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PADCO

PLANNING AND DEVELOPMENT COLLABORATIVE INTERNATIONAL, INC.

EVALUATION OF THE LOW-INCOME SHELTER PROGRAM SRI LANKA

Prepared for
USAID/Sri Lanka

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September 1994

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ABSTRACT

The purpose of this report is to evaluate Phase IV of the USAID Low-Income Shelter Program (LISP) in light of the expected goals, purposes, and objectives as enunciated in the program design documentation. Phase IV covers the first $10 million tranche of a Housing Guaranty loan authorization of $25 million. The evaluation assesses the impact of the Program on the shelter situation in Sri Lanka and the Government's housing policies. It identifies the achievements and constraints to date and recommends appropriate actions to be taken by USAID and the Government of Sri Lanka (GSL) to improve the Program. Finally the evaluation looks at the sustainability issues and attempts to identify the needed inputs to assure the continuation of Sri Lanka's housing programs for low-income families and the use of the remaining $15 million in Housing Guaranty authority under Phase IV. The evaluation period covers those activities undertaken since Phase IV was amended in March 1991, to the end of July 1994. PADCO assigned Dan Coleman to carry out this assignment.

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ACRONYMS AND ABBREVIATIONS

AID	Agency for International Development
CBSL	Central Bank of Sri Lanka
CP	Condition Precedent
GSL	Government of Sri Lanka
HDFC	Housing Development Finance Corp. of Sri Lanka
HG	Housing Guaranty
LISP	Low-Income Shelter Program
MHP	Million Houses Program
NHDA	National Housing Development Authority
NSB	National Savings Bank
PACD	Project Activity Completion Date
PDP	Program Delivery Plan
PP	Project Paper
RHUDO	AID Regional Housing and Urban Development Office
RRDB	Rural Regional Development Banks
SMIB	State Mortgage and Investment Bank
TA	Technical Assistance
TCCS	Thrift and Credit Cooperative Society
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

USAID's Low-Income Shelter Program (LISP) began in 1981 with the approval of a $100 million Housing Guaranty Program and the authorization of the first phase of $25 million, plus technical assistance. Phases II and III totaling $35 million were authorized subsequently, giving a total program of $60 million, all of which was borrowed by mid-1988. Phase IV was authorized in 1987, however a loan "forgiveness" action by the Government of Sri Lanka (GSL) caused the delay of this program, until USAID was satisfied that this did not signify a change in government policy. Finally, this phase was initiated in March 1991, with the signing of Amendment No. 1 to the Phase IV Implementation Agreement. A Program Delivery Plan prepared some six months later confirmed the use of only $10 million of the Phase IV authorization as a first tranche. Of the $10 million in Housing Guaranty (HG) funds, the GSL and USAID agreed that 60 percent would be used to make market rate loans for below-median-income families, and the remainder would be used to make grants to the poorest of the poor, thus making a clear distinction for the use of subsidies.

The Project Goal is to improve the shelter and environmental conditions affecting the urban and rural poor, while the Project Purpose is to assist the GSL develop shelter policies and structure programs and solutions which increase the effectiveness of limited government resources, through coordination with the private sector, and to provide maximum benefits to lower-income families. Phase IV also authorized the use of $750,000 in grant funding for technical assistance and training to support the housing activities.

In addition to the physical shelter outputs, the project contemplated a number of policy and institutional outputs or objectives, which can summarized as follows: (a) develop policies and programs for market oriented housing finance within the context of both structural reform in financial and capital markets and overall shelter policies; (b) rationalize the public sector role in financing shelter; and (c) develop instruments and procedures to facilitate the growth of the housing finance market and remove barriers and disincentives to market growth.

To date a number of impressive achievements have been made. The Central Bank of Sri Lanka (CBSL), which is the implementing agency for the loan component, has approved 42,196 loans for a value of Rs 420 million, all of which were originated by the eight lending institutions participating in the program. Loans range from Rs 7,245 ($ 148) to Rs 86,778 ($ 1,771), with the average loan being Rs 10,008 ($ 204). In keeping with the program requirements, all the borrowers have incomes below the median of Rs 5,475. In addition, the National Housing Development Authority (NHDA), which is implementing the grant component has made 76,055 grants totaling Rs 213 million. These physical outputs exceed the expected number of loans and grants as indicated in the original documentation.

Not all the institutional and policy objectives have been achieved since the program is only about halfway through its expected life. One objective, that of developing market rate lending policies and programs, has been achieved. All the institutions participating in the program are only making market rate loans, including loans financing from sources other than USAID. In addition, all the institutions except the NHDA are achieving virtually full loan recovery rates. The acceptance of these two policies throughout the industry means that the stage is now set to generate long-term housing resources through private sector domestic borrowings.

The second objective of rationalizing the public sector has been only partially achieved. The successful element here is that the public sector is only making grants or subsidies to families who are too poor to borrow. All other families must obtain financing at market rates. This means that scarce government funds are only being directed to assist the poorest of the poor with housing. The less successful part of this objective is that the NHDA is still making housing loans, instead of just making grants and involving itself in policy matters. Nevertheless, the NHDA is making these loans at market rates, and, therefore, it is not distorting the market by making below-market loans.

The third objective has been limited to some degree also. Little progress has been made in developing housing finance instruments and procedures, and it is in this area that the emphasis must be placed during the remainder of this housing program. This is particularly relevant because the two principal sources of external financing — USAID and the ADB — will probably wind up their programs by the end of 1995. Instruments and procedures to generate additional funds must be in place by that time to ensure a continuation of funding for the housing sector. In this way the key issue of sustainability will be confronted and solutions developed.

The Program has encountered its share of problems. The biggest has been the inability of the GSL to allocate sufficient funds to the CBSL to make disbursements for the approved loans. Only Rs 150 million has been reimbursed to the lending institutions, leaving unmet disbursements of about Rs 270 million. This problem should abate when the first HG borrowing takes place shortly and when the national elections are over. The second major problem is the bureaucratic process through which the loans must be approved. The present CBSL procedure increases lending administration costs, and discourages many private sector borrowers from increasing their participation. But, given that the CBSL must comply with the Monetary Act, it is unlikely that this problem can be mitigated significantly.

In the coming months and year, the USAID housing program must focus on the sustainability aspects of the program. A new Program Delivery Plan must be prepared immediately for the use of the remaining HG funds and technical assistance. The Program Delivery Plan (PDP) must recognize that the principle need will be to strengthen those primary lending institutions making secured or mortgage loans, rather than unsecured loans. The purpose of this focus is to ensure a supply of mortgages, which, in turn, can be used by the primary lenders to raise funds in a to-be-created secondary market. To ensure this supply of funds, the proportion of all future loans may need to be increased from the current 60 percent of HG loan funds, while the participation of the NHDA may be decreased so that the mortgage lending institutions can increase their output of secured mortgages. The creation of a secondary market to supply wholesale funds to the primary market should be an additional focus of the USAID housing program. Finally, the program should assist in the development of the proper regulatory and supervisory environment that is so necessary to nurture the primary and secondary housing markets.

1

EVALUATION OF THE LOW-INCOME SHELTER PROGRAM SRI LANKA

1 Background

In January 1981, USAID approved in principle the Low-Income Shelter Program (LISP) Project Paper (PP) for $100 million in Housing Guaranties plus related technical assistance. The stated goal of the LISP program is to improve the shelter and environmental conditions affecting the urban and rural poor. The Project Purpose is to assist the Government of Sri Lanka (GSL) develop shelter policies and structure programs and solutions that increase the effectiveness of limited government resources and provide maximum benefit to lower-income families. This same PP authorized the first phase for $25 million in Housing Guaranties. Subsequent PPs authorized two more phases of $10 million and $25 million, for a total of $60 million in Housing Guaranties and technical assistance to implement this important shelter program. The final Housing Guaranty (HG) borrowing for Phases I, II, and III took place in July 1988.[1]

In August 1987, a USAID consultant prepared an evaluation of the three initial phases of the LISP program.[2] The consultant summarized the achievements of the LISP program as follows:

> "Looking over the 1981 to 1987 period, however, what stands out are not the failures, but the successes and the movement and growth which has taken place in the sector. Under the UHSP and RHSP (urban and rural housing programs), approximately 130,000 families have completed construction or improvement to their homes and another 50,000 are in process. The Sri Lankan housing program has moved from a high cost and concentrated effort to a low cost, extensive national program. It has steadily moved from a large to smaller annual budgets, from providing fewer units at high cost to many at much lower per unit cost, from fewer, wealthier beneficiaries to a far greater number of beneficiaries at median income or below, from One Hundred Thousand Houses to One Million Houses as a program target, from reliance on the government to provide housing to participation of government with the private sector to enable individuals and families to provide housing for themselves, from grants to no interest to low interest loans, (most recently, 6 percent loan charges) and from extremely low or non-existent collection efforts to marginally improved collection with a stronger commitment to improve."

[1] See Annex 1 for a brief description of the first three phases.

[2] See the Evaluation Report by Holloran, 1987.

Based in part on the recommendations contained in the above-mentioned evaluation, USAID authorized Phase IV of the LISP program in August 1987, for an additional $25 million in Housing Guaranties, thereby increasing the total authorization to $85 million.[3] USAID and the GSL executed an Implementation Agreement on March 30, 1988. During this fourth phase of the program, USAID and the GSL agreed to continue to shift the emphasis of the housing program to the "development of a market-based housing finance system by finding ways to enable market forces to play a more active role in the setting of interest rates and ways of increasing the role of the private sector and market-oriented organizations as housing lenders to low-income people, with the NHDA moving out of direct lending and into a more policy-making role."[4]

However, in late 1988, prior to any borrowings under Phase IV, USAID suspended the LISP program. The reason for this drastic step was the announcement in August of that year by the then-Prime Minister that housing loan repayments by low-income borrowers on food stamp assistance would be paid by a philanthropic government account. This announcement was misinterpreted by borrowers in other income categories, who almost unanimously ceased repaying housing loans. Loan recoveries under the HG-financed program fell to virtually zero, thus triggering USAID's decision to halt the implementation of Phase IV.

After the cessation of USAID's housing program, USAID initiated discussions with the GSL on how to rectify the damage to the housing sector, as well as whether and how to reactivate Phase IV. One USAID base document written at that time summed up the Mission's position: "Discussions with various GSL officials convinced USAID that the loan forgiveness did not constitute a change in housing policy, but was rather a political response to the crisis faced by Sri Lanka during the 1988 election campaign."[5] Thus USAID reconsidered its earlier decision and instead decided to continue working to improve shelter conditions for the urban and rural poor in Sri Lanka. In the meantime, the GSL agreed to begin the process whereby the lending institutions would be compensated for the financial damage resulting from this unilateral GSL action.

Given the decision to restart the housing program, consultants under contract to USAID prepared two studies[6] in 1989 to help determine the prospects and direction of the LISP program. Based on these studies and numerous policy discussions, USAID and GSL housing and finance officials revised the Phase IV program. On March 28, 1991, USAID and the GSL signed Amendment No. 1 to the Implementation Agreement of March 30, 1988, which

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[3] Phase V for the remaining $15 million of the $100 million LISP program was authorized in July 1988 to provide assistance to war-damaged housing in the northern provinces. USAID deauthorized Phase V in August, 1993, thus $15 million in program funds will still remain unused after Phase IV is fully disbursed.

[4] In a memo from D. Tsitsos to the ADB, describing in brief all four program phases, Feb. 13, 1991.

[5] See USAID Action Memorandum, March 11, 1991.

[6] See Apt Associates (Merrill, Tufts, and Garnett), 1989, and CMS, Inc. (Griffin, Jeter, and Richardson), 1989.

reflects the new program objectives and strategy. Amendment No. 1 and supporting documents thus form the basis for this present evaluation, which covers the Phase IV implementation period from the date of that Amendment through July 1994.

2 Summary of Goals, Purposes, Inputs, and Outputs

2.1 Project Goal

The Project Goal has remained constant throughout the design and implementation of all four phases of the $100 million Housing Guaranty Program. The Goal of the LISP program is **to improve the shelter and environmental conditions affecting the urban and rural poor**.

2.2 Project Purpose

The Project Purpose has essentially remained the same; however, in the Phase III Project Paper (HG-003), the purpose was modified slightly. The original Purpose was **to assist the GSL develop shelter policies and structure programs and solutions which increase the effectiveness of limited government resources and provide maximum benefits to lower-income families**. In the Phase III PP, the phase **through coordination with the private sector** was added after the phase **limited government resources**, thus reflecting the constant evolution of the program towards private sector solutions. However, the added phase is not contained in the Phase IV Project Paper or related documents, which is probably an oversight since clearly Phase IV is a follow-up to the Phase III private sector housing initiatives.

2.3 Project Inputs

The Project Inputs for Phase IV consist of **$25 million in housing guaranties and $750,000 in technical assistance and training**. Prior to the signing of Amendment No. 1 of Phase IV, USAID and the GSL agreed that a $10 million tranche would be an appropriate initial step. The first official reference to this decision is contained in an internal USAID note written by the Mission Housing Officer in early 1991, in which she states: "The borrowings would be tranched, with the first one now estimated at around $10 million."

Technical assistance and training inputs contemplated the inclusion of the services of one long-term personal services contractor during part of the implementation period, a number of short-term consultancies from expatriate and local consulting firms, housing finance training, and the acquisition of computer equipment.

2.4 Project Outputs

The Project Outputs are clearly stated in the narrative section of the Phase IV Project Paper written in 1988, covering both physical as well as institutional outputs. The physical outputs enumerated in the Phase IV PP are those outputs that are relevant to the entire project, i.e., all four phases, and are almost identical to those stated in the Phase III Project Paper.[7] The narrative description of these physical outputs in the Phase IV PP can be summarized as follows: (a) finance approximately 80,000 small shelter loans to rural households and about 20,000 small loans to urban households, both under the MHP; (b) make approximately 2,500 mortgage loans to eligible households by private finance institutions; (c) assist local authorities to carry out demonstration small-scale urban development activities; and (d) provide some 500 settler township households in the Mahaweli with shelter finance.

The institutional Outputs in this same PP are: (a) NHDA will be making loans which carry an interest rate linked to prevailing market conditions; (b) NHDA will have moved from a low rate of collections (approximately 10 percent in 1983) to at least 77 percent with concomitant reductions in subsidy levels; (c) SMIB, HDFC, selected private sector credit union/cooperatives, and possibly other new private housing finance organizations will emerge as strengthened institutions; (d) these same institutions will have the ability to both raise and lend funds with are not provided by the GSL; (e) these institutions will extend their lending facilities to households of below median income; (f) NHDA will become a "regulatory" agency, while the private sector and NGOs will take over the development and financing of housing for median income households; (g) appropriate financial organizations will extend credit for house building or rehabilitation to the Mahaweli areas; and (h) local authorities will have restructured their finance procedures and revenue base and entered into "turnkey" arrangements with private developers for the provision of urban development.

The PP for Phase IV does not contain a Logical Framework summarizing the outputs and providing objectively verifiable indicators for use in an evaluation. The original Implementation Agreement states that 80,000 families would benefit under the Phase IV as designed in 1988. Amendment No. 1 does not incorporate any discussion on "Project Outputs," but it does include a number of objectives, which could serve, in part, as the Project Outputs. In one internal USAID document,[8] reference is made to an estimated **5,000 beneficiaries of the grant component**, but no estimate is provided for the expected number of loan beneficiaries. On the other hand, the Program Delivery Plan (see below) estimated that the number of **beneficiaries for the first tranche of the loan component to be 23,067 families. These last two quantitative figures — 5,000 grantees and 23,067 borrowers — will be used as the measure of physical outputs under the first tranche of the Phase IV Program.**

Amendment No. 1, which to some degree supersedes the PP, focuses heavily on a number of institutional and policy objectives, implicitly treating them as project outputs, rather than physical objectives. It actually incorporates many of the outputs listed in the original Phase IV PP, as related above. Outputs in the PP with respect to market rate loans, recovery rates, and institutional strengthening are just as relevant to the amended Phase IV as the original

[7] The Project Paper for Phase IV does not contain a Logical Framework.

[8] Tsitsos, Note of the Proposed USAID Housing Guaranty Support, January 24, 1991.

version. Amendment No. 1 objectives, or rather the institutional and policy outputs, are listed as follows:

- Achieve an equitable and efficient balance between the roles of the public and private sectors in meeting the shelter needs of low-income households, which will include making the public sector provision of finance more market oriented, with clear identification of any subsidy elements and limitation of such subsidies to those beneficiaries whose needs cannot be met by market-oriented loans and private sector housing finance;
- Strengthen the GSL's shelter finance system to mobilize capital for shelter, with the National Housing Development Authority (NHDA) expanding its role as a shelter policy and program development agency while private and market orientated financial institutions such as banks and private credit societies increase their role in the provision of housing credit; and
- Institute policies and procedures to provide shelter finance that is affordable to low-income households and thereafter to recover from beneficiaries costs of government shelter programs so that funds recovered from earlier projects will be available to finance new shelter construction on a sustainable basis.

Annex A of Amendment No. 1 is a description of the project as agreed by USAID and GSL. It stipulates clearly what is expected to occur during the life of this project, which are:

- The public sector institutions will move increasingly toward (a) a regulatory function that will protect borrower and public interests in an open market, and (b) a policy making function as opposed to primary implementation responsibilities.
- The Program Component will provide for a grant program for very low-income households to be implemented by NHDA, and a market rate loan program for low-income families with some borrowing capacity to be implemented by selected lending institutions. It also provides for a mixed grant/loan program for households who are creditworthy, but whose incomes are not high enough for market rate loans.
- A Housing Finance Action Group will be set up to identify needed policy changes, analyze them, and advise the GSL on implementation of policy changes.
- USAID will provide $25 million of the multi-year $100 million Housing Guaranty Loan program, along with long- and short-term technical assistance and training, subject to the availability of USAID funds.
- Beneficiaries will be families with incomes below the median income level who are participating the One Point Five Million Housing Program.

2.5 Project Delivery Plan

Amendment No. 1 also states that the details for implementing Phase IV will be contained in a Program Delivery Plan (PDP), to be prepared once the Amendment is signed by USAID and the GSL. Accordingly, a PDP was completed by expatriate consultants in consultation with the GSL and USAID in October 1991. In the background section on Page 1 of the PDP, it states erroneously that: "On March 28, 1991, Project Amendment No. 1 was executed that provides for US$10 million in borrowing authority...." It should be clearly understood that Amendment No. 1 provides for $25 million in borrowing authority. The $10 million covers only the first tranche of the $25 million loan authorization under Phase IV.

The PDP accomplished the following objectives:

- Established the median income and provided for annual updates of this figure, as well as procedures for beneficiary selection.
- Divided the $10 million initial tranche into approximately the rupee equivalent of $6 million for loans and $4 million for grants.
- Confirmed the composition of the Housing Finance Steering Committee (the same Housing Finance Action Group identified in Amendment No. 1).
- Created the organizational structure through which the loan program would be implemented and identified the principal institutional players.
- Set up the lending criteria and determined the market interest rate for the program.

In late 1992, the GSL completed the preparation of the PDP, at which time Phase IV of the LISP program moved into the implementation phase of development.

3 Conditions Precedent

Amendment No. 1 of the Implementation Agreement for Phase IV contains eight conditions that the GSL must meet prior to selecting a Lender under the HG program. These conditions precedent (CP) also affected the start-up of the program insofar as some of them had to be met prior to implementing the project. Listed below are the CPs, the date they were met, and the actions taken to satisfy them.

- Evidence of the establishment and staffing of the Housing Finance Action Group (the Steering Committee).
  - Action: The Steering Committee was formally established in July 1991; the first meeting took place that same month. The establishment of this Committee played a major role during 1991/92 in persuading the GSL to take important steps to advance the program.
- Documentation that final agreement has been reached between the NHDA and the Thrift and Credit Cooperative Society (TCCS) regarding disposition of loans made and service by the TCCS under the Million Houses Program.
  - Action: A formal agreement whereby the NHDA would reimburse the TCCS for all loan losses was reached in October 1991.
- Designation of the apex lending institution.
  - Action: The Central Bank was identified as the apex institution in early 1991, it was confirmed as such in the PDP in October 1991, it was formally appointed as the apex bank in March 1992.

- Completed Program Delivery Plan.
  - Action: The GSL, in conjunction with USAID Consultants, completed the PDP in October 1991.
- Evidence of the establishment by the NHDA of new program guidelines.
  - Action: The NHDA program guidelines were prepared and submitted to USAID on April 15, 1992.
- Estimated financial requirements for the first year of the program.
  - Action: The PDP contained an estimate of the financial requirements for the first year of operation.
- Copies of executed interagency agreement, including apex lending on-lending agreement necessary for program implementation.
  - Action: Following interagency agreement, with date, are listed below:

Agreement	Date
GSL/Central Bank of SL (CBSL)	March 19, 1992
Bank of Ceylon-NHDA (loans only)	October 15, 1992
CBSL-Peoples Bank	May 7, 1992
CBSL-Seylan Bank	May 8, 1992
CBSL-Hatton Nat'l Bank	May 14, 1992
CBSL/SMIB	April 6, 1992
CBSL-Commercial Bank	July 15, 1992
CBSL-Rural Banks	June 24, 1992[9]
CBSL-HDFC	June 29, 1993

4 Assessment of Project Achievements

4.1 Project Implementation

The signing of Amendment No. 1 in March 1991 was the starting date for the revised Phase IV Program. Between then and the date the first loans were made in October 1992, a period of 18 months, the position of expatriate housing advisor was largely vacant. The Mission Housing Advisor departed shortly after Amendment No. 1 was signed, yet the PSC Housing Technician was not hired until the summer of 1992. While this might have been merely coincidental, the fact remains that the Mission Housing Division was short-handed during this critical start-up phase.

The first major activity during this period was the preparation of the Program Delivery Plan in late 1991. Once this document was completed, the CBSL, as the implementing agency,

[9] While the overall agreement to involve the RRDBs in the program was reached on June 24, 1993, agreements with individual RRDB were as follows: Kandy, Kurunegala, Puttalam, Matale Badulla, and Kegalle on March 18, 1993, and Gampaha and Matara on August 4, 1994.

undertook a number of actions, the most important being: (1) preparation of the operating procedures and instructions; (2) execution of the interagency agreements, particularly those agreements between the CBSL and the several sub-apex/primary lenders; and (3) securing an advance from the GSL Treasury which, in turn, would permit the CBSL to authorize the primary lenders to initiate their lending operations. Of these three, the most time-consuming was the preparation of the operating instructions, which occupied the CBSL for well over half of 1992. Only when this document was approved in September 1992, was the CBSL able to initiate the program. The CBSL obtained the first Rs 100 million advance that same month, and the lending institutions began making eligible loans. As these loans were made, they were presented to the CBSL refinance window for approval and refinancing (loan reimbursement).

In the first nine months from October 1992 to June 1993, the CBSL approved 9,409 loans totaling Rs 69.1 million, which was, arguably, a slow start-up. As the institutions gained experience and the program matured, lending activities accelerated, and during the last half of 1993, 18,522 loans in the amount of Rs 172.2 million were approved, giving a total of Rs 241.3 million (about $5.3 million) in approved loans by end of that year. By the end of February 1994, the entire first tranche of $6 million in housing loans had been approved.

However, a problem arose in late 1993. Although HG advances were permitted under the terms of Amendment No. 1, USAID had determined that disbursements to the HG Borrower (the Ministry of Finance) would only be made to reimburse the Borrower for Eligible Expenditures actually incurred. Thus, the GSL Treasury would advance money to the CBSL to refinance the program lenders, and only after the rupee loans were disbursed to eligible borrowers would the GSL be able to borrow the HG funds. This procedure worked well initially because the CBSL was able to obtain advances from the GSL Treasury in the amount of Rs 150 million (in two trances of Rs 100 million and Rs 50 million), which it used to refinance the loans.

After disbursing all of the advance funding, the GSL was unable to access additional funds from the Treasury, and therefore in January 1994, it had to close down the refinance window temporarily, and it remains closed today. The CBSL continued to approve loans, but the volume declined in the first few months of 1994 because the lending institutions lacked the internal financial resources to sustain disbursements at the approval rate. Although lending has continued, with new approvals of Rs 120 million in the first half of 1994 alone, CBSL disbursements will remain frozen until the Treasury makes new advances or the HG funds are borrowed and disbursed, whichever is first.[10]

[10] It should be pointed out that in June and July 1994, loan approvals soared, which may reflect the fact that national elections are being held the following month.

As of the end of July 1994,[11] the CBSL had approved Rs 420.5 million in loans submitted by the lending institutions. At today's exchange rate of Rs 49 to the US$, this translates into about $8.6 million, or $2.6 million in excess of the amount approved for loans under the first tranche of Phase IV. Including the NHDA grant program in the amount of $Rs 213 million, or about $4.35 million, the total amount of funds spent to date is almost $13 million. Thus, the GSL has exceeded the $10 million first tranche by $3 million. However, the GSL has not exceeded the Phase IV program authorization level of $25 million.

Table 1

Loan Approvals and Disbursements

	Approvals		**Disbursements**	
Quarter	**No. of Loans**	**Value (Rs 000s)**	**No. of Loans**	**Value (Rs 000s)**
4th Q. '92	4,273	27,380	2,990	7,610
1st Q. '93	3,551	30,993	3,975	11,178
2nd Q. '93	1,645	15,554	691	9,708
3rd Q. '93	9,391	78,791	8,276	55,539
4th Q. '93	9,131	93,423	9,374	52,477
1st Q. '94	3,355	60,857	599	13,478
2nd Q. '94	5,320	59,256	0	0
July '94	5,350	54,249	0	0
TOTAL	42,016	420,503	25,905	149,991

Source: Central Bank of Sri Lanka

To date, USAID/Colombo has committed funds for technical assistance and training under Phase IV in the amount of $648,288.[12] In addition, the RHUDO has contributed another $75,000 to help implement the project. The general breakdown for the use of the USAID/Colombo funds is as follows:

[11] All lending statistics provided by the CBSL are through July 31, 1994.

[12] These figures were provided by USAID/Colombo.

Item	Committed Funds
Long-term TA	$290,535
Short-term TA	258,278
Training	73,651
Computer Acquisition	25,824
TOTAL	$648,288

The long-term advisor arrived at post in June 1992, and was assigned full-time to this project for about one year. After the first year, he worked part-time on this project and part-time on the PPI project until the present date. The short-term assistance consisted of eight separate consultancies in specific technical areas. Training consisted principally of sending five Sri Lankans to attend the Housing Finance Seminar at the Feds Center of the University of Pennsylvania. Computer equipment was provided to the National Planning Department of the Ministry of Policy Planning and Implementation (the counterpart agency) and to the Central Bank of Sri Lanka (the Apex Bank).

The balance of non-committed funds as of July 31, 1994 is approximately $100,000 of the $750,000 in funds allocated under PIL 29. Annex 2 provides a more detailed breakdown of the TA and training component, including costs.

4.2 Major Achievements

4.2.1 Physical Achievements

Under Phase IV, the goal of improving the shelter and environmental conditions of the rural and urban poor was achieved. As of July 31, 1994, a total of 118,215 poor families have received loan or grant assistance from HG derived funding to improve their shelter conditions. Of this amount, 42,016 families have received loans, while an additional 76,055 families have received grants. Since USAID estimated that only 23,067 families would benefit from the first tranche of $6 million in loans, the figure of 42,016 beneficiaries for the first round of approvals of $8.6 million far exceeds the expected output. The 76,055 beneficiaries who actually received grants far surpasses the 5,000 families who were expected originally to receive assistance under the grant component.

The Program Goal of reaching poor people has also been achieved. All the beneficiary families have incomes below the median, as adjusted periodically, and which today is calculated at Rs 5,475 monthly or US$112. The average loan size from the various lending institutions ranges from Rs 7,245 ($148) to Rs 86,778 ($1,771), with the all-institutional average being Rs 10,008 ($204), all of which are affordable to below-median-income families. When the very low-income loans made by NHDA are excluded, then the average loan size from the remaining, mostly profit-oriented lending institutions is still a very affordable loan of Rs 27,084 ($552) for below-median-income borrowers. The second column in the Table 2 below gives a better idea of average loan sizes being made by the different institutions.

Table 2

Loans by Institution

Institution	Average Loan Size	Number of Loans	Percent of Loans	Value of Loans (Rs 000s)	Percent of Value
Rural Banks	28,494	589	1.4	16,783	4.0
B. Ceylon	7,245	36,126	86.0	261,717	62.2
SMIB	49,209	470	1.1	23,128	5.5
HDFC	55,690	260	0.6	14,480	3.4
Peoples B.	22,498	4,223	10.1	95,010	22.6
Com. Bank	51,080	25	<0.1	1,277	0.3
Hatton Bank	18,083	290	0.7	5,244	1.3
Seylan Bank	86,788	33	<0.1	2,864	0.7
TOTAL	10,008	42,016	100.00	420,503	100.0

Source: Central Bank of Sri Lanka

All the institutions listed in Table 2 are primary lenders, except Bank of Ceylon, which is the sub-apex bank for the NHDA. Bank of Ceylon is not participating as a primary lender yet. Insofar as NHDA has the widest branch network and the most experience in Sri Lanka in providing housing assistance to low-income families, it has made the bulk of the loans, some 36,126 or 86.0 percent of the total. Peoples Bank, a government-owned institution albeit purportedly profit-oriented, has made the second largest amount of loans, 4,223, or 10.1 percent. In terms of loan value, NHDA's percentage drops to just 62.2 percent of the total value, which reflects its clientele of lower-income beneficiaries.

The Project has also achieved its goal of reaching both rural and urban families. Contrary to most USAID housing programs, the majority of the beneficiaries to date live in the rural areas of Sri Lanka. Of the 42,016 beneficiaries as of July 31, 1994, 35,345 or 84.55 percent are rural families, which exceeds the percentage of all Sri Lankan (78.6 percent) of families who live in the rural areas. The average size of rural loans is significantly lower than urban loans — Rs 9,416 versus Rs 14,418 — which further reflects the lower-income level of rural families. Table 3 shows the rural/urban loan distribution by institution and average size.

Table 3

Rural/Urban Loan Distribution

	RURAL			URBAN		
Institution	Number of Loans	Average Loan Size	Average Family Income	Number of Loans	Average Loan Size	Average Family Income
Rural Banks	589	28,494	3,108	NA	NA	NA
BCeylon	31,261	6,669	1,177	4,865	10,939	1,714
SMIB	265	48,467	3,474	205	50,168	3,718
HDFC	216	54,349	3,581	44	62,272	3,954
PeopleB	3,321	22,999	3,031	902	20,651	3,150
Com.B.	19	48,526	3,607	6	59,167	3,842
HattonB.	247	17,981	2,603	43	18,953	3,102
Seylan B.	16	75,937	3,560	17	97,058	3,695
TOTAL	35,934	9,416		6,082	14,418	

Source: Central Bank of Sri Lanka

Other relevant aspects of the Phase IV program include the various purposes for which the loans were made and the maturity dates of the loans. To date, most loans have been made for the construction of new homes and the improvement of existing homes. Statistics show that 26,210 loans have been made for construction purposes or 62.4 percent of all loans, while 14,872 loans or 35.4 percent were dedicated to improving the borrower's home. Another 833 loans or a small 2 percent were used to purchase land, while a negligible 101 loans were made for infrastructure purposes.

Table 4

Loan Purpose

	Number	Percentage
Construction	26,210	62.4
Improvement	14,872	35.4
Land	833	2.0
Infrastructure	101	0.2
TOTAL	42,016	100.00

Source: Central Bank of Sri Lanka

Loans can be granted for varying periods up to 20 years, however most of the loans were for less than 10 years. Loans for 5 or less years totaled 13,696 or 32.6 percent, while a larger amount of loans, 21,021, or exactly 50 percent, were granted for a period of between 6 and 10 years. Loans for 10 to 15 years were still popular, with 7,280 being granted, but only a few loans, 19 to be exact, were made for more than 16 years.

4.2.2 Institutional and Policy Achievements

Phase IV is heavily orientated towards achieving a number of policy objectives. These objectives, as enumerated in Amendment No. 1, can be stated succinctly as follows:

- Develop policies and programs for market oriented housing finance within the context of both structural reform in financial and capital markets and overall shelter policies in Sri Lanka;
- Rationalize the public sector role in financing shelter; and
- Develop instruments and procedures to facilitate the growth of the housing finance market and remove barriers and disincentives to market growth.

In each of these policy areas, the program achievements are described fully in the following paragraphs.

Develop Market Oriented Housing Finance Policies and Programs

Market Rate Lending. As a result of this Program, the GSL has adopted the policy that all lending by both private and public financial institutions must be at market rates. Housing loans are now being granted at an interest rate of no less than 20.5 percent annually, which is generally accepted as a market rate in Sri Lanka, although some housing loans are being made at interest rates as high as 25 percent. This market rate policy has also been accepted by the NHDA, the primary housing agency in the country. In conversations with representatives of the lending institutions participating in the program, borrowers are not deterred by these rates. Apparently the only two alternatives to the USAID program for poor families are a higher interest rate loan from the informal sector or no loan at all; both are clearly worse alternatives.

By applying the USAID program guidelines to all programs, NHDA has fully eliminated all lending at below market rates, and instead has adopted programs that provide either grants or market rate loans, nothing in-between. NHDA is now offering all financial assistance for housing under three basic programs, regardless of the source of funds. These three categories are:

- Poorest of poor families with no means whatsoever to build their own shelter will be provided with Pure Grant Assistance, i.e., a direct subsidy for housing purposes. Families with incomes of less than Rs 300 monthly qualify. Grants are provided in amounts up to Rs 7,000 for rural families and Rs 10,000 for urban families.
- Low-income families with inadequate loan repayment capacity will be provided with a Loan plus a Bridge Grant Assistance. Families with monthly incomes between Rs 300 and R 1,800 in rural areas (Rs 2,300 in urban areas) qualify. The proportion of loan to grant varies according to income, with the maximum grant/loan package not exceeding R 12,500 in rural areas and Rs 17,500 in urban areas.
- Low-income families with adequate loan repayment capacity will be provided with Pure Loan Assistance. Families with incomes between Rs 1,800 and Rs 3,500 monthly in rural areas (Rs 4,000 in urban areas) qualify. Loans cannot exceed Rs 17,500 in rural areas and Rs 25,000 in urban areas.

As a result of the direct intervention of Phase IV, NHDA has rationalized its grant and lending policies and programs, as described above, which apply to all its financial assistance programs. This policy effectively eliminates all below-market rate lending programs, establishes a financial assistance program based on income and affordability, makes all subsidies explicit, and focuses NHDA's attention on recycling loan repayments for new housing loans. Further, this policy conforms to the expected outputs and strategic objectives of the Phase IV Program.

The other financial institutions participating in the program are only providing pure housing loans, all at market rate terms. This applies across the board to public and private sector institutions, to mortgage and commercial banks, and to urban- and rural-based institutions. **The acceptance by all eight of the participating institutions that all housing and mortgage lending must be at market rates is a major accomplishment of the USAID Program.** Furthermore, National Savings Bank, a housing lender which is not participating in the program, has also institutionalized the policy of market rate lending and is now making all housing loans, albeit limited, at rates equal to or higher than that under this program.

<u>Full Loan Recovery.</u> The key to universal acceptance of market rate lending is full or virtually full loan recovery rates. Conclusions about recovery rates for most of the participating institution are difficult to draw because all the loans are relatively recent and a

history of loan collections has not been documented. Profit-oriented lending institutions in both the public and private sector insist that the housing and mortgage loan repayments are being recovered. But the three private sector institutions claim that the cost of collecting these loans is too high and is one of the reasons why they are not fully satisfied with the program.

The NHDA is a special case. As the evaluation of Phases I, II, and III so eloquently states, the NHDA has transformed itself gradually from making only grants, to no-interest rate loans, to low-interest rate loans, and now to market rate loans. This has been a remarkable transformation, but one that is still not complete because the institution is not fully collecting market rate loans. However, the NHDA does not believe it will ever achieve more than a 65 percent collection rate, and, in fact, if it ever achieves this rate — and it has come close at 61 percent during one month — it will be satisfied. Reasons for this low level of expectation include the rural nature of most of its loans; borrowers with non-regular sources of income; low loan amounts coupled with high collection costs; high employment rates among poor people; remoteness of many rural borrowers; lack of financial sophistication of the borrowers; and difficulty in foreclosure. Nevertheless, NHDA is still making efforts to collect all loans, and recently instituted a new collection system whereby third-party collectors are hired on commission to make collections. Internal statistics show that collections have improved where this new system is being implemented.

NHDA has established the principal of market rate lending and loan recovery, albeit not full collection, among its clientele, and, in the opinion of the General Manager, this is a worthwhile achievement. Moreover, the NHDA is fostering financial responsibility in its target group, and, over the long run, it is expected that this will bring about important changes in the nation's financial system and the peoples' attitudes in Sri Lanka.

Rationalize the Public Sector Role

The objective here was to relegate the public sector to a role of policy formulation and to the provision of assistance through subsidy programs only to families whose needs cannot be met by market-oriented loans and the private sector. To some degree, this objective has been met in that the NHDA has developed and implemented the subsidy program for the poorest of the poor as described in the section above. All other families must obtain market rate loans regardless of the institutional source. On the other hand, the NHDA is still making market rate loans in part because no other institution has the institutional capacity to make the volume of loans that the NHDA has. A substantial part of this institutional capacity is due to the overstaffing of the NHDA, insofar as those costs are covered by the public sector budget. But at least the NHDA is not using this advantage to undercut the other lending institutions by providing below-market rate loans and thereby distorting the financial markets.

The problem is that the other lending institutions have not been able or have not wanted to increase their lending capacity. The two major mortgage lending institutions — HDFC and SMIB — remain small institutions with limited lending capacity due to their relatively few branches. The private sector commercial banks are larger and, in general, more widely located; however, they are unlikely to generate a large lending portfolio of low-income families, as is explained in Section 5 below. Of the two public sector commercial banks — Bank of Ceylon and People's Bank — only the latter has been active as a primary lender, and given the continued government control of these two institutions, it is uncertain to what degree they will commit their resources to housing. The Regional Rural Development Banks (RRDBs), or at least the five now participating in the program, are in general weak institutions, with minimal financial controls, although they do have the potential to be larger players. And, finally, the Thrift and Credit Cooperative Society (TCCS), which was active in previous USAID phases, has still not found a way to become involved in this phase of the program.

What all this means is that the growth of the financial institutions, other than NHDA, as mortgage lenders needs to increase significantly so as to develop the capacity of the primary lending sector. In this way, the primary sector will have the ability to use the additional capital that is expected to be generated for the housing sector now that the principal of market rate lending has been accepted. This is particularly true since the largest lender, the NHDA, makes non-mortgage loans that would not be acceptable as security for an institutional lender acting as a wholesaler in the provision of funds for the primary market.

Develop Housing Finance Instruments and Procedures

Achievement of the third objective has been limited. The creation of the Refinance Window in the Central Bank has been a step in the right direction, but only if it continues to be used as a conduit for addition external or internal lending resources. The procedures developed for using this window are worthwhile, although it is generally agreed that the procedures are too bureaucratic for small loan programs. On the positive side, the program has promoted the use of basic lending instruments for fixed-rate mortgage lending in those financial institutions not previously involved in the mortgage lending business. With time, all the institutions will experiment with and adopt other lending instruments, probably variable lending instruments. But now is not the appropriate time, due to the relative lack of experience of all institutions in mortgage lending.

On the other hand, the financial sector has not developed the resource mobilization instruments and procedures that would assure the sector a steady flow of funds to be used for mortgage lending. Traditionally, housing has been financed by the Sri Lankan budget and by external donors. Savings has played only a minor role in resource mobilization while long-term borrowings from the domestic market have played no role at all. With the increased sophistication of Sri Lanka's financial markets, there is no reason why those markets cannot be tapped, particularly if the capital market restructuring plans, now in draft form, take place as planned. If they do, then the major collectors of funds — the National Savings Bank, the Pension Funds, and the Insurance Companies — will be able to play their role as a wholesale or second tier provider of funds to the primary lenders, including those institutions lending for housing purposes.

Savings mobilization from individuals is still an option. Despite the potential for asset/liability mismatches, i.e., short-term savings and long-term lending, it is still possible for savings to play a supportive role and this should certainly be explored. Although mobilizing funds from the small saver can be expensive unless it is done on a large scale through a comprehensive branch network, this potential source of funds should not be overlooked. But the existence of Sri Lanka's relatively advanced financial sector, and the potential for its enhancement, indicates that the use of wholesalers to generate funds would probably be a more cost-effective and realistic way of raising funds than saving. If a long-term source of internal funds is developed during the remainder of this Phase, then this objective will have been accomplished. The trick will be to ensure that these funds are directed to low-income families as well as families in the higher income brackets.

4.2.3 Serendipitous Achievements

The participation of women as borrowers under the program was not an stated objective when the program was originally designed. Nevertheless, statistics show that of the 42,016 loans to date, 13,022, **or 31 percent of all loans,** have been granted to **women-headed households**. While current figures on the number of women-headed households is not available, it is estimated that this figure is less than the percentage of women-headed households participating in this program.[13] Thus this program has been disproportionately beneficial to Sri Lankan woman.

5 Impact of the Program on the Housing Sector

5.1 Changes in Public Policy

5.1.1 Market Rate Loans

The major change in public policy is the GSL's adoption of the policy of charging market rates on housing loans to all but the poorest of poor families. By accepting this policy, the GSL has laid the groundwork for the use of market rate resources to provide housing assistance to low-income families. In turn, this allows the government to use its limited resources to assist only those families whose incomes are so low that they cannot qualify for housing credit. Concomitant with the market rate policy, is the policy of providing explicit subsidies for only the very low-income families rather than to provide subsidies for families that can afford to assume a housing credit. The principal impact of this policy change is that government funds will not be used to fund housing that low-income families can acquire otherwise through credit facilities.

A second policy change is the public sector's acceptance of full loan recovery as a realistic policy. As stated in an earlier section of this report, all but one of the public lending

[13] In 1981, the number of women-headed houses holds was 473,841. Given the increase in population and the socioeconomic problems, this figure has increased significantly since that time.

institutions have adopted this policy, and, as a result, they expect to recover almost all the loans made under this program. The one exception is the NHDA, which expects to collect no more than 65 percent, if that, of its loans. The impact of this policy is that these loans can be recycled through the housing finance system as they are repaid, thus ensuring that there will be some funding available for housing, regardless of other funding constraints.

5.2 Changes in the Private Sector Financial Institutions

As strictly defined, there are only three private sector financial institutions participating in the program: Bank of Seylan, Hatton National Bank, and Commercial Bank. These three banks have made a total of 348 approved loans to date, which is less than one percent of the total program. This level of participation is too low and the period of time too short to determine accurately if these financial institutions have truly changed their banking and lending policies as a result of their involvement in the program. Nevertheless, there are some indications that changes have occurred, whether they are permanent is unclear.

Prior to the initiation of this program, these banks made secured loans, with the proceeds being used for housing purposes. These loans were classified as personal loans, not housing loans. Most frequently, these loans were made to bank staff or to long-time customers and in no case, were loans made to low-income families. Today, three private banks are now making low-income housing loans. Due their small size, only a few of these loans are mortgage loans, which in itself is a relatively new phenomenon. Regardless, private sector banks participating in the program are now aware that low-income families can be creditworthy. Thus the program has exposed some of the private sector banks to housing lending in general and to housing for low-income families in particular. The impact of this new lending activity is that the private sector banks are now poised, at least potentially, to expand their housing lending to a wider market segment.

In the case of one of these banks, some consideration is being made to granting housing loans using the proceeds from a debenture issue backed by these same mortgage loans. In all probability, these loans would serve a higher income clientele; nevertheless, it is instructive that this bank is using the USAID Program as a springboard into a new lending market.

Yet, it is not clear whether any movement into the mortgage or home lending business constitutes a real policy change within these three private banks. While the large spread under the HG Program has been an incentive to them to enter into this market, they generally claim that they still lose money on the Program due to the high administrative and collection expenses of small loans relative to the income generated. The inability of the Central Bank to reimburse the banks for the approved loans has soured their appetite for the program, and, in fact, all three have virtually ceased lending until the reimbursement tap is turned on again.

Moreover, the Banks continue to mention that they are principally participating in the program for social reasons, i.e., their contribution to help house the nation's poor people.

For all these reasons, it is not likely they will be major housing lenders for poor people and instead they will be marginal lenders, particularly if they are unable to continue to obtain long-term financial resources with such a favorable spread. But if they use this program to develop housing programs to be funded by resources mobilized through savings or debentures, then this will constitute a positive policy change and accordingly have a major impact on the housing sector.

5.3 Changes in Public Sector Institutions

Five public sector financial institutions have participated in the Program. Two are specialized mortgage credit institutions — State Mortgage and Investment Bank, and Housing Development and Finance Corporation of Sri Lanka; two are commercial banks — People's Bank and Bank of Ceylon; and the fifth are the District-based RRDBs, of which five banks are participating at this time. All except the Bank of Ceylon are participating as primary lenders, although staff at the Bank of Ceylon have expressed some interest in moving from the sole role of sub-apex bank to NHDA to include some direct lending.

In general, all the public sector lending institutions express satisfaction with the LISP program. Their principal complaint is that the inability of the CBSL to reimburse them promptly for approved loans is affecting their credibility as well as their cash flow. The two specialized mortgage institutions are using the program to finance land purchase loans in conjunction with an ADB housing loan program, since the latter's lending terms do not permit the proceeds to be used for land purchase. The People's Bank and the RRDBs are using their loans for a wide variety of purposes; however, as their names implies, the RRDBs are only working in the rural areas.

The impact of the program has varied from bank to bank. For the SMIB, it is making loans available to low-income families, something it did not do prior to its participation in this program. For the HDFC, the LISP project permitted the institution undertake a number of new initiatives, including the provision of loans for low-income families for the first time, granting of loans for land purchase, the development of a title protection plan in lieu of title insurance and the development of new marketing techniques. For People's Bank, which had been lending to the housing market for years, it also permitted the institution to enter the low-income housing market. For the RRDBs, this was an opportunity to make housing loans for the first time. Thus in all cases, the USAID program permitted each of the government banks to undertake a new lending activity or to reach a new market segment.

6 Program Relevance

6.1 Relevance to the GSL Development Objectives

6.1.1 One Point Five Million Houses Program

Effective 1990, the GSL announced that a target of 1.5 million houses would be built by the year 2000. This new target follows two earlier targets, the 100,000 Houses Program initiated in 1978, and the Million Houses Program in 1984. The 1.5 million houses appears to cover the entire period of these three programs, which eventually will encompass 22 years (1978-2000) of shelter development.[14] The figure of 1.5 million units encompasses a broad range of shelter solutions, including land purchase, home improvement and expansion, and home construction. In essence, what it means is that 1.5 million families or households will have attained better shelter over the life of the target program.

The USAID housing program has made a significant contribution to the 1.5 Million Houses Program. Under the three initial phases of the program, USAID helped to finance about 180,000 shelter solutions, while with the equivalent of $25 million in HG funds under Phase IV, another 100,000 solutions will have been provided. Given the magnitude of the USAID contribution, and the overall shortage of funding from internal and external sources, it is evident that the GSL would have made far less progress in achieving its goal of 1.5 million houses by the year 2000 if USAID has not been involved.

6.1.2 Poverty Alleviation

The GSL is pursuing policies which focus of the alleviation of poverty in both rural and urban areas. In general, these programs are people-based development programs. They are predicated on the concept that people, and especially the poor, are self-reliant and can initiate, decide, and implement programs to help themselves. The overall approach is that the Government will provide support, but that the communities will decide and act. Therefore, these same local groups and communities can be empowered to devise solutions to their problems. This presupposes, among other things, that poor families are creditworthy and bankable, and that by combining credit with saving mobilization, poor families can free themselves from indebtedness and move into productive activities.[15]

The objectives of the USAID housing finance program intersects well with the objectives of the GSL's poverty alleviation programs because the USAID program assumes and has proven that poor people are creditworthy and bankable. USAID has led the way in showing that poor people can participate in the formal housing finance markets, and, by doing so, they can

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[14] It is not totally clear that the 1 million houses target was met by the end of the last decade, and that the new goal of 1.5 million houses is expected to be met during the decade of the nineties. At the present rate, the latter goal will probably not be met.

[15] See GSL Report on Poverty Alleviation.

secure productive loans that will permit them to help resolve their shelter problems, not simply put them deeper into onerous debt that they may never repay.

6.2 Relationship to the USAID Mission Strategy

LISP is making a major contribution to the Mission's strategic objectives in economic growth by providing increased opportunities for large numbers of people to participate in the formal financial sector, thus permitting them to contribute to as well as benefit from economic growth and development. Under this program, 118,071 poor families have benefited from increased opportunities to improve their living conditions. Of this number, about ___ percent have benefited by participating in a market-oriented program, whereby they are required to repay, at market rates, the loan they have received for this purpose. While not all these loans will be repaid, the very conditionality of loan repayment will have a positive impact on poor peoples' attitudes toward the market economy. Moreover the loan repayments will be rolled over to make additional market rate loans for more poor families, thus helping to ensure the continuation of this program.

This program further contributes to economic growth by bringing into the economic and financial system many poor families that previously were excluded because affordable lending programs for shelter did not exist for them. Therefore, because they are able to participate in the market economy through this program, they are able to contribute to national economic growth.

Assuming the remaining funds in the Phase IV authorization are used in essentially the same manner and rhythm as the first tranche, about 100,000 poor families will have benefitted from this program. Given that each household consists of about five persons, then some 500,000 persons, or about one in every 30 Sri Lankans, have or will have benefitted from this program by the completion of all of the Phase IV activities. This is not a negligible number of beneficiaries for an investment of $25 million in HG funds that will be repaid, and only $750,000 in grant funds.

The program also contributes to economic growth by filling out the remaining element in USAID financial markets objectives. Through the PPI program, USAID is fostering infrastructure financing, and, through its capital market program, it is promoting the capital market financing. The ongoing housing finance program completes and complements the overall efforts of USAID in financial markets.

6.3 Other Donor Assistance

The only other donor active in the housing sector is the Asian Development Bank, which has made a $21 million loan to provide financial assistance to the SMIB ($14 million) and the HDFC ($7 million) to on-lend to low-income families. The beneficiaries are similar to the AID program except that they provide for 75 percent loans, do not include loans for land purchase, and are for families at the 55 percentile on the income scale. Technical assistance is being provided under the ADB loan to those two institutions. The ongoing program is the only housing loan the ADB has made to Sri Lanka, and the ADB is not considering at this time any additional loans to the sector.

7 Sustainability of the Program

7.1 On Completion of the HG Program

Program sustainability is the most critical issue facing USAID and the GSL at this time. On completion of Phase IV, there is no assurance that the remaining $15 million of LISP will be authorized as a phase V activity. Therefore, it is crucial that the remaining funds in the Phase IV authorization be used in such a way as to ensure that all of the program objectives or outputs will be achieved, especially the institutional and policy objectives.

As indicated in Section 4 of this report, the first objective, that of developing market-oriented housing finance policies, has, to a large extent, been achieved and it will continue under the next tranche. All financial institutions involved in housing lending have accepted the policy of market rate lending for housing. The lending agencies in the public and private sector have also accepted and are implementing the policy of full loan recovery, with the one exception of NHDA. With the passage of time and the continued reinforcement provide by the implementation of all of Phase IV, this policy will become more entrenched as a government policy. The most important element in the sustainability aspects here is that the groundwork has been laid for the use of market rate mortgage loans that will be repaid, to generate additional funding from the capital markets for housing purposes. This source of funding cannot be tapped if the primary lending institutions are not making these types of loans. Thus, USAID has directly promoted the sustainability of the housing market by including these two elements in its housing program.

The second objective of rationalizing the public sector has been partially achieved in that the GSL has successfully implemented the policy of providing subsidies to help the poorest of the poor to resolve their housing problems. The NHDA, the government arm responsible for carrying out this policy, has been singularly successful in efforts to assist the poor through its programs for different income groups, and it is expected that these efforts will be sustained. The movement toward extracting the GSL from lending programs must be continued. This can be done by strengthening the primary mortgage lending institutions such as the HDFC and the SMIB, which are only making mortgage or secured shelter, and which could be sold on a secondary market if it existed.[16] To ensure the sustainability of the primary lending institutions, they must be able to generate funding from other sources, using their mortgage portfolio as security for those funds. Only in this way can the primary lending institutions continue to make housing finance available.

[16] The NHDA only makes unsecured housing loans, thus these loans could never be placed in a secondary market.

The third objective of developing instruments and procedures to facilitate the growth of the housing finance market has only been explored so far. Steps were initiated during the first tranche which could lead to the achievement of this objective by the completion of Phase IV. Therefore, the remaining funds in Phase IV should be directed to activities which will help the housing finance market to develop new techniques and programs. More specifically, this means assuring a flow of funds to the housing finance market when the HG funds are exhausted, which may be as early as the end of 1995, given the expected use of funds over the next 18 months. It also means supporting the development of the primary lending institutions to assure a sufficient number of mortgage loans to be refinanced.

With the growth and development of the primary housing market, the need to mobilize resources that will permit the housing finance institutions to make housing loans is critical. The Concept Paper entitled "Sustainable Housing Finance for Low-Income Shelter" offers one way to mobilize resources for housing and, therefore, USAID and the GSL should consider its merits along with variations of this theme. At the same time, new savings instruments, the other major source of housing finance, should be considered to complement long-term domestic borrowings as the two principle founts of housing finance resources. If this concept, and complementary actions, can be implemented, then the final objective of Phase IV could be achieved and sustainability realized.

To ensure the speedy development of the primary mortgage lending institutions and the mobilization of long-term funding for these institutions, USAID and the GSL should immediately prepare the Program Delivery Plan for the use of the remaining $15 million Phase IV funds. This is particularly critical, since the CBSL is now approving loans in excess of the $6 million authorized in the first tranche. Key issues to be covered in the next PDP are whether to change the breakdown in the proportion of the loan component (now 60 percent) versus the grant component (40 percent), and whether some way should be adopted to ensure a greater use of the funds for secured lending versus non-secured lending. Once again, it should be pointed out that the sustainability of the program hinges on the development of a portfolio of mortgage loans that can be used to access long-term financing for mortgage lending to beneficiaries.

7.2 Financial Institution Lending Policies

There are two elements to financial institution lending policies that are related to this program. One is the market rate lending policy and the other is the policy of lending to low-income families whose incomes fall below the median. All the banking institutions participating in the program appear to be committed to making market rate housing loans. With respect to the public sector banks, it is always possible for the GSL to instruct those institutions to make below-market rate loans; however, it is certain to be over management's objections and contrary to agreements reached with international donors that public sector financial institutions must meet international banking criteria. It should also be pointed out that NHDA, being more tied to GSL policy implementation, would be the first of the housing institutions to go counter to prevailing market rate policy, although today, it is adhering strongly to that policy. On the other hand, it is highly unlikely that the private sector banks and the mortgage lending banks will ever provide below-market rates, particularly if the mortgage institutions are fully privatized, as expected soon.

The second element relates to serving low-income families. The private banks will probably continue to make a few loans to this income group, but their commitment will be lukewarm and the number of loans limited, at least until they are convinced that lending to these groups is as profitable as lending to their traditional clients. The two specialized mortgage lending institutions, SMIB and HDFC, will continue to serve this group as long as they have access to funds, although they will also serve the higher-income groups as well. Since they have limited or no access to savings, and their operations are concentrated in Colombo, they have a limited outreach. As they grow and develop island-wide operations, and secure more resources, they will be able to make a larger impact on the housing sector. The two institutional groups most likely to focus a major part of their lending efforts on low-income families are the RRDBs and the TCCS. A goal of the next tranche should be to expand the number and lending activates of the RRDBs in the program while at the same time exploring ways to reinvolve the TCCS and similar institutions serving the poor.

8 Program Obstacles and Solutions

8.1 Advance Shortfalls and Disbursement Delays

The major program obstacle, one that has caused significant delays in program implementation, has been the lack of advance funds from the GSL Treasury to the CBSL to reimburse the sub-apex and primary lenders for the approved loans. The apparent reason for this delay is the general shortage of Treasury funds, given the competing demand from other equally important programs. As stated earlier, the impact of the advance delays has been to curtail approvals, leading to a loss of credibility in the program and real cash flow problems for some of the institutions, not to mention a reduction in profitability.

Insofar as the Treasury is on the verge of borrowing the HG loan for the first tranche, this problem will be solved shortly. However for the second tranche, this problem could recur. But there are two possible solutions as there were for the first tranche. One is that AID could approve an HG advance, as is contemplated in the Implementation Agreement. The second is for the GSL to make the advances on a timely basis. It is doubtful that AID will approve an advance, although it might be appropriate for the Treasury to proceed to make a formal request. If the request is denied, then the Treasury will have to make the advance. There is some indication that this situation will not repeat itself, since the national election will be over by mid-August, at which time, more funds will be freed up in the Treasury that can be used to make program advances.

8.2 CBSL Approval Procedure

The CBSL loan approval procedure is burdensome and the documentation required is excessive. For example, if a loan requires four disbursements, the CBSL requires that the lender submit a complete set of documentation each time one of the four disbursements occurs. The smaller the loan, the more onerous and costly this disbursement, since the income generated on a loan is proportionate to its size. The smaller the size, the smaller the income, yet the paperwork remains the same for all loans. The effect of this procedure is that it adds to the loan origination costs, with a particularly adverse effect on the smallest loans. The CBSL insists it is only following the provisions of the Monetary Act, and can thus do nothing to change or expedite the procedure. The consultants report on increasing program utilization[17] made a cogent argument for changing the loan approval process; however, it was to no avail. Assuming this will continue to be the case, the only solution would be to change the apex lender, which is probably not feasible this late in the program.

9 Sector Opportunities

It should be emphasized once again that only the first tranche of Phase IV program has been implemented, although some spill-over into the next tranche is now occurring. While the overall objectives will continue in force during the second tranche, that tranche should not necessarily be a carbon copy of the first tranche. In a memorandum to AID/Washington just prior to signing Amendment No. 1, the Mission Housing Officer wrote that the second tranche will be used to accomplish the following: (a) move the NHDA entirely out of direct lending; (b) further privatize housing lending to low-income households; (c) assist in the establishment of a system of prudential supervision as the appropriate role for government in a sound financial system; and (d) develop long-term sources of capital on the domestic market.

At the very least, the second tranche offers a unique opportunity to introduce ways to continue to privatize the sector by strengthening the primary lenders, to develop long-term domestic sources of capital by fostering the issuance of long-term debt, and to help establish a strong bank supervisory environment that would nurture both of those efforts. On the other hand, it is unlikely to expect NHDA to remove itself as a primary lender, although, if it continues to make loans at market rates, it will not distort the market and thus not inhibit the development of the primary and secondary markets.

10 Lessons Learned

- USAID housing programs, using HG funds, are capable of reaching large numbers of poor families, especially rural families, by granting very small loans to creditworthy borrowers and grants to families at the subsistence level.

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[17] See Warner and Gray (ISTI), 1993.

- Low-income families are able to borrow for housing at market rates and repay those same housing loans, especially if the lender is a profit-oriented institution that enforces repayment.
- Rural families, including small town families, are just as capable in carrying successfully indebtedness for housing purposes as are urban families.
- Private sector financial institutions are unlikely to play more than a token role in the granting of housing loans for low-income families unless loan origination and loan administration costs are lowered.
- Since high loan origination and administration costs in Sri Lanka will prevent some lenders from making mortgage loans for low-income families, the ability of lenders to tap outside sources for long-term housing finance will be limited.

11 Recommendations

Prepare the Program Delivery Plan for the Second Tranche of Phase IV

This new PDP should be prepared immediately. Depending on discussions with the GSL, it may be possible to modify the existing PDP, since the principal issues will be the proportion of loans to grants, and the increase in the amount of secured loans to non-secured loans.

Develop New Financial Market Instruments and Programs

The Mission should more forcefully to develop resource mobilization programs, including accessing long-term debt from the capital market, along the lines now being suggested in the Concept Paper, "Sustainable Housing Finance for Long-term Shelter," as well as increasing the use of savings as a source of housing finance.

Strengthen the Primary Lending Sector

The Mission should provide addition support to those primary lending institutions which are making secured mortgage loans. This assistance should be in the form of additional training, including the aid in developing a domestic training capacity for these institutions.

Create a Bank Supervisory Environment

In conjunction with the World Bank and the USAID Capital Markets, the Mission should assist in the development of the proper institutional supervisory capacity which would ensure the successful launching of a long-term debt issue for housing finance.

Reduce CBSL Loan Approval Process and Procedures

Although this recommendation has been made in previous consultancies, it is being seconded in this evaluation in the expectation that one more recommendation in this area will not hurt and might even help. Besides, it is critical for the continued and increased participation of the private sector lending institutions in low-income housing programs.

Bring the TCCS Back into the Program

Efforts should be make once again to expand the present program to include the TCCS so that one more private sector oriented institutional group could be involved as a lender.

ANNEXES

Annex 1
Summary of Phases I, II, and III

HG-001

Authorization:	$25 million
Date:	December 19, 1980
Description:	$23 million was allocated to the Aided Self-Help (ASH) Component, for loans to households to finance building materials for housing and basic infrastructure, including the Model Villages Program, Electoral Program Housing, and Fisherman's Housing (later terminated). The remaining $2 million was allocated to the Slum and Shanty Upgrading (SSU) Component as pilot projects to provide infrastructure and land tenure to urban households.
Objectives:	To move the GSL away from direct construction and to increase cost recovery.
Borrowings:	$21 million on July 28, 1982 (the remaining $4 million was borrowed along with $10 million in HG-002).

HG-002

Authorization:	$10 million
Date:	September 29, 1983
Description:	Entire Program was to finance Million Houses Program (MHP) in rural areas, including upgrading, building materials loans, sites and services, infrastructure projects. First-time interest rates were charged for this kind of program. ASH and SSU were continued as eligible expenditures.
Objectives:	Assist in the transition from ASH and SSU to MHP; support imposition of interest charges, maximize cost recovery; support expansion of SMIB (or another institution) into a full-fledged housing bank; strengthen SSU Division; strengthen role of Ministry of Local Government, Housing and Construction and work toward a comprehensive housing policy.
Borrowings:	$14 million on February 21, 1986

HG-003

Authorization:	$25 million
Date:	August 2, 1985
Description:	Continued support to MHP, with expansion to urban areas; introduced the use of Thrift and Credit Cooperative Society (TCCS) in MHP loan origination and servicing; continued

	assistance to SMIB and HDFC; financed demonstration programs in local authority financing and in Mahaweli housing.
Objectives:	Support NHDA's transition from direct lending in the RHSP to emphasizing the role of financial institutions, such as TCCS, and monitoring a successful collection system; provide continued support to joint sector housing finance institutions; approved GSL National Housing Policy in implementation.
Borrowings:	$15 million on July 1, 1987 and $10 million on July 25, 1988

Annex 2
Technical Assistance and Training

ACTIVITY	PROVIDER/ RECIPIENT	ACTIVITY DATES	AMOUNT
Long-term Advisor	Howard Kane	June, 1992 to Present	290,535
<u>SHORT-TERM STUDIES</u>			
Loan Servicing & Collection Study; Land Tenure Study	Abt Assoc. (Jones, Miller)	Feb/Mar, 1993	48,704
Working Agenda for the Steering Committee	Abt Assoc. (Merrill, Diamond)	Feb/Mar, 1992	39,389
TA for Program Delivery Plan	PADCO (Kopstein, Van Fossen)	Sep/Oct, 1991	95,619
Increasing Program Utilization	ISTI (Warner, Gray)	Apr/May, 1993	48,753
Demand Study for Small Housing Loans	Urban Inst.	Oct, 1991	8,162
TA for Low-Income Housing Program	Purch. Order (Howard Kane)	May, 1992	7,193
Assessment of Housing Finance Training	ISTI (Dissanayake)	Apr/May, 1992	5,458
Housing Finance Demand & Supply Study	LAMSCO (Dissanayaka, DeLanerolle)	Jan, 1993	5,000
<u>TRAINING</u>			
Training at the Fels Center	6 Sri Lankan participants*	3 courses, 1991, 1992,1993	73,503
TDY in Washington	Premaratne	Aug, 1992	148
<u>EQUIPMENT PURCHASE</u>			
Purchase of Computer equipment	Dept of National Planning	Aug, 1992	12,000

Purchase of Computer Equipment	Ministry of Planning	13,824
TOTALS		

* The five participants in the Fels Center courses were Meththananda, HDFC; Iddagoda and Rajapakse, SMIB; Pillai, NHDA; Premaratne, Ministry of Planning; Piyalissa, CBSL.

Source: USAID/Colombo

Annex 3
List of Contacts

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

Ministry of Finance:
Dr. Ranee Jayamaha, Senior Executive/Advisor, Financial Sector Monitoring Committee

Central Bank of Sri Lanka:
T.G. Savundranayagam, Director, Development Finance Dept.
R. Cooray, Additional Director, Banking Development Dept.

National Housing Development Authority:
S. Vadugaiyah Pillai, General Manager

National Savings Bank:
M.J. Silva, Chairman

State Mortgage and Investment Bank:
Gunapala Iddagoda, Deputy General Manager

Housing Development Finance Corporation of Sri Lanka, Ltd.
E.A. Meththananda, Managing Director
R.M. Gunathilaka, Deputy General Manager (Finance)

Bank of Ceylon:
Ms. A.M.L. Jayamaha, Assistant General Manager

People's Bank:
Asoka Kariawasam, Assistant General Manager

Seylan Bank:
Rohan Perera, General Manager

Hatton National Bank:
Ruvini Thenabadu, Manager (Central Credit)

Commercial Bank:
Gamini Wijesinghe, Manager/Rural Credit

Kegalle Regional Rural Development Bank:
R.J. Perera, Chairman

USAID/Sri Lanka:
Kamalini Fernando, Mission Housing Officer
Howard Kane, Mission Technical Advisor

RHUDO/Delhi:
Charles Billand, Regional Housing Officer

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