sub-Apex lenders and the HDFC, and (ii) adopting with its Sub-Apex lenders standardized computer-based loan documentation summaries;

- Pursuing with Sub-Apex lenders other than HDFC, the idea of increasing significantly their direct HG-004-eligible housing loan activities, even at the expense of whatever on-lending activities they may be contemplating;

- Ensuring that the HLIS and insurance mechanisms are being properly implemented; and

- Revising current loan repayment requirements to permit, at the option of the lender, semi-annual repayments.

2. The eligibility requirement should be rephrased to embrace a maximum affordable loan size concept, rather than a specific income limitation.

3. The Mission should notify USAID/RHUDO and USAID/Washington that the HG-004 Program can be revitalized within a reasonable time-frame if the HDFC approach becomes effective.

4. With the Sub-Apex lenders, the Mission should try and reach a mutual understanding and agreement regarding the use of title-related documents such as HDFC's property determination reports for the purposes of securing housing loans.

5. Given the desirability of having the support of the FTTC Chairman regarding HDFC's intention of lending directly to TCCS members and of appointing selected TCCSs as its loan origination and servicing agents, the Mission Housing Advisor should seek to obtain such support as soon as final arrangements with HDFC have been completed.

6. Given the value of having senior GOSL officials knowledgeable about and supportive of the HG-004 Program, the Mission should collaborate with the U.S. Embassy in the planning of a comprehensive briefing for this purpose. Invitees could include President Wijetunga. This recommendation presumes the prior effective implementation of the HDFC approach.

7. Until the primary market for HG-004 funds is up and running, the Mission should defer further explorations about the feasibility of developing a secondary market for low-income housing loans. The following section of the report addresses the feasibility of such a market and suggests as a first step developing access for the securities of the HDFC to a longer-term debt market currently being developed.

VI. THE SECONDARY MARKET POTENTIAL

The secondary market potential for mortgage backed instruments is a function of the development of the overall debt market. In connection with the recently commenced ISTI-managed Financial Markets Project, Mr. Priyal Perera, a research analyst on that project, has recently completed a background survey for the purpose of developing a secondary market in government and corporate debt securities. This work is included below:

A. DEVELOPMENT OF THE DEBT SECURITIES MARKET

The primary debt securities market (bonds, debentures) is very small and the secondary market is virtually nonexistent in Sri Lanka at the present. The government is the only institution that regularly issues long-term bonds (called rupee securities). Due to the low interest rates offered on these bonds (16 percent per annum for four-year bonds and 16.5 percent per annum for five-year bonds), only the captive sources have invested in these securities (more than 95 percent). There is no secondary market for these bonds mainly as a result of low yields being offered and the cumbersome procedures involved in transferring the securities to another party. In the event of a transfer, registration has to be done at the department of public debt at the CBSL and the superintendent of public debt has to personally sign any documents involved. It is estimated that this procedure takes more than a week to complete. However, it is recognized that a developed secondary Treasury-bill market (outside the CBSL) is a prerequisite for the development of the debt securities market.

1. Daily Turnover of Secondary Public Market for Treasury Bills Outside the CBSL

At present, secondary market transactions in Treasury-bills are mostly with the CBSL. However, there are a small number of secondary market transactions outside the CBSL that are performed by a very few institutions (BOC, Keells T&R, Forbes and a few other accredited money brokers). It is believed that of these institutions the BOC would be the most significant participant since it has funding capacity and the largest holdings of treasury bills at any one time. The other institutions engage in secondary market transactions very rarely and the amounts involved are very small. Even at the BOC, transactions do not occur on a daily basis. However, over a monthly period, around Rs. 40[4] million worth of treasury bills are transacted at the secondary market. On most occasions, it is the provident funds and the unit trusts that come to the secondary market to discount their bills when they are in need of cash. Taking all other accredited dealers into account, less than Rs. 50 million worth of transactions take place during a month in the secondary market. These estimates are arrived at by excluding repurchase agreements on treasury bills. On the other hand, amounts transacted by way of repurchase agreements (done exclusively on treasury bills) are very large because most bank funds obtained through repurchase agreements are free of reserve requirements.

2. Total Capital Raised by Companies Through Bond Issues (Public Offerings) and Private Placements

As of the end of 1992, there was only one listed company debenture quoted on the Colombo Stock Exchange, the Cheminex issue[5]. The value of this offering was Rs. 375 million. In the recent past,

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[4] This figure is the monthly average for secondary market activity for the year 1992. The highest and the lowest monthly amounts transacted during 1992 were Rs.133.5 million and Rs.0.275 million respectively.

[5] The Cheminex debentures were issued in 1990 at a coupon rate of 16 percent per annum and are convertible into ordinary shares of Cheminex.

however, there have been other public companies that have issued debentures through private placements. Housing finance institutions in particular have raised funds by issuing debentures mostly to captive sources (see below).

During 1992, around Rs. 1.4 billion was raised through debenture issues by other than housing finance institutions through private placements. The table below sets forth the principal terms of these issues.

PRIVATE PLACEMENTS OF DEBENTURES — 1992

COMPANY	AMOUNT RS. MILLION	MATURITY YEARS	RATE
1) DFCC[6]	669	3	T-bill rate + 0.50%
2) Kelani Tyres	280	5	T-bill rate + 1.00% [7]
3) Lanka Hardware	25	5	16%
4) Veyangoda Text.	120	5	16%
5) Royal Ceramics	100	5	16%
6) NDB (convertible)[8]	275	6	12%
Total	1,469		

Source: The information on debenture issues was obtained from several institutions (development banks, merchant banks) that engage in this type of activity. There may have been other issues that are not accounted for in this survey. However, for large debenture issues, it is expected that the private companies would contact the above mentioned institutions because they have the expertise and the know-how for issuing debentures.

3. Housing Finance Institutions That Have Issued Debentures

In addition to the issues cited above, the housing finance institutions have also raised funds by issuing debentures from time to time. During 1992, the NHDA issued debentures to the value of Rs. 627.5 million. Of this amount, Rs. 600 million was issued for one year at 18 percent per annum. The State Mortgage & Investment Bank (SMIB) and the Urban Development Authority (UDA) have also issued debentures in the past. However, they did not issue any debentures during 1992. It should be noted that

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6 When provident funds have excess cash they sometimes invest in DFCC debentures. Usually, the rates given are just above the T-bill rate (around 0.5 percent per annum and above). Currently, a greater proportion of the debentures are placed with the National Savings Bank (NSB) with the rest being placed with the provident funds.

7 The rate is adjusted once a year. Hence, the debentures were issued on a floating rate basis.

8 These debentures are convertible into equity in six years time.

none of these debentures are traded in the secondary market and that in most instances the debenture issues are placed with other state-owned institutions.

HOUSING FINANCE DEBENTURES
ISSUED AND TAKEN UP BETWEEN 1980 - 1992

INSTITUTION	AMOUNT Rs. Millions
1) NHDA	694.0
2) SMIB	1450.3
3) UDA	1849.9
Total	3994.2

Source: The CBSL

B. INTEREST RATE ENVIRONMENT

The tables below and on the following page set forth the interest rate environment over the past five years in general and some specific longer-term interest rate information. It will be observed that in many instances the yield curve is inverted. This is a fundamental obstacle which must be addressed before secondary market operations can function effectively.

LONG-TERM RATES — 1991

Maturity (yrs)	GOSL	SMIB	NHDA (2)
1	18		18
2	16-17		16
3		17.5(1)	
4	14-16		
6			15
10	10		

Source: Central Bank
(1) Rs. 500 million issued with a three-year maturity
(2) Rs. 100 million issued with a one-year maturity
Rs. 32 million issued with a two-year maturity
Rs. 32 million issued with a six-year maturity

INTEREST RATES 1988 - 1992

End of Period	Primary Treasury Bills	Central Bank Advance Rate	Commercial Bank Deposit Rates 3 Months	6 Months	12 Months	24 Months	Savings Deposits	Lending Rates of Long-Term Credit Institutions SMIB	DFCC	NHD	NSB	NDB
1992[1]	17.4[2]	17.0	18.0	18.5	20.0	21.0	14.0	20.5	14-19	6-12	18-22	11.3-18.5
1991	16.0	17.0	18.5	18.0	20.0	21.0	14.0	20.5	14-19	6-12	18-22	11.3-18.5
1990	16.9	15.0	22.5	21.0	21.0	18.5	14.0	19-20	14-19	6-12	18-20	11.0-18.5
1989	17.5	14.0	19.4	16.0	20.5	18.0	14.0	16-19	14-19	3-10	14-20	10.3-17.5
1988	18.9	10.0	16.0	13.5	15.5	16.0	11.0	10-20	14-19	3-10	14-20	8.2-15

Source: Central Bank
(1) November 1992
(2) As of December 11, 1992 the Treasury Yield curve was a follows:

	Maturity 3 mo.	6 mo.	12 mo.
Nominal Rate	17.71	17.99	18.89
Effective Rate	18.92	18.80	18.89

C. FEASIBILITY FOR THE ESTABLISHMENT OF SECONDARY MARKET OPERATIONS IN MORTGAGE BACKED SECURITIES

As noted in the first paragraph of this section, the secondary market potential for mortgage backed instruments is a function of the development of the overall debt market. In particular, the secondary market for government securities needs to be addressed. This is a principal goal of the USAID-sponsored Financial Markets Project which commenced in January 1993 and is integrated with the objectives set forth in the World Bank's Staff Appraisal: Sri Lanka Private Finance Development Project (March 19, 1993).

The Debt Securities Team Action Plan under the Financial Markets Project cites a number of working principles for the development of the government securities market which apply to the development of a secondary mortgage market:

- Government debt is the foundation of a debt securities market. Development must begin with reform of the market for treasury securities because government debt establishes the "risk free" yield curve off which all private securities will be priced.

- The short-term sector of the government debt securities market should be developed first and thereafter the market for gradually increasing maturities.

- The primary and secondary markets are interdependent.

- The availability of information is critical to the development of an efficient market.

As in the stimulation of demand for primary loans, the HDFC could become the focal point for the development of a secondary market in mortgage backed instruments. However, as outlined in the previously cited report "Mobilizing Financial Support for Housing", Abt Associates, November 28, 1989, we see this market evolving from the development of the market for HDFC's own debt securities.

Specifically, as the government debt market becomes established, the market for straight debentures will have a rational pricing mechanism that should facilitate the issuance of appropriately priced debt securities for non-governmental obligors. In such a climate, the HDFC's debentures might be acceptable to institutional investors on a private placement basis in the first instance, and at a later stage through public offerings, to a more retail investor base. In possibly a third phase, as dictated by the growth in mortgage lending, consideration will need to be given to the establishment of a secondary market in mortgage backed instruments.

In the above scenario, the role of the HDFC would be that of a portfolio investor. The HDFC would hold mortgage loans originated and serviced by itself and others. The TCCS and Ceylinco programs would fit well with such a portfolio investment role.

The HDFC's sources of capital would include the sale of debentures to institutional investors on a private placement basis, at first. Whether a government guarantee would be required to sell the debentures is a function of the performance and reputation of HDFC's management coupled with market pricing. Without a government guaranty, the debentures would need to offer a risk premium to similar maturities of government debt. The economics of such an operation will depend on market rates at the time. That is, could new mortgage loans be put on HDFC's books at rates higher than HDFC's cost of capital?

The ISTI team noted two additional potential sources of liquidity for the housing sector that bear further analysis.

- The Tax Amnesty (Housing and Commercial Buildings) Act No. 30 of 1992: This legislation was passed in May 1992 and provides for a "black money"[9] tax amnesty from income, wealth and turnover taxes for residential construction of non-luxury housing. Such housing may not exceed a floor area of 125 square meters on a land area not exceeding one-fortieth of a hectare.

- Control of Insurance (Amendment) Act, No. 40 of 1986: This act amended the Control of Insurance Act No. 25 of 1962 but did not remove its prohibition against an insurance company investing in or lending against real estate. The 1986 amendment is undergoing review by the Committee on Financial Reforms which, we understand, is considering relaxing the prohibition so that 20 percent of an insurance company's assets could consist of real estate investments or loans secured by real estate.

The amounts involved from either of these legislative changes could be significant. As of year end 1990 (the latest figures available to the ISTI team), the combined net assets of the two state-owned and three private-sector insurance companies were approximately Rs. 5.2 billion. The estimates of "black money" range upward of a multiple of that figure.

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[9] Black Money refers to funds derived from income not reported for tax purposes.

APPENDIX A
PERSONS AND INSTITUTIONS CONTACTED

I. PUBLIC SECTOR

Ministry of Policy Planning & Implementation
National Planning
Mr. K.A.L. Premaratne, Director

Central Bank
Development Finance Department
Mr. T.G. Savundranayagam, Director
H.D. Tissera, Deputy Director

National Housing Development Authority
S.V. Pillai, General Manager
Anusha Krishnakumar, Deputy General Manager

Housing Development Finance Corporation of Sri Lanka Ltd
E.A. Meththananda, Managing Director

State Mortgage & Investment Bank
Robin Talwatte, Chairman
D.B. Rajapakse, General Manager

Bank of Ceylon
Frank Kurukuladithiya, Assistant General Manager

Peoples Bank
P.D. Gunasena, Assistant General Manager Commercial Credit

II. PRIVATE SECTOR

Ceylinco Group
Lalith Kotelawal, Chairman

The Finance Co. Ltd
S. Wijesinghe, Director

Seylan Bank
Rohan Perera, General Manager

Hatton National Bank Limited
Daya Muthukumarana, Deputy General Manager

Commercial Bank of Ceylon Ltd
S.K. Wickremesinghe, Chairman

Union Assurance Limited
Hydery A Rahmanjee, Chief Executive

Sinaputhra Finance
Tissa Wijeratne, Chairman

Colombo Land and Development Co. Ltd
Anton Wijegoonewardene, Managing Director

CKN Fund Management (Pvt) Ltd
Jivaka Weeratunge, Joint Managing Director

III. OTHER

Federation of Thrift and Credit Cooperative Societies
P.A. Kiriwandeniya, Chairman
L.B. Dasanayake, General Manager
K.G. Wijeratne, Assistant General Manager
W.G.T. Bandara, Treasurer

Asian Development Bank - Consultants
Housing Sector Development Study
George Jelinex, Team Leader
Lex Barker, Housing Finance Specialist

Ceylinco Group - Consultants
William and Anne Wright
International Executive Service Corps
Advisors on Mortgage Financing

Abt Associates
Philip D. Jones

Regional Rural Development Bank Management in Kandy and Polonnaruwa

TCCS Personnel in:

Kandy **(Balgolla, Ulpathyaya)**

Polonnaruwa **(Kaduruwela, Debarella)**

IV. UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT

George Jones, Deputy Director
Howard Kane, Housing Advisor

.24'

APPENDIX B
MEETING NOTES

K.A.L. Premaratne, Director - National Planning, Ministry of Policy Planning and Implementation

Public Investment Program 1992 - 1996 contains the Government's policy which is a Loan-Based Program

- Government grants to the poorest of poor. — Max Rs. 7,000 to 8,000.
- Government facilitates loans (from other financial institutions)

Bridging Grants — (Combined Loan and Grant) — Targeted at 10 percent to 25 percent of the program and have the effect of lowering the interest rate to the borrower.

Grants are to be a maximum of approximately Rs. 275 million per year.

Income Levels: Median = Rs. 5,000/mo.
Lowest Quartile = Rs. 2,000/mo.

Asian Development Bank Program $15 million

State Mortgage & Investment Bank and the Housing Development Finance Corporation to be privatized by year end 1994

The National Housing Development Authority has political clout. HG-001, 002, and 003 were administered through the NHDA.

HG-004 — put into effect in March 91, lending agreement signed in October 1992

- Market interest rates
- 100 percent loan program -- no grants (?)

Illustrative Spreads

Interest Rate	Payable By	Remarks
4%	S.L. Treasury	Floating over U.S. Treasuries - paid to U.S. lenders
10.5%	Central Bank (Apex)	6.5% spread to cover Fx risk - paid by Central Bank to Treasury
12.5%	Sub Apex Institution	2.5% spread - includes 1.0% for credit guaranty sinking fund.
20.5 %	Borrower	8.0% spread - to cover overhead, risk and profit - can be subdivided if primary lender is different from Sub Apex.

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Primary lender collects payments monthly and repays every 6 months. The effective margin, therefore he claimed, rises from 8 percent to 35 percent. The credit risk is covered by the sinking fund. The objective is to get the commercial banks to lend to the poorer segment of the public.

Mentioned 15-year maturities with three-year grace periods.

Mentioned the need to find a suitable Apex lender instead of the Central Bank.

Rs. 100 million per year is adequate level of borrowing for this type of program. Recent history: October — Rs. 600 thousand; November — Rs. 2.0 million; December — Rs. 27.0 million. Hatton Bank has recently made an application.

Mentioned the need to upgrade existing facilities in an incremental fashion. The training of bankers is key.

E.A. Methananda, Managing Director, Housing Development Finance Corporation

The request has been approved for HDFC to act as a Sub-Apex institution for the Central Bank.

Small loans to low-income borrowers are costly for the commercial banks to manage.

- no way to approach grassroots level.
- requires specialization.

So far activity has been concentrated on mostly low-income borrowers living in areas surrounding the cities.

HDFC was started by the Maharajah Group

- Government took a larger stake due to a financial problem which required additional equity.
- There are 18 service units.

HDFC is specialized which leads to efficiencies; one stop shopping concept, including legal review, title search and clearance.

- 30 percent of monthly income debt service limit
- HDFC has parate execution powers
- HDFC borrowers are creditworthy; foreclosures are very rare

There is a Central Land Registry System in Sri Lanka.

Security Bond System

- is an alternative to a mortgage
- based on the guaranty of two or more persons (but what happens if someone dies?)

National Savings Bank

- million of accounts - owned by the Government
- a safe place to keep money.
- a number of depositors let their money sit for years.

HDFC

- has a deposit insurance scheme.
- looking to repackage mortgages for potential purchasers such as:
  - -- Employee Provident Fund
  - -- Employees Trust Fund
  - -- Insurance Corporation

Study on Thrifts showed that :

- as of 1985, there was a 100 percent recovery rate

- as of 1989, insurgency (JVP) disrupted the communal meeting system and contributed to the failure of many Thrifts.

Thrift movement is very effective now and HDFC does not want to disturb it.

The HDFC could help Thrifts originate loans and then the HDFC would buy these loans from the Thrifts. The Thrifts could provide a servicing function.

In 1985 the NHDA channelled its funds though the Thrifts (the Kandy Model).

Fiscal incentives should be considered to stimulate housing finance.

HDFC provides title clearance at cost which becomes an eligible expense for borrowing purposes.

Regional Rural Development Banks are owned by the Central Bank but could act as mortgage lenders.

<u>Rohan Perera, General Manager, Seylan Bank</u>

An illustrative housing cost scenario is as follows:

10 Perches	Rs. 30,000 in a rural area
House	Rs. 50,000 (other than Waddle and Dorp)

- Rs. 35,000 construction cost for 1 bedroom, Asian toilet, kitchen, sitting room, water supply pump) 5,000,

- Rs. 10,000 for electricity, Rs. 5,000 for Abessinian pump.

USAID - Limits are too low in terms of income

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Perera suggests - limit in terms of amount

Financing 125 Tea Estates

- looking to electrify line houses.
- tremendous problems to document ownership
    - parliament
    - survey for each land group
    - deeds, etc.
    - get letter of occupancy from Tea Estate.

There are large number of people who could afford loans but cannot obtain them

Seylan Bank takes only 2 weeks.

Government should be financing the really poor, but there is also the other poor.

Deposit term structure — too short to lend long. A mortgage discount facility would be useful. Lack of long-term lending is a serious shortcoming.

The HG-004 scheme could be useful but because it is restricted to the below subsistence level, it is not useful.

Methodology of potential borrower — save for a year debt service amount — becomes down payment — and creditworthiness test.

Rs. 1.0 billion — to upgrade line houses — Government cannot afford this.

Seylan Bank has 55 branches across the country which lend for crop production — (USAID/MARD)
Seylan would not lend through TCCSs

Fragmentation of valuable land into homesteads is bad vs. planned condo-concentration.

<u>**T.G. Savundranayagam, Director, Development Finance Department, Central Bank**</u>

Peoples Bank is not participating in the HG-004 loan program.

RRDBs — Six will be participating

Household income ceilings is Rs. 4,600 per month for any part of the country

Rs. 55 million amount approved of which roughly half has been disbursed (?)
Rs. 240 million to be approved for loans.
Rs. 160 million to be granted - via NHDA.

History of political debt forgiveness is a problem

Five commercial banks will be participating.

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Commercial banks - need to be socially motivated to participate in this program. They should get on the political bandwagon.

Perhaps the Government could sweeten the pot? — Deposits and Fiscal measures

Bank of Ceylon — Loan program through the NHDA.

He wants to have a matched maturity concept to control use of funds specifically to the Housing Program.

One cannot look upon this program as a purely commercial venture, one must take into account politics and moral suasion.

S. Wijesinghe, Director, The Finance Co., Ltd.

The income cap is too low and the interest rate too high. A maximum rate of 16 percent is more realistic from a debt servicing standpoint. Cut out the middlemen to preserve the spread.

This is not attractive business for a bank, but under the law, the Central Bank cannot lend directly to a non-commercial bank.

The spread gets subdivided so that it may not compensate the primary lender for the risk undertaken.

The Ceylinco Housing Subsidiary makes 10 to 12 year housing loans.

He suggested that HDFC could be the Apex lender. It is a specialized housing institution. However, a Housing Finance Discounter (refinancing agency) should be a government organization.

TCCSs should be a good originating/servicing vehicle.

Title Insurance already exists through Ceylinco and the Insurance Corporation of Sri Lanka.

Frank Kurukuladithiya, Assistant General Manager, Bank of Ceylon

Interest rates are too high. The rate charged to the Bank of Ceylon by the Central Bank is 16.5 percent (?)

In the old days, the State Mortgage Investment Bank and the National Savings Bank would make 20-25 year housing loans.

Servicing is expensive and subject to inflationary pressures. He does not like long-term loans and only likes HG-004 on a wholesale basis. If the NHDA does not repay the Treasury/Central Bank will make good.

For loans of up to Rs. 100 thousand, we are talking about basic shelter for a casual employee. How does one assess the repayment capacity of such an individual? The Rs. 4,600 household income could be certified by a village headman, but he is subject to bribes.

Social Service is one thing — Banking is another.

He would not want to lend to FTCCS (because of division of spread problems), but he would lend to individual TCCS. The TCCSs usually deposit their funds with the Peoples Bank.

Robin Talwatte, Chairman and D.B. Rajapake, General Manager, State Mortgage and Investment Bank

Singed the lending agreement on October 8, 1992. As of March 10, 1993 SMIB had approved 102 loans for Rs. 4.3 million, roughly 15 per month. It has disbursed on only 5 for a total of Rs. 196 thousand. The use of proceeds is normally for the purchase of land and not for construction.

Household Income Limits

	Rural	Urban
Original	Rs. 2,960	Rs. 3,700
Current	Rs. 4,600	Rs. 4,600

The debt service ratio has an upside limit of 30 to 33 percent. SMIB feels that Rs. 4,600 really only represents a subsistence level of income. The borrowers cannot afford to repay with interest. Therefore, some sort of subsidy is necessary.

USAID set a low income target. SMIB recommended Rs. 7,000.

TCCSs probably are the best vehicle to receive small wholesale packages for redistribution. The Peoples Bank has the best connections to the TCCSs.

The HG-004 Program's maturity match is good and the spread does compensate for risk to a certain degree.

The SMIB's backbone clients number: 7,000 → 12,000 and are largely urban-based. The SMIB now works through representatives.

The SMIB recently completed a Rs. 500 million fund raising, at 18 percent for a 3-year term. It was a tough sell.

A variable rate loan is a problem under the Roman Dutch legal contract concept.

The SMIB is run on a commercial basis and is on the list for privatization.

P.D. Gunasena, Assistant General Manager, Peoples Bank

Problems — Documentation by managers and no demand for wholesale distribution.

The Cooperative societies have not responded. The have their own funds and their main business is pawning. They do not want to take risks lending for fear of non-collection. They had a bad experience with politically directed lending in the past. They are not that interested in mortgage lending. Their balances with Peoples Bank are less than in the past and they are considering setting up their own bank.

The majority of the loan portfolio of Peoples Bank is derived from rural borrowers. Therefore, the bank could push the HG Program hard if not for the documentation constraint. They have 335 branches.

He believes that the TCCSs also are not interested in the HG-004 Program.

He noted that an income level of Rs. 4,600 would include teachers.

Willful defaults are a problem; thanks to the Government's actions with regard to loan forgiveness.

The housing portfolio of Peoples Bank represents 23 percent of the total portfolio. Of which, 50 percent is affluent individuals and 50 percent to white-collar workers.

Personalized monitoring is a key to success in the HG-004 Program.

Peoples Bank can push the Program if documentation is kept simple.

D. Muthukumarana, Deputy Manager, Hatton National Bank Limited

He feels that the objective of the Program is to create low income shelter via loan financing rather than grants which would be utilized for consumption.

Land contribution (by Government) is important since the poorest of the poor can use their own labor to build cheaply. However, this ends up as a lot of rural leases from the Government. In turn this creates a collateral issue for a bank to lend for the improvement on a leasehold.

TCCSs are powerful cooperative society with a lot of money. They do not want banks poaching on their territory. They have links to NGOs such as CIDA, NORAD, FTZ and SEDEC.

They have as much money as they need for their desired level of mortgage.

He noted the misunderstanding in which the Sub-Apex institutions were to repay on a matched basis rather than a 20-year maturity. He also stated that the documentation was cumbersome.

He suggested that the Treasury on lend directly with the Banks. That would make it easier to get the money reimbursed rather than through the Central Bank. He also suggested that the Program should operate on an advance basis rather than a reimbursement basis.

The security arrangement with the TCCSs is as follows: An NGO will lend/grant funds to a TCCS which will deposit the funds with Hatton. Hatton will then lend to members using the deposit as security.

George Jelinex and Lex Burker, Consultants, ADB Housing Sector Development Study

New twists which could be useful in the HG-004 Program:

- The Government could grant land so that the borrower would need to raise construction finance only.
- Develop an equity participation scheme; e.g., lease with option to buy.

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The Central Bank has gotten a hold of HG-004 and has made it unworkable. Also the NDHA ends up in a 2 percent penalty situation due to the disbursement process (?)

The Situs (Sp. ?) method of financing was mentioned. Twelve families contribute a fixed amount per period. One family is chosen to receive all payments, i.e., one to get everything.

P.A. Kiriwandeniya, Chairman, L.B. Dasanayake, General Manager, K.G. Wijeratne, A.G.M., W.G.T. Bandara, Treasurer, FTCCS

TCCS were organized in 1904, starting with Colombo. Federation itself started in 1980.

The Canadian Cooperative Association assisted the FTCCS in 1985 after which the Government of Sri Lanka recognized the FTCCS.

A USAID study indicated that the TCCS was an appropriate group to help deliver the Million Houses Program. Some 60 to 80 percent of the membership are below the poverty line.

CIDA is working with TCCSs through the Canadian Cooperative Association.

Federation TCCS - Located in Colombo

District TCCS
- 27 organizations
- 280 Division Banks

Primary TCCS
- 7,500 organization (1,400 clusters)
- 800,000 individual members
- Rs. 700 million total assets
  - -- 20 percent liquid and lent to DTCCS at 12 to 16 percent
  - -- 80 percent invested in member loans at 16 to 20 percent

47 percent of PTCCS financing is for housing in the average range of Rs. 7,000 - Rs. 15,000.

The Bank of Ceylon, Hatton, Seylan have solicited individual TCCS members. FTCCS - doesn't like this — weakens the organization. Bankers would take away the strongest members. But Peoples Bank — which holds their deposits are unwilling to lend.

RRDBs are regarded as a competitors.

S.V. Pillai, General Manager, National Housing Development Authority

The previous low collection rates were due to political promises. Collections are now up to 60 percent.

USAID insisted on an Apex lender but not necessarily the Central Bank. The NHDA originally offered to be the Apex lender.

NHDA previously worked well with the TCCS until the debt amnesty.

NHDA adopts a two guarantor system versus a mortgage lien security.

The division of the spread is problem and also could be viewed as causing too high a rate. The Bank of Ceylon should be made the parallel Apex for the NHFDA so that the spread would not be subdivided.

Villagers and urban residents will not borrow from money lenders at high rates for housing. They may pay 20.5 percent, but high rates of interest lead to high default rates.

NHDA since October 1992 has committed for Rs. 50 million of which Rs. 20 million has been disbursed.

The Central Bank should advance funds rather than reimburse loans already made. The Central Bank procedure is causing big problems and delays. There is also a penal rate of interest changed to primary lenders by the Sub-Apex for delays.

TCCSs lend at below market rates to their members.

<u>H.A. Rahmanjee, Chief Executive, Union Assurance Limited</u>

The Control of Insurance (Amendment) Act, No. 42 of 1986, which amended Act No. 25, 1962 prohibits any investment in real estate by an insurance company except for its own office. Otherwise Union would be very interested in real estate finance.

The proposed new insurance law would permit up to 20 percent of assets to be invested in real estate.

In the insurance sector no foreign investment is permitted.

Union, by law, must invest 50 percent of its reserve funds (including share capital) in Government securities. The balance must be invested as follows:

30 percent - Government Securities
70 percent - Approved investments

- -- Government Securities
- -- Deposits with commercial banks (not more than 5 percent)
- -- Deposits and Investments with SMIB and HDFC
- -- Investments in public quoted companies (not more than 5 percent).

<u>Anton Wijegoonewardene, Managing Director, Colombo Land and Development Co., Ltd.</u>

Black Money can now go into real estate due to a new Amnesty Law.

- Housing or industrial units
- New construction up to 1,000 sq. ft. per unit either for rental housing or build and sell.

He noted that the NSB invests mostly in Government Securities and only in limited amounts for housing. Government could provide land and link with agriculture and Black Money.

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Some current housing development do not look at the overall picture; e.g., ground is not prepared for drainage.

Can the Government put some pressure on the TCCS to participate in the program?

Why not commercialize the UDA and the NHDA, which also develop property.

Question — to what extent can the collection target be achieved? That is, is it realistic?

From the Government viewpoint the Housing Program is at heart political and is driven by the need for Foreign Exchange.

The semi-urban target for the HG program may be those borrowers who have earned the down payment necessary for a house while in the Middle East. This type of borrower can become prey to developers who sell the properties without putting the infrastructure in place.

Mr. Dissanayake, Chief Manager, RRDB, Kandy System

Agricultural Loans were started in 1987 and this RRDB will be introducing low-income housing loans for their customers (depositors). The borrowers must demonstrate the capacity to maintain a deposit for six months. The maximum maturity is five years; minimum is three years.

The Kandy RRDB has Rs. 89 million in deposits and advances and 16,000 depositors.

The cultivation cycle is 242 days.

Housing loans are now Rs. 8 million derived from the SMSIE program.

The RRDB uses a 30 to 36 percent debt service ratio for housing loans at a 20.5 percent interest rate in the Program. On other loan schemes the interest rate is up to 24 percent.

They are able to obtain clean title for securing their loans. The target for the Kandy system (13 branches) is ten loans per month.

There are 16 RRDB districts with 10 to 15 branches each.

The RRDB system is owned by the Central Bank but independently managed. The Central Bank reimburse the RRDB directly under the Program.

TCCS - Balagolla
369 members of which 240 are women, 129 are men (all ethic groups, i.e., Sinhalese and Tamil). Its share capital is Rs. 90,000.

The members are small farmers and landless people.
The Central Bank has given support through the District Union.

Deposit Rates

12% - 1 year
14% - Compulsory Deposit - each month - for three years.
12% - Group account
18% - Group account 1 yr.
6% - Housing loan
14% - Children's deposits
12% - Non-member deposits
18% - Fixed deposits.

Lending Rates

5% - Instant loan (?)
20% - Short-term loans (including Housing) for 1 yr.
20% - District Union (maximum Rs. 15,000)
8% - Housing authority - Million Homes Program.
16% - Small farmers.

District Union Housing Loan total Rs. 2.4 million.

Balance Sheet and Profit and Loss statements seem to be presented in a normal fashion.

CIDA (June 28, 1992) and Canadian Cooperative Association (Feb. 4, 1962) had visited.

It is claimed that 20.5 percent interest rate too high because interest is being paid to outsiders (however, see spread comments from the following TCCS).

Audit offices of COOP prepare the accounting forms (under Government supervision).

TCCS - Ulpathyaya

Established 1937 - 123 members (60 females, 63 males)

Total Share Cap.	Rs. 96,500
Members Dep.	220,000

Audited/Registered under the Cooperative Act - 1982

Compulsory Deposits	Rs. 58,000
Fixed Deposits	59,000

Same interest rate structure as the Balagolla TCCS

Children Deposit	79,000
Non-member	134,000
Member loans	481,000
Housing loans (50 members)	157,000

Repayment history 100 percent due to community pressure

The Manager is paid Rs. 1,300 per month while the Assistant Manager is paid Rs. 1,000 per month.

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TCCS recognizes that a 4 percent spread would be attractive.

Land Acquisition — if executed via Government is under the control of a Parliament member and is not necessarily permanent.

Polonnaruwa — RRDB

Was not familiar with HG-004, but would like to participate. They are thinking of getting into housing finance.

There are seven branches in the system with 10,000 customers and a total staff of 50.

These loans are for: Agricultural loans - farm machinery, small industries, self-employment.

Total loans Rs. 22,913,000, number of loans, 3,132.

There are 8,748 Saving Accounts; totalling Rs. 13,441,393; 95 percent of loans are current.

TCCS — Polonnaruwa

This is a District Society covering 75 Primary Societies with 8,600 members.

The combined share capital of the Primary Societies is Rs. 4.7 million.

At the District level, the share capital is Rs. 9.1 million.

The District Society do not make their own housing loans.

Agricultural loans totalled Rs. 4.5 million.

Project loans (Self-employment loans for low-income group) totalled Rs. 400 thousand with a maximum loan of Rs. 7,500 per member.

Capital formation Program (Paddy Cultivation)	-	Rs. 10 million
	-	465 members
	-	15 societies

24 percent interest is charged by the Society to a member, 21 percent interest from District to Society, 19.5 percent Federation to District.

The program requires a 20 percent compulsory deposit for 4 years by a member.

For the moment, they do not have a housing loan program. But could make a program; would expect a 4 to 6 percent spread.

95 percent of loans are paid on time.

The Federation would provide training for Housing Loans.

TCCS — Debarella

This was a meeting with approximately 40 to 50 people, parents, children, etc. The gathering was polled and felt that 20.5 percent interest was acceptable for a housing loan.

Examples:
- Woman has land; wants to build house; needs Rs. 50 thousand.
- Nobody in the group earns more than Rs. 4,600 per month — many are farmers.
- Another woman has 1/2 acre; wants to build house and toilet; can pay only coincident with the harvest; every 6 months.

It is felt that a 2-3-5 percent spread was necessary for the primary lender.

Range of desired maturities is 7 to 15 years. Prepayment option desirable. Land acquisition loans are desirable.

Aside from Agriculture, the other professions represented were traders, candy manufacturing, banana cutting, carpentry.

P.A. Kiriwandeniya, Chairman, FTCCS, Second Meeting

One parliamentary Act
- The Cooperative Act.
- Governs the TCCSs
- Can borrow from primary lender
- Registration
- Arbitration
- Auditing by Government Cooperatives Department
- Liquidation
- Regulates borrowings from outside the system other than Peoples Bank and Bank of Ceylon. It is more than a formality to obtain authorization.

Peoples Bank was originally the central Cooperatives Bank. It had the monopoly right to deal with the cooperative.

A spread of 2 percent at the District Level is not sufficient because of the overhead factor resulting from employment of educated professional staff.

Spreads are divided 1/3 to the Primary and 2/3 to the District. On a business analysis, the primary society should come around to agreeing with this.

There are 27 District Unions; 8,000 Primaries Societies with a target 15,000; seeking 1 Society for every 200 families or 1 Society for every two villages.

5 to 10 Primary Societies is a cluster of which is serviced by 1 field officer from the District.

USAID funds should go to the District Level and be lent on a referral basis to Primary members.

Own Money Flow

Member
↓ ↑ 15% / 16% interest paid
Primary TCCS
↓ ↑ 18% interest paid
District Union

Federation - Interest charged 21%
↓
District
↓
Member - Interest paid 23%

On a consolidated basis the spread stays within the system.

Collections will be better if USAID money flows through the Federation

- monitoring
- Federation bears the credit risk.
- can advance funds within two weeks.

Question of priority — Housing must get equal priority with agriculture etc.; credit question is separate.

Federation - can undertake credit training
- Six months payment period is acceptable depending on the cash flow pattern.

RRDB have been problematic to TCCS.

T.G. Savundranayagam, Director Development Finance Department, Central Bank, Second Meeting

Selected six RRDB at first - via USAID and the Banking Development Department of the Central Bank.

It is difficult to streamline the paper process but possibly, it could be streamlined since the Sub-Apex Lender takes the credit risk. However, the Central Bank has found a few instances of double lending on the same collateral.

He would not be worried by the TCCS as primary lenders.

There are psychological reasons for requiring extensive documentation (re-collection)

Regarding the Loan Guaranty scheme, perhaps private insurers such as Ceylinco and Union Trust could take this on.

Concessional funds cannot be used for any purpose other than Housing Loans. Therefore, only reimbursements are allowed rather than advances. The Central Bank would consider a six-month in advance repayment plan.

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