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USAID/SRI LANKA

**DISGUISED SUBSIDIES,
DISTORTIONS, AND MARKET
SEGMENTATION IN THE SRI
LANKAN FINANCIAL SYSTEM**

Final Report

August 9, 1991

Price Waterhouse

August 9, 1991

Mr. Talbot Penner
Chief, Office of Private Sector Development
USAID/Sri Lanka

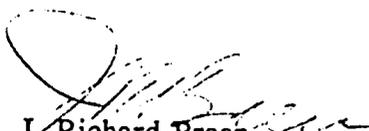
Dear Mr. Penner:

Re: Financial Sector Development Project
Contract Number PDC-2206-Z-00-8191-00
USAID/Sri Lanka -Credit Subsidies in Sri Lanka's Financial System: A Preliminary
Appraisal
PIO/T No. 940-0001-3-034-2228

Attached please find five copies of our final report entitled Disguised Subsidies, Distortions, and Market Segmentation in the Sri Lankan Financial System, prepared by Price Waterhouse, Prime Contractor under FSDP.

It has been a pleasure working with you on this important assignment. We look forward to further collaboration with you in the future.

Sincerely,



J. Richard Breen
Project Director, FSDP

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EXECUTIVE SUMMARY

I. PROJECT DESCRIPTION AND SCOPE

Pervasive subsidies have long been identified as one of the key distortions in Sri Lanka's financial system. As such, USAID/Colombo contracted a team of consultants from APRE's Financial Sector Development Project (FSDP) to study the extent and incidence of interest rate and other credit subsidies in Sri Lankan financial markets (See Appendix A for the Scope of Work). Data on existing credit programs and patterns were used to develop broad estimates of the magnitude of effective credit subsidies for different target groups and different purposes. The study has also identified the sources of these subsidies. The results of this study will be used in the design of a planned project to support the liberalization of interest rate structures in Sri Lanka.

II. PROJECT STAFFING AND METHODOLOGY

This study was conducted by a team of FSDP consultants consisting of: Martin Barrett, Chief of Party and Economist; and Deborah Dungan, Financial Analyst. The study took place over a four week period in March and April 1991.

Information for the study was obtained from interviews and a broad range of written documents. Team members conducted interviews in Sri Lanka with both public and private sector representatives (see Appendix B for a list of persons contacted). In Colombo, the team met with government officials of the Central Bank, the Ministry of Finance and the National Housing Development Authority as well as representatives of the International Monetary Fund and the World Bank. Meetings were also conducted with commercial, development and specialized banks, capital market institutions such as investment companies, and financial planning institutions. Written sources used for this project include official reports and studies of the World Bank, IMF and the Asian Development Bank.

III. FINDINGS AND ANALYSIS

The role of market forces in the determination of interest rates is subject to a variety of constraints in Sri Lanka. The net effect is that credit is made available to borrowers in priority activities on subsidized terms in amounts and at rates which fail to reflect the full cost of financial intermediation. The purpose of this report is to provide an indication of the cost, incidence, and implications of these subsidies. The broad conclusions that emerge from this report are summarized as follows:

- Cost of Subsidies

The direct cost of subsidized credit, given through refinancing facilities for on-lending to priority borrowers, is small -- less than one percent of the average amount of credit outstanding in 1990 -- when measured as the spread between the maximum on-lending rate and the average weighted prime rate. However, when measured with reference to shadow lending rates, a more realistic indication of the full cost of financial intermediation, the cost of these subsidies is much larger -- 15% of the average amount of credit outstanding, or almost 800 million Rupees in 1989.

- Effect of Subsidies on Credit to Target Sectors

The subsidization of refinance facilities appears to have done little to increase overall credit to target sectors. Banks appear to have substituted Central Bank credit for their own traditional resources. Moreover, the most frequently utilized lines of credit involve a relatively small element of subsidy.

- Insufficient Guarantee Fees to Cover Central Bank 's Liabilities

The Central Bank provides partial guarantees on medium and long-term loans extended under a program designed to increase employment opportunities through the promotion of small and medium-sized enterprises. Although a guarantee fee is payable by the lending institution, the Central Bank assumes part of the lender 's credit risk. The guarantee fees paid by lending institutions under this arrangement appear to be insufficient to cover the Central Bank 's expected liabilities.

- Cost of Subsidies to the National Savings Bank (NSB)

The NSB has long been heavily subsidized by the government through direct budgetary transfers and indirect tax concessions to depositors. The effect of these arrangements has been to enable the NSB to maintain its presence in deposit markets by paying relatively high rates on deposits regardless of cost. Direct budgetary transfers to the NSB are expected to amount to about Rs. 200 million in 1991.

- Undercapitalization of the State-Owned Banks

Still another element of subsidy arises from the fact that the monetary authorities have allowed the state-owned commercial banks to price their loans without regard to the full costs of financial intermediation, inclusive of the cost of realistic provision for loan losses and the cost of maintaining bank capital at minimally adequate levels. Both state-owned commercial banks are grossly undercapitalized. If realistic provision were made for the full cost of financial intermediation and possible loan losses, the banks would be technically insolvent. The state-owned banks have

absorbed much of the accumulated burden of providing credit at artificially low rates, thus undermining the main thrust of government policy (increased competition and more institutional independence).

- Discrepancy Between the Average Weighted Prime Rate and Realistic Market Rates

Preliminary estimates suggest that if the state-owned banks were to cover the full cost of financial intermediation, then average lending rates would have to be set at close to 30 percent. Actual lending rates, as measured by the average of monthly prime lending rates, are roughly 22 percent.

- Subsidized Debt Inhibits Diversification of Money and Capital Markets

Secondary trading in government securities is unlikely to develop as long as interest rates on government securities are guided by the Central Bank, and government debt is held by captive investors who have no incentive to increase their return on assets. Further, a non-bank market for private debt is inhibited from developing because many investors are locked into government securities and because issuers can arrange medium and long-term financing through the state-owned banks or development finance institutions at subsidized rates. Finally, in the absence of requirements to make meaningful provision for loan losses, commercial bank lending rates are set at relatively low levels, even on loans to highly leveraged companies. As a result, the cost of equity appears high to potential borrowers and the volume of equity issues remains stagnant.

The total costs of subsidized credit in Sri Lanka are very high. This is not due, however, to the direct expense associated with the Central Bank's refinance and credit guarantee schemes. These costs are in fact a small part of the total cost of subsidized credit. The highest costs, although more indirect, are primarily due to the failure of commercial banks to price their loans in a way that reflects the full cost of financial intermediation. The two major state-owned banks are the leaders in this practice. In effect, most borrowers in Sri Lanka are being subsidized by banks charging unrealistically low interest rates. This distortion in interest rate structures, as well as other market imperfections explained in Chapter II, result in significant aggregate costs. The most important of these are:

- o Inhibited Competition
- o Near-insolvency of many financial institutions, including the state-owned commercial banks and the NSB
- o Sluggish money and capital markets.

Therefore, the indirect costs of subsidized credit are much more significant than the direct costs of Central Bank refinancing and credit guarantees.

IV. RECOMMENDATIONS

Based upon the findings and analysis of available information, the team recommends the following:

- Central Bank Should Monitor Bank 's Pricing Policies

Until the banks are privately owned, the Central Bank, should be prepared to evaluate the extent to which the banks ' pricing policies are consistent with regulatory requirements. This need not interfere in what is generally a prerogative of bank management. In a more competitive market environment, the state banks would have very little discretion over interest rates. But that is not the case in Sri Lanka where the state banks are the prime mover in the determination of bank lending rates, and have been permitted to set lending rates without regard to the full cost of lending. At the very least, the Central Bank should monitor those costs. There is no assurance that the state banks would do so on their own, or that they would price their loans accordingly. USAID should strongly encourage the Central Bank to monitor the banks ' pricing policies.

- Treasury Bill Rates Should Respond to Market Conditions

At the same time, much more needs to be done to allow Treasury bill rates to respond more fully to market conditions. This calls for a thorough review of the auction mechanism. At bottom, this requires a readiness on the part of both the Central Bank and the government to accept the market 's view on the level and term structure of interest rates. This implies that if the Central Bank does buy at auction, it should do so only at the average of competitive bids submitted by other auction participants. Likewise, other official institutions (many of them captive investors) should not be allowed to dominate the auction by bidding for large amounts of bills at relatively low discounts. They should be eligible to bid only on a non-competitive basis. Allocation of bills to these institutions would be based on the average of competitive bids. USAID should consider providing the expertise needed to help the Central Bank revitalize and restructure its Treasury Bill auction process. USAID has provided this type of assistance in other countries, including Egypt in late 1990.

- NSB Should Diversify its Asset Portfolio

The NSB appears to be in a very precarious position now that its depositors no longer enjoy preferential tax treatment and the government has agreed to phase out the direct subsidy within a matter of two to three years. Thus, unless the NSB manages to increase the average return on its assets, it will have to lower the rates paid to depositors, in which case it may be vulnerable to sudden, and potentially very large, deposit withdrawals. Of course, if liquidity problems do arise, the NSB can turn to the Central Bank for assistance. Alternatively, the government may agree to

an advance redemption of at least part of the NSB 's holdings of low coupon rupee bonds. But this would reintroduce a subsidy in a different guise. In any event, if NSB is to operate independently, it must learn how to manage a more diversified asset portfolio. USAID could provide training to NSB in the techniques of portfolio management. The services of a consultant, or a team of consultants, experienced in the management of large institutional asset portfolios would be valuable.

- Mortgage Institutions Should Originate Adjustable Rate Mortgages and Design New Mortgage Instruments

The two mortgage-specialized institutions -- State Mortgage and Investment Bank (SMIB) and Housing Development Finance Corporation (HDFC) -- face a somewhat similar challenge. Both institutions hold large amounts of fixed-rate mortgages, originated years ago when interest rates were much lower. SMIB has financed most of its lending through the placement of medium-term debentures with the Central Bank and, to a lesser extent, with the ETF, although it has started to accept deposits as an additional source of funding. However, both SMIB and HDFC are exposed to interest rate risks, and if they are to pay fully competitive rates on deposits then the returns on the mortgages they hold must adjust more rapidly to changes in market conditions. This means that they should begin to originate adjustable rate mortgages of one kind or another. This need has been clearly recognized at both institutions, but they need assistance in designing new mortgage instruments. USAID should consider ways of providing technical assistance to these institutions in the design and management of adjustable-rate mortgages. Close coordination with the Asian Development Bank would be necessary, as the ADB is currently examining this issue.

- State Banks Should be Rehabilitated

Consideration should be given to somewhat different approaches to the privatization, or recapitalization, of the state banks. In principle, they could be recapitalized in their present form by the government, or sold to private investors after they had been fully rehabilitated. Either of these approaches will take quite some time. In the interim, it may be possible to arrange the sale of at least some part of their extensive branch network to private banks, or to newly created institutions owned jointly by the public and private sectors. USAID should consider providing specialized consultants to assist in the research and analysis of creative, politically feasible means of privatizing all or part of these banks.

I. INTRODUCTION AND BACKGROUND

The main thrust of financial policy in Sri Lanka, as it has unfolded over the past decade, has been to provide for a more open and competitive financial system. Rates payable on deposits are free of direct controls of any kind, and, with the rapid development of finance companies and the entry of new foreign banks, the markets in which these rates are determined have become more competitive. Likewise, there is little direct interference by the authorities in the determination of bank lending rates, apart from rates on loans to priority borrowers that are funded through the Central Bank's refinance facilities. For the most part, commercial banks are free to price their loans to different borrowers, both private and government-owned companies, on the basis of commercial criteria.

However, the absence of direct controls does not mean that interest rates in Sri Lanka are fully and spontaneously determined by market forces or by meaningful inter-institutional competition. The plain fact is that the market for commercial bank credit has long been dominated by two state-owned banks -- the People's Bank and the Bank of Ceylon. Despite the entry of new banks, both private and foreign, the market occupancy of the state-owned banks remains very large. As a result, the entire spectrum of rates on short-term loans is determined largely by these two institutions. Similarly, rates on medium- and long-term loans are shaped primarily by two development finance institutions, both of which are partly or wholly state-owned and enjoy easy access to low cost, external resources, or to government funds and Central Bank refinancing lines. In the residential mortgage market, the cost and availability of credit is largely determined by the State Mortgage and Investment Bank (SMIB), a mortgage-specialized institution whose operations are funded almost entirely by the placement of government-guaranteed obligations with captive lenders at non-market rates of interest.

Indeed, the very meaning of "market rates of interest" is somewhat ambiguous in Sri Lanka. The fulcrum on which the entire structure of bank deposit and lending rates turns is the Treasury bill rate. However, the Treasury bill rates are not very responsive to market forces, at least not in the short-run. While it is true that the bills are offered at auction to a wide range of eligible market participants, the Central Bank determines the cut off rate, or the minimum bid accepted at auction, and if necessary absorbs all unsold bills at a rate of its own choosing. Thus, the rate is strongly influenced by non-market forces.

Moreover, the eligible participants in the auction include several state-owned or government sponsored institutions, notably the National Savings Bank (NSB) and the Employees Provident Fund (EPF). Both are structured to invest most of their assets in government securities, and both are designed to mobilize large resources for that purpose. The NSB has been heavily subsidized so that it can pay relatively high rates of interest on deposits, while contributions to the EPF are mandatory for virtually all employees and their employers in

the public and private sectors. Both institutions are captive investors, and since they are effectively insulated from competition, are in a position to bid for large amounts of bills at relatively low interest rates.

All this suggests that the role of market forces in the determination of interest rates is subject to a variety of constraints, some of which are clearly intended to facilitate the delivery of credit to priority borrowers on relatively easy terms. The net effect is that credit is made available to borrowers in priority activities on subsidized terms -- in amounts and at rates that fail to reflect the full cost of financial intermediation. The purpose of this report, as its title implies, is to provide an indication of the cost, incidence, and implications of these concealed subsidies. The broad conclusions that emerge from this survey can be briefly summarized as follows:

(1) The use of refinance facilities, under which the Central Bank provides credit to participating banks for on-lending to priority borrowers at below market rates, clearly entails an element of subsidy. The direct cost of these subsidies, when measured by the spread between maximum on-lending rates and the average weighted prime rate, is relatively small -- less than one percent of the average amount of credit outstanding in 1990. However, when measured with reference to "shadow lending rates," or a more realistic indication of the full cost of financial intermediation, the costs of these subsidies are much larger -- 15%, or almost Rs. 800 million in 1989. Even so, the refinance facilities appear to have done little to increase overall credit to their target sectors, as banks appear to have substituted Central Bank credit for their own resources. In short, the direct effect of selective refinance facilities is not very substantial, in part because the most heavily utilized lines involve a relatively small element of subsidy.

(2) In addition to the refinancing arrangements, the Central Bank provides partial guarantees on medium- and long-term loans extended under a scheme designed to increase employment opportunities through the promotion of small and medium-sized enterprises. Although a guarantee fee is payable by the lending institution, the Central Bank assumes part of the credit risk to which the lender would otherwise be exposed. Under this arrangement, the guarantee fee appears to be insufficient to cover the Central Bank's expected liabilities.

(3) The NSB has long been heavily subsidized by the government, directly through budgetary transfers and indirectly through tax concessions to its depositors. Either way, the effect of these arrangements has been to enable the NSB to pay relatively high rates on deposits, and thereby maintain its presence in deposit markets regardless of cost. Apart from the cost of foregone tax revenue, the direct cost of subsidizing the NSB amounted to almost two percent of its average outstanding assets in 1989. This subsidy is to be reduced gradually as the NSB increases the average return on the assets it holds by reinvesting the proceeds of maturing government debt in securities on which rates are more clearly related to current market conditions. Even so, direct budgetary transfers to the NSB are expected to amount to about Rs. 200 million in 1991.

(4) Still another element of subsidy arises from the fact that the monetary authorities have allowed the state-owned commercial banks to price their loans without regard to the full costs of financial intermediation, inclusive of the cost of realistic provision for loan losses and the cost of maintaining bank capital at minimally adequate levels. Both of the state-owned banks are grossly undercapitalized, and if realistic provision were made for possible loan losses, the banks would be technically insolvent. In other words, the state-owned banks have absorbed much of the accumulated burden of providing credit at artificially low rates. Inadvertently or otherwise, the authorities have allowed the state-owned commercial banks to maintain their predominant position in financial markets, and, in the process, have undermined the main thrust of policy -- toward more competition and more institutional independence.

(5) Very preliminary estimates suggest that if the state-owned banks were to cover the full costs of financial intermediation, then average lending rates would have to be set at close to 30 percent in an environment in which actual lending rates, as measured by the "average weighted prime rate " (AWPR) are roughly 22 percent. This gross discrepancy implies that virtually all borrowers enjoy access to bank credit on concessionary terms -- not just priority borrowers whose loans are eligible for refinancing through the Central bank. Furthermore, if loans were more realistically priced, the market occupancy of the state-owned banks would be substantially smaller, while the cost of bank credit in general would be higher than it actually is.

(6) As matters now stand, however, it is no wonder that more diversified money and capital markets have been slow to materialize. For as long as interest rates on government securities are guided by the Central Bank, and government debt is held largely by captive investors, many of which have no incentive to increase the return on assets, secondary trading in government securities is not likely to develop. Moreover, the development of a non-bank market for private debt is inhibited, in part because many would-be investors are locked into government securities and in part because would-be issuers can arrange medium or long-term financing through the state-owned banks or the development finance institutions at subsidized rates. Nor is it surprising that new issues of stock are small in amount or that turnover on the exchange is relatively low. In the absence of requirements to make meaningful provision for loan losses, commercial bank lending rates are set at relatively low levels, even on loans to highly leveraged companies. As a result, from the potential borrowers ' point of view, the cost of equity appears relatively high. Subsidized debt markets will continue to inhibit the volume of equity issuance as long as the cost of borrowing remains artificially low.

II. THE FINANCIAL SECTOR IN PROFILE

In order to put these issues into perspective it may be useful to provide a brief and somewhat selective overview of the size, ownership, and modus operandi of the principal financial institutions in Sri Lanka. Viewed in perspective, the financial system offers a wide range of services through a variety of institutions, many of which have been licensed only recently as part of the government's efforts to open the system to increased competition. But despite its size, sophistication, and the entry of new banks, both domestic and foreign, the financial system remains subject to pervasive official influence.

A. Distortions in Interest Rates

As indicated in Table 1 on the following page, the commercial banking sector remains dominated by the two state-owned banks, despite some loss in their market position over the past few years. Both institutions have more extensive branch networks than the private banks, and both enjoy a privileged role in acting as depositories for the government and government corporations. Not surprisingly, their market occupancy is still very high. Taken together, the assets held by the state-owned banks comprised some 68 percent of total commercial banking assets. The remainder was distributed among 24 other banks. The implications of this degree of market concentration on the level of bank lending rates are quite clear. Both of the state-owned banks are large enough to take the lead in bringing down the rates quoted by the competition, and whenever either bank moves its lending rates higher, then other lenders are likely to follow suit.

This does not mean that the state-owned banks necessarily act in concert, or that lending rates at all commercial banks move in lock-step. The state banks generally charge lower interest rates for credit to priority sectors, and may feel a need to follow rather rigid rate guidelines to avoid charges of political favoritism or discrimination. Private and foreign banks are generally more flexible in the rate and non-rate terms they quote. However, when all is said and done, the state banks loom so large in the market that changes in their lending rates are too important for the competition to ignore. Perhaps more importantly, if there is any bias in the way these banks quote rates, it is probably on the low side, since the state banks have been allowed to operate without fully recognizing either the cost of possible loan losses or the cost of maintaining capital at adequate levels.

Rates on savings and time deposits are also subject to official influence, although the prime mover in this market is the National Savings Bank (NSB), not the commercial banks. The NSB was originally created as a vehicle to mobilize savings in financial form (particularly in areas that were not well served by commercial banks), and for that purpose it uses both its own branches and a much larger network of post offices as additional deposit-taking locations. Nominal interest rates have been fixed at levels designed to provide positive real rates of return on deposits, even though the average return on its assets, which are almost fully invested in government securities, is much lower. Until recently, the government was

Table 1

Distribution of Assets Among Selected Financial Institutions
(Amount in Rs. millions)

	<u>1985</u>		<u>1989</u>		Government Ownership
	Amount	%	Amount	%	
Commercial Banks	62,383	61.8%	106,351	58.7%	
State-Owned	44,378	44.0%	69,713	38.5%	100%
Private & Foreign	18,005	17.8%	36,638	20.2%	--
Finance Companies	5,531	5.5%	8,213	4.5%	--
Development Finance Institutions	1,551	1.5%	6,065	3.3%	
NDB	971	1.0%	4,187	2.3%	100%
DFCC	580	0.6%	1,878	1.0%	36%
Mortgage Specialized Lenders	952	0.9%	2,818	1.6%	
SMIB	928	0.9%	2,621	1.4%	100%
HDFC	24	0.0%	197	0.1%	78%
Savings Intermediaries	30,484	30.2%	57,808	31.9%	
NSB	14,343	14.2%	19,508	10.8%	100%
EPF	14,755	14.6%	34,000	18.8%	100%
ETF	1,386	1.4%	4,300	2.4%	100%
TOTAL ASSETS	100,901	100.0%	181,255	100.0%	

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required to cover this differential in full, so that the NSB was completely insulated from market forces. Moreover, the nominal rates paid by the NSB were effectively even higher, since interest received on NSB deposits was until very recently fully or partially exempt from tax.

The NSB cannot accept deposits from corporations nor does it offer loans to its customers, not even loans collateralized by time deposits. Thus, despite tax concessions to NSB depositors, commercial banks have been able to attract deposits at rates somewhat lower than those paid by NSB. Still, as long as the NSB remains subsidized, and pays whatever rates needed to maintain its market share, commercial banks must offer roughly comparable rates or run the risk of substantial deposit withdrawals. In effect, the general level and term structure of deposit interest rates is shaped by the subsidized rates offered by the NSB. Of course, in the absence of any subsidy, the NSB would be compelled to adjust the average rate on its deposits to changes in the average return on its holdings of governments. And as matters now stand, the government has decided to limit the direct subsidy in 1991 to Rs. 200 million.

Furthermore, many of the non-bank lenders have been unable to mobilize funds from domestic sources, at least not in very large amounts. The two development finance institutions -- the National Development Bank (NDB) and the Development Finance Corporation of Ceylon (DFCC) -- are both medium- and long-term lenders. Neither institution is in a position to properly match its assets and liabilities. All of their medium- and long-term loans carry fixed rates and the only funding options available are relatively short-term obligations. This leaves them dangerously exposed to interest rate risk. However, if they were to issue medium or longer term debt, they would have to pay interest at much higher rates than those offered by banks on deposits with relatively long maturities and then pass those costs on to borrowers.

In fact, both development institutions depend very heavily on funding provided by the ADB and IDA. Typically, those loans are made directly to the government of Sri Lanka, which assumes all of the exchange rate risk, and funds are then made available as needed to the development finance institutions at rates below commercial bank lending rates. Apart from loans that are refinanced by the Central Bank, the development institutions are free to charge market rates on the loans they originate, but more often than not those rates are not much higher than the AWPR. This suggests that the term structure of lending rates is relatively flat, and that it fails to reflect the additional credit and interest rate risks inherent in longer term loans.

Much the same distortion is present in the market for residential mortgage credit, which is dominated by the State Mortgage and Investment Bank. SMIB is a government-owned institution, mandated to specialize in mortgage and property improvement loans. Thus far, its loans have all been made on a fixed-rate basis, for terms up to 20 years, with rates now set at 19 percent for the purchase of newly built housing, and 20 percent for the purchase of existing units. Its lending activity has been confined mainly to the Colombo area, and is

funded largely through the placement of medium-term, government-guaranteed debentures with Central Bank or other bank lenders.

Although SMIB is authorized to accept deposits from the public, it has just begun to make use of that capability. Given its existing portfolio of mortgages, SMIB is vulnerable to interest rate risk due to a heavy concentration of older loans originated at rates lower than the rate on newly issued debentures. In this sense, older borrowers enjoy credit on subsidized terms to the extent that the rates they pay are out of touch with current market conditions, or below the rate they would pay if the loan balance had to be regularly refinanced at current lending rates. Not surprisingly, SMIB and the Housing Development Finance Corporation (HDFC) have both begun to explore the possibility of introducing some form of an adjustable rate mortgage linked directly to market rates. But the choice of a meaningful reference rate is difficult in an environment in which the critically important interest rates are all subject to heavy official influence.

B. Portfolio Constraints and Credit Flows

For the most part, the allocation of credit between non-priority and priority borrowers is determined largely by bank lenders, with little direct interference by the monetary authorities. To be sure, the state banks have long been subject to official pressure to accommodate the needs of priority sectors, and they are not unresponsive to those pressures. However, much of the credit extended to priority borrowers is funded with the banks' own resources, at rates related to those paid by all other borrowers. Thus, apart from the use of Central Bank refinance facilities and the uncertain influence of "moral suasion", the flow of credit through commercial banks is determined largely by whatever credit demands develop at non-regulated interest rates.

As shown in Table 2 on the following page, there is no indication that commercial bank credit to priority borrowers -- broadly defined to include all loans to the agricultural, industrial, and export sectors -- has in any way "crowded out" non-priority borrowers. The distribution of commercial bank credit between "priority" and "non-priority" loans has changed very little over the past decade, despite some change in distribution of credit among different classes of priority borrowers. Moreover, the effect of selective refinance facilities on the overall structure of lending rates is not very substantial because usage has been limited, even though some of the lines are "open-ended". Indeed, the facilities that are most heavily utilized -- for pre-export financing -- involve a relatively small element of subsidy, at least in terms of interest rates. In short, most of the credit extended to priority borrowers is made at market-related rates of interest, and the allocation of credit by commercial banks has generally been guided by market forces.

By contrast, other institutions, many of which might emerge as a major force in the development of the debt and equity markets, are subject to very severe portfolio constraints. The NSB is required by law to hold at least 60 percent of its total assets in government securities, but as a matter of policy the bank has been almost fully invested in government

Table 2

Distribution of Commercial Bank Credit to Priority Sectors
(In percent of total loans and advances)

End of Period	1980	1985	1989
High priority sectors	<u>29.3</u>	<u>25.7</u>	<u>30.2</u>
Export	16.0	17.2	21.0
Agriculture	13.3	8.5	9.2
Industry	22.4	24.4	19.5
<u>All priority sectors</u>	51.7	50.1	49.7
<u>Low priority sectors</u>	49.3	49.9	50.3
Memorandum items:			
Priority loans	51.7	50.1	49.7
Central Bank refinance	(3.4)	(4.7)	(4.8)
Banks' own resources	(48.3)	(45.4)	(44.9)
Exporting	16.0	17.2	21.0
Central Bank refinance <u>1/</u>	(1.3)	(3.2)	(4.2)
Banks' own resources	(14.7)	(14.0)	(16.8)
Agriculture	13.3	8.5	9.2
Central Bank refinance <u>1/</u>	(1.3)	(0.7)	(0.4)
Banks' own resources	(12.0)	(7.8)	(8.8)

Source: Central Bank of Sri Lanka

1/ Excludes refinancing of any medium- and long-term credits extended to the export sector.

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obligations. To make matters worse, the NSB has been allowed little, if any, discretion in the management of the government securities portfolio. Under a directive from the Treasury, the NSB 's holdings of Treasury bills were limited (until very recently) to relatively small amounts so that its investment outlets were restricted largely to "Rupee " bonds, which are medium-term government securities issued at below market rates. In effect, responsibility for management of the NSB 's assets has long rested largely with the Treasury, not with the NSB itself. Instead, the NSB has focussed single-mindedly on the mobilization of deposits, and it still describes its institutional mission in those terms. Even as the government subsidy is phased out, the NSB is not well-equipped to manage the resources it mobilizes.

Other major institutional investors are similarly constrained. The Employees ' Provident Fund (EPF) covers most employees in the private and corporate sector. Contributions are mandatory, except for the relatively few employees covered by private provident funds. Under the terms of its charter, the types of eligible investments are determined by the Monetary Board, and, not surprisingly, almost 95 percent of its total resources are invested in government securities, mostly in the form of Rupee loans.

The Employees Trust Fund (ETF) is also government-sponsored, but was established specifically to promote employee ownership through the acquisition of equity interests in enterprises. Although contributions are made solely by employers, and amount to only 3 percent of each employee 's pay, the ETF is potentially a very large source of equity capital. Yet, for one reason or another -- perhaps institutional inertia, the need to consult with the Cabinet on many investment decisions, or maybe due to the absence of suitably designed investment instruments -- the ETF has been unable to realize its potential. Whatever the explanation, most of its assets are in fixed-income securities or bank deposits.

C. Other Market Imperfections

In one way or another, all of these subsidies or constraints have inhibited the development of a more fully competitive market, and left many institutions with a well defined (and in some cases protected) market niche. The effect of many of these distortions has been to maintain the financial system in status quo. Competition is further inhibited by the absence of secondary markets for short-term claims (e.g. Treasury bills, bank or trade acceptances). As matters now stand, there are virtually no short-term documented claims traded by banks. And the one market in which banks do trade money, the interbank market, is imperfect at best.

The inter-bank market is limited almost entirely to short-term call deposits, and it is dominated by the two state banks. Although term transactions are occasionally done, there is no recognizable term structure of rates at which significant amounts can be traded. Thus, any bank that relies on this market to a large extent would be exposed to the risk of sudden and sharp increases in the cost of money. The growth of newer institutions is, therefore, limited to the rate at which individual banks can develop lending opportunities and then

fund themselves internally through their own deposit base. In a more integrated system, one in which secondary markets played an effective role, institutions capable of developing new lending business could fund themselves by borrowing from, or selling assets to, other banks capable of attracting deposits at lower cost. Banks without sufficient lending outlets would lend funds, or buy assets, elsewhere in the system.

At the very least, the development of a more integrated system would require a change in the conduct of the Treasury bill auction. If the auction process is to provide a meaningful mechanism for the determination of the level and term structure of interest rates, then it should be transparently free of official influence. This means that the Central Bank must be prepared to accept the market's view of the appropriate yield: it should not, as a rule, act as a residual buyer and when it does buy bills at auction it should do so only at the average of competitive bids submitted by market participants. Moreover, the institutions eligible to participate in the auction must likewise be free of official influence. This would exclude all captive lenders. This does not mean that the NSB or the EPF would be unable to buy bills as they are offered, but simply that any bids they make should be on a non-competitive basis, and that the amounts allotted to them might have to be restricted. Beyond that, the Central Bank should withdraw its open-ended facility under which banks can buy (or sell) bills at predetermined rates. For if the market is to have a greater voice in the determination of rates, the Central Bank must have less.

However, as matters now stand the primary and secondary markets for Treasury bills are still subject to pervasive official influence, intended mainly to reduce the cost of the government's domestic financing requirements. The effect of all this, perhaps unintended, has been to inhibit the development of secondary market activity, not only in Treasury bills but in other short-term instruments as well. Moreover, in the absence of any secondary debt market, commercial banks in general are sheltered from the force of market pressures to operate more efficiently. Furthermore, within the banking sector there is no workable market arrangement for the redistribution of liquidity from those banks that cannot make effective use of funds to those that can.

III. THE COST OF CONCEALED SUBSIDIES

Other distortions arise from the fact that financial intermediaries in Sri Lanka have long been used to conveying credit on preferential terms to priority borrowers through selective refinance facilities, credit guarantees, and other arrangements. The policy rationale for many of these practices is seldom made explicit, although there is a general presumption that each of the many arrangements is needed to insulate certain groups from the effects of market developments. Some of the refinance facilities, for example, are clearly designed to generate increased employment opportunities for borrowers who might otherwise simply have no access to credit, perhaps not even through "informal" sources. Likewise, the subsidization of pre-export financing may be needed to compensate exporters for any overvaluation of the Rupee in terms of other currencies and/or provide incentives to encourage the repatriation of export receipts. But whatever the declared rationale for these practices, they all convey an implicit subsidy to certain borrowers in ways that are well concealed. Unlike direct subsidies, which entail a clearly visible claim on budgetary resources, the immediate burden of subsidized credit is carried largely by financial institutions.

A. Central Bank Refinancing Schemes

Under each of the many refinance facilities, the Central Bank provides funds at interest rates well below the discount rate or the Treasury bill rate for loans extended to priority borrowers. The funds are advanced to borrowers at somewhat higher on-lending rates, but the maximum allowable rates remain below market rates by amounts that vary from one refinancing line to another. Stripped of all their details, the selective refinance facilities subsidize the targeted borrowers by amounts that vary depending upon the level of on-lending and the amount of credit advanced through Central Bank refinancing. Most of these refinancing arrangements can be grouped under four different categories, which are best discussed separately since the history, rationale, utilization, and allowable margins vary considerably from group to group.

For the agricultural sector, Central Bank refinancing is available in support of two separate, but clearly related, objectives: price stabilization and crop cultivation. The first of these objectives is carried out by the Paddy Marketing Board, which can borrow under the GPS scheme at rates that are well below market. The refinance rate in 1991 was fixed at 5 percent, and the on-lending rate, as shown in Table 3 on the next page, was only 5.5 percent. When the Board is in the market as a buyer, its purchases have been relatively small -- usually no more than 5-10 percent of total production. Although the refinancing line is open-ended, utilization of the line has been relatively small and all of the refinancing has been done by one of the state banks. This refinancing facility is likely to revert to a stand-by basis as the Board's operations are expected to be phased out, if not fully eliminated.

The other major refinancing mechanism for the agricultural sector, the New Comprehensive Rural Credit Scheme (NCRCS), is designed to facilitate the extension of seasonal loans for

Table 3

Central Bank Refinance Facilities - Estimated Direct Subsidy Costs
(Rupees Million)

	Current Utilization Level (1)	Current Maximum Lending Rate	Reference Rate (2)	Percentage Difference	Cost of Subsidy
GPS	110.18	5.5%	29.0%	23.5%	25.9
Agricultural Credit Scheme (NCRCS)	393.10				66.8
Commercial Bank	(322.78)	12.0%	29.0%	17.0%	(54.8)
RRDBs	(70.32)	12.0%	29.0%	17.0%	(12.0)
Export Credit	2662.39				390.9
Cat. I	(1596.36)	16.0%	29.0%	13.0%	(207.5)
Cat. II	(1066.03)	11.8%	29.0%	17.2%	(183.4)
Medium & Long Term Credit (MLCF)	1995.37				303.2
Commercial Bank	(1304.42)	13.8%	29.0%	15.2%	(198.2)
Other Banks	(690.95)	13.8%	29.0%	15.2%	(105.0)
TOTAL	5161.04				786.8

Source: Central Bank of Sri Lanka

- (1) Average of monthly levels for the period -- Jan. to Dec. 1990
- (2) The reference rate used in those estimates is the shadow lending rate for state-owned banks as calculated in part 6 of this report.

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crop cultivation. Refinancing is available to any participating institution in unlimited amounts for periods up to nine months. The refinancing rate in 1991 was set at 6.5 percent, with allowable margins of 3.5 percent on loans to cooperatives and 7.5 percent on loans to individual producers. In addition, the Central Bank guarantees 50 percent of any loans made under the NCRCS. Also, its payments in settlement of bad or defaulted loans have been substantially more than its fee income. The recovery rate on these loans was about 68 percent in 1989, so that the effective cost of this program was higher than the estimate shown in Table 2. Most of that cost was absorbed by the two state banks, as almost 90 percent of the refinancing was initiated by those institutions.

Refinancing is available for pre-export credits covering traditional, or Category I, exports (primarily tea, rubber, and coconuts), and for a wide range of non-traditional exports, shown as Category II. For the first of these categories, refinancing is subject to an overall limit (Rs. 1,663 million in 1989), but available in an unlimited amount for Category II exports. Although the first of these lines is very heavily utilized, the refinancing and maximum on-lending rates, 13 and 16 percent respectively, are relatively high, so that the element of subsidy is reduced. Under Category II, the allowable margin, at 3.8 percent, was slightly higher, while the refinancing rate, at 8 percent, was somewhat lower. These differences can only be understood as part of an effort to encourage the development of non-traditional exports, although whether they will be effective in that regard seems unlikely unless the Rupee is realistically valued in terms of other currencies. It should be noted however that the scheme is also intended to encourage the timely repatriation of export receipts, since exporters are allowed a partial interest rebate if the underlying credits are paid on time.

The fourth large group of refinancing facilities is available under the Medium and Long-Term Credit Fund (MLCF), and covers certain medium- and longer term loans for which refinancing is not available under any other facility. Within this group, the Central Bank provides refinancing to four categories of priority sectors or types of borrowers -- agriculture and fisheries, exports, companies that enjoy tax holidays, and other manufacturing companies. Refinancing rates, allowable margins, and the amount of the loan eligible for refinancing vary from one category to another, even within certain categories by the size of the loan.

Under MLCF, refinancing of agricultural credits alone is done under 28 different schemes of which 9 are funded with the Rupee counterpart of loans from international organizations and the remainder by the Central Bank. The refinancing rate and on-lending rates are the same for all eligible borrowers, and were set at 9 and 16 percent respectively in 1989. Some of these credits are partially guaranteed by the Central Bank with the allowable margin relatively wide, presumably to cover the costs associated with originating and servicing these loans and/or the costs of provisions for possible loan loss. Even so, the amount of refinancing in this category is quite small. With respect to exports, the on-lending rate was only 11 percent, with only 70 percent of the loan amount eligible for refinance. For loans

to companies with tax holidays only 60 percent is eligible for refinancing at an on-lending rate of 14 percent. Medium- and longer-term loans to certain other companies can be refinanced in full at an on-lending rate of 16 percent.

Information on the amount of refinancing of medium- and long-term loans, classified by sector, is not publicly available. The on-lending rates for MLCF shown in Table 3 represent an unweighted average of the rates for each of four very different categories. Approximately two-thirds of the loan amounts listed were originated by commercial banks, and most of the remainder by the development finance institutions. The direct cost of the subsidy is relatively small, at least when compared with the total amount of medium- or long-term credit outstanding.

B. Central Bank Credit Guarantees

In addition to the above-mentioned refinancing arrangements, the Central Bank provides partial guarantees for certain types of loans that are available from either the ADB or IDA. The objective, of course, is to reduce any participating lender's exposure to credit risk, and thereby increase the lenders' readiness to make use of available funds. However, the guarantee typically covers only part of the loan amount, and the bank lender may still require more collateral than a loan applicant can provide and/or build a specific risk premium into the lending rate. Thus, there can be no assurance that the guarantee itself will be reflected in a lower-than-market rate to the borrower.

However, all the available information suggests that the guarantee fees, as set by the Central Bank, have been relatively low. Table 4 (see following page) summarizes the results of credit guarantee programs administered by the Central Bank in connection with a series of loans for the promotion of small and medium scale industries. The first of these loans, for small scale industries only, was committed in 1979 and fully utilized less than three years later. Roughly two-thirds of the total loan amount was covered by the guarantee (Rs. 23.4 million), and of that amount the Central Bank has thus far agreed to pay about Rs. 1.7 million in settlement of claims. The participating lenders' exposure to loan losses is much larger, as the amount of loans in arrears or in default amounted to Rs. 4.9 million, or 16 percent of the total.

The experience under the first of the schemes in support of small and medium scale industries (SMI-1) was somewhat improved, as the net cost of the guarantee program was only 3 percent of the loans guaranteed. From the lender's point of view, however, the experience was somewhat worse. Approximately 25 percent of the loan volume originated under this program was non-performing -- in arrears or in default. Under SMI-2, the effective coverage of the guarantee dropped to about half of the loans granted and premium income was more than sufficient to cover payments of claims. But once again, non-performing loans amounted to an estimated 23 percent of the loans granted. Of course, that amount may go even higher, as most of the loans have many years to run before they are finally paid off.

Table 4

Central Bank Loan Guarantee Programs, End of 1989

(Amounts in Rs. Millions)

	<u>SSI</u>	<u>SMI-1</u>	<u>SMI-2</u>	<u>SMI-3</u>
(1) Loans Granted	31.2	286.1	1,392.5	637.0
(2) Guaranteed Amount	23.4	157.5	713.6	440.1
(3) Fully Repaid	22.4	148.6	52.0	4.4
(4) Liability Admitted	1.7	19.3	9.1	--
(5) Premium Collected	.9	11.6	18.4	2.1
(6) Net Outlay (-) or Premium Income	-.8	-7.7	9.3	2.0
<hr/> Memorandum Item: Estimated amount of non-performing loans, as measured by the total claims submitted to the Central Bank plus loans in arrears.				
Amount	4.9	71.2	314.6	2.2
Percent of Total	15.7	24.7	22.5	--

Source: Central Bank of Sri Lanka

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All this indicates that the direct costs of the credit guarantees are not very significant in amount. But, it is equally clear that the residual credit risks to which lenders are exposed are quite high. In principle, lending rates should be adjusted to reflect those risks. That is, the rates should be high enough to cover the full cost of intermediation, including provision for possible loan losses. Yet, more often than not, term loan rates appear to have been determined simply by adding a relatively small margin to the average cost of deposits and operating expenses. The state banks in particular have the tendency to charge lower rates for credit to priority sectors -- frequently contrary to considerations of risk -- and there is no reason to expect that loans funded from non-commercial sources, notably IDA and ADB, are priced any differently. If anything, these loans appear to be priced on the low side.

C. Reference Rates for Term Lending

Until a few years ago the rates on medium- and long-term loans made by the NDB and DFCC were generally below the short-term rates charged to prime borrowers. They were able to do so because of their access to low-cost, external resources and government funds -- either in the form of equity or Central Bank refinancing lines. As long as such low cost funds were available, there was little incentive for the development finance institutions (DFIs) to operate any differently or to mobilize resources in the domestic market. However, this mode of operation left them dependent on funds that the government or foreign donors provide on concessionary terms and relieved non-bank businesses of any need to turn to the capital market, for either debt or equity.

More recently, the DFIs have begun to charge rates on term loans that are more responsive to changes in short-term rates, but the relationship between short- and medium-term rates still appears to be mechanically linked. Under most of the recent loan agreements between the government and both ADB and IDA, the local currency counterpart of funds disbursed by the international organizations is made available to the DFIs at rates below the AWPR during the preceding six-month period. The government's relending to the DFIs under the third loan in support of small and medium industries was set at 7 percent less than the AWPR, and the DFIs in turn could refinance any loans originated by other participating institutions at rates 6 percent below the AWPR, lagged six months. Any participating institution is then free to charge rates that are sufficient to cover administrative costs and credit risks.

In a sense, the borrowers' financing costs are "market-determined" but in a market in which the most important participants are official or semi-official institutions. The AWPR, if weighted by the relative size of state and private banks, must reflect the dominant position of the former group. The rates charged by the state banks to prime borrowers may not fully reflect their exposure to credit risks. Even if it were an appropriate market rate for short-term loans, it is not a particularly useful reference rate for medium or longer term lending. To be sure, any participating bank is free to incorporate a "borrower specific risk premium" on any loan it originates, so that there may be some differentiation in lending rates, either

by borrower or by loan maturity. However, the most important commercial bank lenders in this market are, of course, both state-owned. Neither bank has ever clearly or fully recognized credit risks as an integral part of the costs to be recovered through lending rates. Nor have they been required to do so. In any event, medium- and long term loans appear to be priced in much the same way by the principal lenders, simply by adding 2 percent to the AWPR.

IV. SHADOW LENDING RATES AS A PROXY FOR MARKET RATES

The costs of subsidized credit, when measured by reference to Treasury bill rates or by comparison with bank lending rates, should be interpreted as minimal estimates since both of these reference rates are biased on the low side. For reasons mentioned earlier, Treasury bill rates in Sri Lanka will remain an imperfect measure of market tendencies as long as the Central Bank acts as a large residual buyer and/or captive institutions (NSB, EPF, and ETF) are allocated large amounts of any bills offered. The last two of these institutions are government-sponsored entities. Their investments are confined largely to government obligations, and employer and/or employee contributions to both funds are mandated by law. Under these circumstances, there is no compelling need for these institutions to bid for bills (or any other government obligation) at rates that would enable the funds to respond more fully to the needs of their beneficiaries.

As described, both funds are insulated from competition. Given that immunity, they are not driven by "market forces" to increase the returns on their portfolios. Moreover, as quasi-official entities, their management cannot ignore the government's need to contain financing costs. This is mentioned not to question the competence or integrity of the senior management of these organizations, but simply to point out that they are subject to the kinds of conflicting pressures that are inherent in government-sponsored financial institutions almost everywhere.

By contrast, there is no direct official interference in bank lending rates. Apart from on-lending rates for loans funded through the use of Central Bank refinance facilities, rates on bank loans are, by and large, free of direct official influence. Even so, the market in which lending rates are determined is dominated by the two state-owned commercial banks, and, either inadvertently or by design, each bank has been allowed to price its respective loan portfolio at rates that fail to cover the full costs of financial intermediation (inclusive of the cost of building or maintaining bank capital at minimally adequate levels). To the extent that the state-owned banks fail to recognize the need to generate an adequate return on capital in pricing their loans, they are implicitly subsidizing the borrowers they serve.

Not surprisingly, the banks have become grossly under-capitalized, at least by standards that are generally accepted in other countries. At the end of 1989, the ratios of capital and reserves to total assets at the Peoples Bank and Bank of Ceylon amounted to 2.3 and 2.8 percent, respectively. But specific provisions (or reserves) are made only against loans that management classifies as non-performing, and there is every reason to believe that these provisions greatly understate the potential for loan losses at both state-owned institutions. In short, if the banks were required to make realistic provision for possible loan losses, their reported capital would vanish. The plain fact is that each of the state-owned banks is insolvent. If liquidated in their present condition the recoverable value of the assets they hold would fall short of the redemption value of deposits and other liabilities.

Of course, the banks are in no immediate danger and can continue to operate as on-going concerns even in their present shape, especially if loanable funds continue to grow at their present rapid rate. However, whether they could continue to function or maintain their market occupancy in a more competitive environment is another matter. In the absence of a well developed money market, the range of short-term investment vehicles available to depositors is quite limited. Under these circumstances the banks are hardly exposed to any meaningful degree of market pressure. If they were more fully exposed, and subjected to potentially large deposit withdrawals, then the burden of non-performing loans and the inadequacy of their capital base would be laid bare. To be sure, the government has an obligation, express or implied, to commit additional capital to the banks when and if the banks are unable to meet their obligations to depositors. But this kind of "quasi-capital " may only become available, if at all, when a bank is in extremis. If the banks are to operate without recourse to the government -- and without extended assistance from the Central Bank -- then they must manage to generate capital on their own and maintain adequate equity levels.

The fragility of the state-owned commercial banks is symptomatic of the burdens and costs that these institutions have carried, largely in response to official pressures. But it also reflects a failure to yield to competition, or to limit their own size and rate of growth to the amount of capital they can generate. Bank credit has been made available at rates that fail to recognize all of the costs that need to be recovered through interest revenues. The minimum lending rate(s) that would be sufficient to cover all costs -- interest paid on both deposits and non-deposit sources of funds, operating expenses, the cost of realistic provision for loan losses and the implicit cost of maintaining capital at minimally adequate levels -- can be termed "shadow lending rates ". Very rough estimates of "shadow " rates are presented in section VI below, but before turning to those estimates it may be useful to outline the model from which the estimates are derived.

V. A MODEL OF BANK OPERATIONS

The fundamental proposition that underlies the model outlined here should be made clear at the very outset. Depository institutions of any kind -- whether state-owned or privately capitalized -- must recognize the cost of capital as part of the costs to be covered by net interest income. Both types of institutions share the same fiduciary responsibility to depositors, and both are exposed to many of same credit and interest risks. Irrespective of the legal form of ownership, bank capital performs the same essential function: it is needed to enable an institution to absorb the effects of any unanticipated shocks or losses, so that it can operate as an on-going concern without recourse to more than temporary assistance from the Central Bank or reliance on continuing subsidies from the government.

A. The Basic Model

Many of these relationships can be illustrated by reference to a simplified model of bank operations. For the moment, assume that assets are limited to loans (L) and required reserves (R), and that the other side of the balance sheet includes only deposit liabilities (D) and net worth (NW). Thus, the balance sheet is given by:

$$(1) L + R = D + NW$$

The income statement can be represented simply as:

$$(2) NI = IR - (IE + NIE)$$

where (NI) represents net income, (IR) interest revenues, (IE) interest expense, and (NIE) non-interest expense, or operating costs. Each of these variables can be expressed as a proportion of total assets (TA).

$$(3) NI/TA = (IR - IE - NIE)/TA$$

The left hand side of (3) can also be written:

$$(4) NI/TA = (NI/NW) \times (NW/TA)$$

As a matter of accounting arithmetic, equation (4) always holds, ex post. But the ratios on the right hand side can be interpreted as policy targets. The first of these ratios (NI/NW) is the return on equity, and can be viewed as the targeted return on capital, or cost of capital after taxes. The second of these ratios (NW/TA) is a familiar measure of capital adequacy, and can be interpreted as the minimum ratio that banks must satisfy for regulatory purposes. Taken together, these ratios determine the average return on assets

(NI/TA) that is consistent with (1) the targeted return on capital and (2) the maintenance of capital at minimally adequate levels.

The implications of these relationships are easily illustrated. Suppose that the minimal capital requirement, as established by the regulatory authorities, is 8 percent of total assets, that the bank is in full compliance with that standard, and that the targeted return on capital is 10 percent. In this case, the required rate of return on assets, as measured by (NI/TA), would be .008. If the bank realizes that rate of return, moreover, then it would be in a position to increase its total assets at a rate equivalent to the rate of return on capital (10 percent), and at the same time satisfy the minimum capital requirement.

Of course, if a bank is undercapitalized to begin with, the targeted rate of return on capital would have to be correspondingly higher in order to build its capital base to minimally adequate levels. This in turn implies that the bank would have to generate similarly higher rates of return on the assets it holds. As an example, suppose the capital/asset ratio is only 5 percent of assets. If management settles for a 10 percent return on capital, the bank would still be undercapitalized at the end of the planning period. To bring the bank into full compliance with the minimum capital requirement, the return on capital would have to be raised to 60 percent. This implies that the required return on assets, net of all other costs, is 3 percent.

The unsubsidized cost of credit, or shadow lending rate, can be derived from the income statement as follows. After rearranging terms, the income statement, equation 2, can be written:

$$(5) IR = IE + NIE + NI$$

Since reserves against deposit liabilities are held in the form of non-remunerated balances with the Central Bank, the loan portfolio is the only source of interest income (IR) in this version of the model. Likewise, the only interest expense (IE) is the cost of deposits. Non-interest expense or operating costs (NIE) can be taken as a fraction of total assets. Thus, the income statement can be rewritten:

$$(6) NI = r^*(L) - r_1(D) - r_2(NW) - o$$

where r^* represents the average return on the loan portfolio (L), r_1 is the average effective rate of interest on deposits, r_2 is the target rate of return on capital, and o represents operating expenses expressed as a fraction of total assets.

Each of the balance sheet items can be easily expressed in terms of total assets as follows. Required reserves are some fraction (k) of deposit liabilities, where k represents the weighted average requirement against both demand and time deposits. Similarly, net worth can be treated simply as a fraction (b) of total assets.

Hence, the balance sheet can be represented as:

$$(7) L + k(D) = D + b(L + kD)$$

where $k(D)$ represents reserve balances with the Central Bank. After rearranging terms, the balance sheet can be described in terms of the parameters of the model (b and k) as follows:

$$L = 1 - k + kb \quad D = 1 - b$$

$$R = k(1 - b) \quad NW = b$$

The income equation can be written:

$$(8) r^*L = r_1(D) + r_2(NW) + o$$

where r^* is the return on the loan portfolio needed to recover all costs -- interest expense, operating costs, and the cost of capital. This can also be written as:

$$r^*(1-k+kb) = r_1(1-b) + r_2(b) + o$$

or as

$$(10) r^* = \frac{r_1(1-b) + r_2(b) + o}{(1-k+kb)}$$

All this expression means is that the return on the loan portfolio must be sufficient to recover deposit interest, capital costs, and operating expenses, which is treated as an "off-balance sheet" cost. For illustrative purposes, consider the following parameter values, some of which roughly approximate the condition or performance characteristics of the state-owned banks in Sri Lanka.

Net worth ratio (b)	=	.01
Operating expenses (o)	=	.09
Target return on NW (r_2)	=	.20
Reserve requirement (k)	=	.13
Deposit costs (r_1)	=	.10

This leads to a minimum required rate (r^*) on the loan portfolio of 20.4 percent. But it should be clear that the minimum required return is sensitive to changes in the parameter values. In this particular case, the cost of capital is relatively low because the capital base, or capital/asset ratio, is similarly very small. Suppose instead that capital were maintained at a minimally adequate level of, say, 8 percent of assets. This would clearly raise the cost of capital, since the target return on capital applies to a larger capital base. However, any

increase in the capital ratio, entails a corresponding reduction in the deposit/asset ratio, and hence a reduction in deposit expenses. Moreover, any reduction in the deposit base would reduce the proportion of assets immobilized in the form of required reserves, and thereby allow an increase in the loan portfolio. On balance, however, the net effect of all these changes would be to increase the required return on the loan portfolio -- in this case to 21.3 percent.

Any increase in reserve requirements (k) would also raise the required rate of return on the loan portfolio, as long as reserves are held in the form of non-interest bearing accounts with the Central Bank. Obviously, the effect of any increase in requirements is to reduce the proportion of total assets held in the form of loans and advances. Thus, if both deposit and capital costs remain unchanged, the average return on the loan portfolio would have to be higher to compensate for any reduction in the size of the portfolio.

B. Selective Refinance Facilities

The model can be extended to allow for loans to priority borrowers through the use of refinancing facilities with the Central Bank. Under present arrangement in Sri Lanka, the Central Bank provides a wide range of refinancing facilities, each differentiated by the interest rate at which refinancing is available and/or the maximum on-lending rate that a participating institution can charge on any advances to priority borrowers. But for simplicity (and for ease of calculation) it is assumed that the entire spectrum of refinancing rates can be represented by a single rate (r3), and that on-lending rates are the same for all classes of priority borrowers. In other words, on-lending rates are simply (r3 + m) where m represents the maximum allowable margin between the two rates.

The balance sheet now becomes:

$$(11) L(n) + L(p) + R = D + B + NW$$

where L(p) and L(n) represent loans to priority and non-priority borrowers, respectively, and B represents the use of refinancing facilities with the Central Bank. In this version of the model it is assumed that refinancing through the Central Bank (B) is simply some fraction (d) of total assets and that loans to priority borrowers at concessionary rates are the same amount. Thus, $B = L(p) = d(TA)$, so that the balance sheet items, expressed as a proportion of total assets, can be represented as follows:

$$\begin{array}{ll} L(n) = 1 - k(1 - d - b) - d & D = 1 - d - b \\ L(p) = \quad \quad \quad \quad \quad d & B = \quad \quad d \\ R = \quad k(1 - d - b) & NW = \quad \quad b \end{array}$$

The income statement can be written:

$$(12) r * L(n) = (r3+m)L(p)-r1(D)-r3(B)-r2(NW)-o$$

As an example, suppose that the refinancing rate (r_3) is 8 percent, that the maximum allowable margin (m) is 4 percent, that re-financing through the Central Bank (B) amounts to 15 percent of total assets, and that the other parameters take on the values used in the earlier illustration. That is,

Net worth ratio	= .01
Operating expenses	= .09
Target return on NW	= .20
Reserve Requirements	= .13
Deposit cost	= .10

In this particular case, the required lending rate, or shadow rate on non-priority loans, turns out to be 20.1 percent -- slightly lower than the rate calculated in the earlier version of the model. This result is easily explained by the fact that the refinancing rate is lower than the cost of deposits and that refinancing is exempt from reserve requirements. But the model implicitly assumes that there is no difference between the operating costs associated with priority and non-priority loans, when in fact there is reason to believe that costs of priority loans are significantly higher. The delivery of credit to rural areas requires an extensive branch network and loans to priority borrowers are relatively small in amount. For these reasons alone, origination and servicing costs are likely to be much higher than for a similarly sized portfolio of non-priority loans. If the allowable margin (m) fails to capture that difference, then part of the burden of subsidizing priority borrowers would be shifted to "non-priority" borrowers through higher lending rates and/or absorbed by lenders in the form of a lower than targeted return on capital.

C. Provision for Loan Losses

The shadow lending rates, as calculated above, make no allowance for credit risks or for the need to make provision for possible loan losses. To the extent that assets and net worth are both overstated by the failure to make realistic provision for loan losses, the shadow lending rate appears to be much lower. The model can be modified to incorporate provisions for possible losses, but before doing so it is important to distinguish between existing allowances and additions to loan loss reserves. The accumulated provisions appear as a liability on the balance sheet, and any change in provisions has its counterpart in offsetting changes in other liabilities and/or the net worth account. Thus, the effect of any increase in provisions is to lower interest expenses and/or the cost of capital. But the additions to reserves represent a direct charge against income, and the direct cost is always greater than any offsetting reduction in interest expense or capital costs.

The practice at the state-owned banks has been to make specific provision for bad loans, or loans that are considered unrecoverable, and to make general provision for loans classified as doubtful. Under guidelines announced earlier this year, non-performing loans are to be classified -- in part on the basis of the age of any overdue amount -- into three different categories: substandard, doubtful, and loss. Thus, loans in arrears for three to six-

months will be treated as substandard, but become doubtful if the loan remains in arrears beyond six months and up to one year. If all or part of the loan is uncollected beyond that period, it falls into the loss category. Moreover, the Central Bank has indicated that it will require commercial banks to make specific provision against possible loss for substandard and doubtful loans in addition to full provision for loans in the loss category. This means that the amount of provisions that a bank is required to make would depend on the distribution of non-performing loans among different classifications and on whatever provisioning requirements are established for each type of classified loan.

However, it is convenient to assume that different provisioning requirements can be represented simply as fraction (x) of the loan portfolio, which can be interpreted as an average provisioning requirement, weighted by the distribution of non-performing loans across different classifications. With the inclusion of provisions for possible loan losses (P), the balance sheet equation becomes:

$$(13) L + R = D + P + NW$$

Provisions can be expressed as a fraction of advances, $P = x(L)$, or as a fraction of total assets, so that the balance sheet items, expressed in terms of assets, can be represented as follows:

$$\begin{array}{ll} L = 1 - k(1 - b - x) & D = (1 - b - x) \\ R = k(1 - b - x) & P = x \\ & NW = b \end{array}$$

As before, the income statement can be written:

$$(14) NI = r^*(L) - r_1(1-b-x) - r_2b - o - x'(TA')$$

where x' represents the change in provisions over the accounting period and TA' is the change in total assets, $TA - TA(-)$. Thus, the change in provisions is $x'(1 - TA(-)/TA)$ or $x'(1 - 1/1+g)$ where g is the rate of growth in assets. After rearranging terms, equation 14 becomes:

$$(15) r^* = \frac{r_1(1-b-x) + r_2(b)}{1-k+kb+kx} + o + x'(1-1/1+g)$$

Assuming that the growth in assets is 20 percent, that weighted average provisioning requirements are 10 percent, and using the same parameter values stated earlier, the required return on the loan portfolio, or shadow lending rate, would be 21 percent. For a better capitalized institution, the required rate would be correspondingly higher. If the capital/asset ratio were 8 instead of 1 percent, the shadow lending rate would be 23 percent.

VI. INDICATIVE ESTIMATES OF SHADOW RATES

To develop reasonably accurate and defensible estimates of shadow lending rates, derived from the model explained in the previous chapter, requires much more information than is publicly disclosed about the financial condition and performance of the commercial banking system in Sri Lanka, and is far beyond the scope of this report. Nevertheless, it may be useful to summarize some very preliminary estimates based on what appear to plausible assumptions about the state-owned banks. On the basis of their published financials, the state banks showed combined reported capital of about Rs.1.7 billion -- or roughly 2.4 percent of their combined assets. However, both institutions are very heavily burdened by non-performing loans, and have hardly begun to make realistic provision for possible loan losses.

Provisioning requirements under new guidelines announced by the Central Bank a few months ago call for a 20 percent provision against substandard loans, 50 percent against doubtful, and full provisions against bad loans. What this implies in terms of increased provisioning requirements is not clear, since the distribution of the state banks' non-performing loans among these classifications is not clear. Anecdotal information, based largely on conversations with officers at the state banks, suggests that additional provisions of perhaps as much as Rs. 9 billion might be needed at both state-owned banks. If this view is correct, then the state-owned banks would have a capital shortage or negative net worth of Rs. 7.3 billion.

In principle, this deficiency can be repaired in either of two ways. As in other countries, the banks might be recapitalized in the form of a special issue of interest-bearing government securities. Alternatively, the banks might be required to build capital on their own -- by reducing interest and operating expenses, increasing interest revenues, asset sales, or whatever else may be needed to increase the amount of internally generated income. Obviously, these are not mutually exclusive approaches. Indeed, if a recapitalization was not simply intended to give the banks a longer lease on life, it would have to be accompanied by a change in the banks' financial performance.

For present purposes it is convenient to assume that the state banks have to earn their way out of difficulty, without any recapitalization and that all additional income be generated by an increase in lending rates. Just how high lending rates would have to go depends very much on the returns on other assets, on the cost of deposits and other liabilities, and how the balance sheet is structured. Here, we make the following assumptions, all of which seem plausibly related to the banks' performance in 1989. First, the average effective cost of deposits is about 10 percent, and the refinancing rate with the Central Bank is 11 percent. Second, the return on short-term assets and long-term investments were both 15 percent. Third, non-interest expenses amount to about 5 percent of assets, and reserve requirements

are 13 percent of all deposit liabilities. Fourth, banks are required to reduce the shortfall of capital by about Rs. 1.8 billion per planning period until such time as capital reaches a minimally adequate level.

Given the mix of assets and liabilities of the state banks in 1989, these assumptions imply that the return on reported loans and advances would have to be about 22 percent, or about 4.5 percent higher than the AWPR. It hardly needs to be emphasized that the banks' reported loans and advances included a large amount of non-performing loans. This implies that the required rate on all performing loans would be about 29.2 percent. This is an indicative estimate of what can be termed the "shadow" lending rate in Sri Lanka. Of course, these estimates are no better, or worse, than the assumptions on which they rest. But if the assumptions seem plausible, then the implications are clear. If the state banks were required to earn their way out of difficulty, without any infusion of capital from the government, they would have to charge substantially higher rates on loans and/or reduce the average rates of deposits. In the process, they would have to yield market occupancy to other, more efficient institutions.

Whatever credence is attached to these specific numerical estimates, it seems quite clear that lending rates have been much too low to allow the state banks to recover the full cost of non-performing loans. Indeed, in the past the banks have been allowed to operate without fully recognizing non-performing debt as a cost to be recovered. That practice appears to be changing now that the monetary authorities have adopted new guidelines for the classification of non-performing loans along with more realistic provisioning requirements. However, there can be no assurance that these requirements will be accompanied by changes in the way state banks fix the rates on loans or deposits unless they are also required to comply with meaningful capital standards. In all likelihood, the banks will have to be recapitalized by the government and/or thoroughly rehabilitated before they can be privatized -- if privatization is not beyond the bounds of political feasibility in Sri Lanka. Either way, there must be changes in the way the state banks perform, and their performance should be monitored regularly.

VII. CONCLUSIONS AND RECOMMENDATIONS

The total costs of subsidized credit in Sri Lanka are very high. This is not due, however, to the direct expense associated with the Central Bank 's refinance and credit guarantee schemes. These costs are in fact a small part of the total cost of subsidized credit. The highest costs, although more indirect, are due primarily to the failure of commercial banks to price their loans in a way that reflects the full cost of financial intermediation. The two major state-owned banks are the leaders in this practice. In effect, most borrowers in Sri Lanka are being subsidized by banks charging unrealistically low interest rates. This distortion in interest rate structures, as well as other market imperfections explained in Chapter II, result in significant aggregate costs. The most important of these costs are:

- o Inhibited Competition
- o Near-insolvency of many financial institutions, including the state-owned commercial banks and the NSB
- o Sluggish money and capital markets.

In conclusion, the indirect costs of subsidized credit are much more significant than the direct costs of Central Bank refinancing and credit guarantees.

Based upon the findings and analysis in this report, we recommend the following:

(1) Until such time as the banks are privately owned, the Central Bank, as part of its supervisory responsibilities, should be prepared to evaluate the extent to which the banks ' pricing policies are consistent with regulatory requirements. This need not interfere in what is generally a prerogative of bank management. Under different circumstances, in a more competitive market environment, the state banks would have very little discretion over interest rates. But that is not the case in Sri Lanka where the state banks are the prime mover in the determination of bank lending rates, and have been permitted to set lending rates without regard to the full cost of lending. At the very least, the Central Bank should monitor those costs, as there is no assurance that the state banks will do so on their own, or that they would price their loans accordingly. USAID should strongly encourage the Central Bank to monitor bank lending rates with regard to the full costs of financial intermediation.

(2) At the same time, much more needs to be done to allow Treasury bill rates to respond more fully to market conditions. This calls for a thorough review of the auction mechanism. At bottom, this requires a readiness on the part of both the Central Bank and the government to accept the market 's view on the level and term structure of interest rates. This implies that if the Central Bank does buy at auction, it should do so only at the average of competitive bids submitted by other auction participants. Likewise, other official institutions (many of them captive investors) should not be allowed to dominate the auction

by bidding for large amounts of bills at relatively low discounts. They should be eligible to bid only on a non-competitive basis. Allocation of bills to these institutions would be based on the average of competitive bids. USAID should consider providing the technical expertise needed to help the Central Bank revitalize and restructure its Treasury Bill auction process. USAID has provided this type of assistance in other countries, including Egypt in late 1990.

(3) The NSB appears to be in a very precarious position now that its depositors no longer enjoy preferential tax treatment and the government has agreed to phase out the direct subsidy within a matter of two to three years. Thus, unless the NSB manages to increase the average return on its assets, it will have to lower the rates paid to depositors, in which case it may be vulnerable to sudden, and potentially very large, deposit withdrawals. Of course, if liquidity problems do arise, the NSB can turn to the Central Bank for assistance. Alternatively, the government may agree to an advance redemption of at least part of the NSB's holdings of low coupon Rupee bonds. But this would reintroduce a subsidy in a different guise. In any event, if NSB is to operate independently, it must learn how to manage a more diversified asset portfolio. USAID could provide training in the techniques of effective portfolio management. The services of a consultant, or a team of consultants, experienced in the management of large institutional asset portfolios, would be extremely valuable.

(4) The two mortgage-specialized institutions -- SMIB and HDFC -- face a somewhat similar challenge. Both institutions hold large amounts of fixed-rate mortgages, originated years ago when interest rates were much lower. SMIB has financed most of its lending through the placement of medium-term debentures with the Central Bank and, to a lesser extent, with the ETF, although it has started to accept deposits as an additional source of funding. However, both SMIB and HDFC are exposed to interest rate risks, and if they are to pay fully competitive rates on deposits then the returns on the mortgages they hold must adjust more rapidly to changes in market conditions. This means that they should begin to originate adjustable rate mortgages of one kind or another. This need has been clearly recognized at both institutions, but they need assistance in designing new mortgage instruments. USAID should consider providing technical assistance to these institutions in the design and management of adjustable-rate mortgages. Close coordination with the Asian Development Bank would be necessary, as the ADB is currently examining this issue.

(5) Finally, consideration should be given to somewhat different approaches to the privatization, or recapitalization, of the state banks. In principle, they could be recapitalized in their present form by the government, or sold to private investors after they had been fully rehabilitated. Either of these approaches will take quite some time. In the interim, it may be possible to arrange the sale of at least some part of their extensive branch network to private banks, or to newly created institutions owned jointly by the public and private sectors. USAID should consider providing specialized consultants to assist in the research and analysis of creative and politically feasible means of privatizing all or part of these banks.

Credit subsidies in Sri Lanka's financial system: a preliminary appraisal

Scope of Work

Purpose of the study

The study is designed to assess the extent and incidence of interest rate and other credit subsidies in Sri Lankan financial markets. Although exact figures are of course illusory, data on existing credit programs and patterns shall be used to develop broad estimates of the magnitude of effective credit subsidies for different target groups and different purposes. The study shall also identify the sources of these subsidies. The results of this study will be used in the design of a planned project to support the liberalization of interest rate structures.

Background

In its (draft) *Financial markets development strategy* (December 1989), USAID/Sri Lanka has identified pervasive subsidies as one of the key distortions of Sri Lanka's financial system. We are therefore seeking ways to reduce these distortions by promoting initiatives to separate transfers (grants) from loans. One successful step in that direction was the development of the Unified Assistance Scheme for the rehabilitation of the North and East which combined grants with loans at regular interest rates, a scheme that replaced the original idea of loans at heavily subsidized interest rates. In recent months, we have also been exploring options for separating grants and loans in the part of the housing finance system aimed at low-income groups. We consider support for such policy changes in housing and other sectors a promising option for a future (potentially fast-disbursing) project.

To explore these options further and to view them in the context of the overall financial system requires a better understanding of the magnitude and incidence of financial market distortions that are attributable to direct and indirect subsidies to various target groups. The ways in which the financial system is used to channel subsidies to these target groups are legion. They range from the relatively open and straightforward refinancing schemes operated by the Central Bank to steps that effectively undermined payment discipline, for example, through the recent *de facto* housing loan forgiveness for foodstamp recipients.¹ Another recent example is the notion to use "interest-free" loans to offset the elimination of fertilizer subsidies for farmers.

¹ Over 50 percent of the country's households qualify for foodstamps.

The motives for open or hidden subsidies through financial markets cover a vast spectrum of development concerns, political objectives, or simple budgetary skulduggery. Although financial intermediaries may at times be appropriate conduits for transfers, we have not seen any evidence that Sri Lankan policy makers have chosen credit subsidies after a careful appraisal of alternatives. Rather, credit at "reasonable" or "affordable" rates is generally treated as virtually a birthright of whatever target group is enjoying current attention.

As a result of such policies, a significant portion of all credit advanced to the private sector is lent at negative real interest rates. For example, in 1986 24.6 percent of all advances to the private sector were made at rates below the inflation rate, vs. 26 percent in 1987.²

In many instances, borrowers are "paying" for credit subsidies in other forms. High transaction costs to the borrower (travel, waiting times, etc.)³ are part of the reason that the Central Bank's refinancing schemes have not been fully used. The two major commercial banks, owned by the state, that have the branch network for reaching the target population for these refinancing schemes, have little incentive to participate actively. Out of 29 refinancing schemes established by the Central Bank to encourage lending by commercial banks in rural areas, ten have not been used at all, and utilization rates for the others ranged from 3 to 50 percent. Even in schemes that do work, borrowers incur high non-interest costs. A recent rural credit study conducted by an FAO team with ADB financing demonstrated the high cost of subsidized programs to the borrowers. As a result, many of the well-intentioned credit subsidy programs never reach their intended target population, but manage instead to hobble the functioning of financial markets.

The two dominant state-owned banks, Bank of Ceylon and People's Bank, account for most of the use of the refinancing schemes; estimates put the total amount of refinancing in 1986/87 at Rs. 470 million, reaching a somewhat limited group of 40,000 borrowers in rural areas. Total subsidies, combining transfers through loan defaults and interest rate subsidies, have been estimated at Rs. 4,750 per borrower, or 40 percent of the average loan size of Rs. 11,750. (For comparison, productive enterprise grants to farmers and small entrepreneurs in the North and East under the rehabilitation program amounted to Rs. 4,000.)

While much of the attention of students of Sri Lanka's financial system has focused on these highly visible credit programs in pursuit of social objectives, the relative credit volumes suggest that the really significant transfers may occur elsewhere. Clearly, many state-owned enterprises have been receiving indirect subsidies through government manipulation of financial intermediaries dealing with them. They may receive credit at preferential terms, they can negotiate rescheduling of debt during difficult periods, etc. As far

² Data from the Central Bank's *Review of the economy*. The inflation rate is the Colombo Consumer Price Index, generally believed to understate actual inflation significantly.

³ A recent study estimated that non-interest rate costs for the borrower exceed explicit interest rate costs for small loans (under Rs. 8,000); the same study found that "smaller borrowers pay approximately twice the interest rate to obtain a loan."

as we know, the value of these kinds of subsidies has never been assessed even in gross terms.

Study approach and specific tasks

The proposed study will largely rely on readily available data, complemented by key informant interviews. The nature of the investigation, however, may require both special analysis of existing raw data from whatever source, and the collection of primary data on particular aspects. At this point, we cannot predict whether either one or both options will need to be exercised. We have provided for such eventualities, which would require reliance on Sri Lankan researchers or institutions, by increasing the size of the contingency in the estimated budget for this activity.

Task 1: Review work on Sri Lanka's financial system. Sri Lanka's financial system has been the subject of a series of studies, notably by the IMF, the Asian Development Bank (which also sponsored a special study of rural financial markets conducted by the FAO), and more recently by World Bank staff members as part of a multi-country assessment of the impacts of financial liberalization. The information compiled in these studies provides an excellent introduction into the major features of the country's financial system. The concern of this task is twofold: to understand the overall context for the issues addressed in this study, and to identify relevant data sets and data sources for further investigation. For example, data needed to address some of the questions outlined here may not always be available in published form. In that case, the consultant team will have to try and obtain more detailed data from various sources, infer the needed information from available data, or mount a special data collection effort.

This task is critical in identifying needs for subsequent data collection and analysis.

Task 2: Categorize total credit volume by lender, borrower and purpose. Using readily available data for the bulk of total credit, the contractor will compile a tabulation of the distribution of credit by major type of lender, borrower and by broad purpose. Among lenders, the tabulation might distinguish such categories as state-owned commercial banks, privately owned banks, finance companies, etc. Lenders might be defined in terms of sector, public vs. private, etc. This exercise is designed to establish a frame of reference for the analysis of subsidized credit schemes. In effect, it will require little more than a rearrangement of available tabulations.

Task 3: Estimate subsidy costs for Central Bank's refinancing schemes. The Central Bank's 29-odd refinancing schemes are among the most visible subsidized credit programs. The consultant team shall attempt to estimate total subsidy costs at current and at maximum utilization levels for these schemes, that is, relative to total loan amounts. The main focus of this estimation should be on interest rate subsidies, although the costs of guarantees should be included as appropriate. The consultants shall propose reference interest rate(s) for these estimates; one option might be to base estimates of "market interest rates" on

Treasury Bill rates, adjusting them for maturity and risk, as outlined in the 1988 interest rate study conducted for USAID/Sri Lanka.

Task 4: Identify other "open" interest rate subsidies and estimate their costs and incidence. The consultants shall examine other credit schemes that are designed to provide credit at subsidized rates, including financing for low-income housing, small entrepreneurs, etc. Clearly, with the wide spectrum of credit programs incorporating a host of development and social objectives, we do not expect anything approaching complete coverage. The assessment should, however, include the major programs, and account for the bulk of total lending to both the public and the private sectors at rates significantly below market rates. The consultants shall also make a special effort to include donor-sponsored programs that provide some form of interest rate subsidy to end borrowers.

Task 5: Assess the magnitude of non-interest rate subsidies and their incidence. Non-interest rate subsidies include direct guaranties (already partially included in the estimates of the Central Bank's refinancing schemes in Task 3), moral persuasion and indirect or implicit guaranties to urge lenders to accept higher-risk clients, and effective loan forgiveness for particular target groups. They may also include favorable tax treatment of borrowing costs. In practice, these different forms of non-interest rate credit subsidies may not always be easily separated. For example, encouraging state-owned banks to lend to certain client groups characterized by higher risk typically involves some responsibility on the part of the government to cover losses attributable to inadequate repayment rates. Similarly, the decision in the Presidential election campaign to forgive the housing loans to foodstamp recipients drastically reduced repayments of other loans from this target group and related segments of the population, thereby creating at least a moral obligation on the part of the new government to help financial institutions hurt by the higher default rates.

As in the other tasks, we do not expect that the consultants will be able to study these questions exhaustively and definitively. The main thrust should be the articulation of an appropriate analytical framework and its application to a situation characterized by limited data and uncertainty.

Task 6: Compare the incidence of costs and benefits of credit subsidies. The emphasis in this comparison is more on the benefit side, since much of the total cost is ultimately financed through the Treasury, so that their incidence becomes difficult to trace. Thus, on the cost side, we are more interested in the impact of subsidized programs on financial institutions as well as target populations, since a common assertion holds that subsidized credit schemes often result in other costs to the borrowers. On the benefit side, the consultants are expected to provide an assessment of the degree to which the target population and other borrower groups are affected.

Task 7: Prepare final report and conduct a seminar. At least three days before their departure, the consultants will submit a draft final report to USAID. They will also present a seminar on their main findings for both USAID staff and invited guests. The final report (and the seminar) should cover the main issues addressed in the individual tasks, giving

the audience a sense of the actual net transfers under subsidized credit programs.

Duration and timing of consultancy

USAID/Sri Lanka estimates that the work outlined here can be completed by a two-person team in a four-week TDY to Colombo, with a few additional days for report completion in the States. We are fairly flexible on timing, but would expect that the final report should be available by the end of September, which would require that the consultancy be completed by the end of August.

Required skills and background of the team

The team should comprise an economist and a financial analyst. The economist would be the team leader. S/he should have an advanced degree in economics, and at least five years experience in financial markets analysis. None of the estimations asked for here require great theoretical depth, but the relevant experience is essential in ferreting out the full range of effective subsidies provided.

The second team member should have an advanced degree in accounting or financial analysis, although relevant experience (minimum of five years) is more important. Relevant experience includes appraisal of lending practices and their costs, involvement in actual lending operations, or analysis of financing alternatives to determine the real cost of a particular option to either the user or the provider of financial resources, controlling for factors such as risk and term.

Deliverables

The consultants are encouraged to submit working memoranda on the findings of specific tasks throughout their consultancy, which can then be used in the actual final report. In any case, a draft of the final report should be submitted to USAID prior to the departure of the consultants, preferably prior to the seminar held at the end of the TDY. USAID will provide written comments on the report within two weeks of submission, allowing for another two weeks to revise and respond to comments, as necessary.

LIST OF PEOPLE INTERVIEWED IN SRI LANKA

CENTRAL BANK OF SRI LANKA

Dr. Ranee Jayamaha	Finance and Banking Commission, Central Bank
Dr. N.L. Sirisena	Director, Non Bank Financial Institutions Division, Central Bank
Dr. A.J.M. Zuhair	Superintendent of Public Debt, Central Bank
Mr. Y.A. Piyatissa	Director, Development Finance Department, Central Bank
Miss Chrishanthi Abeynayake	Director of Rural Credit Department, Central Bank
Mrs. Rose Cooray	Rural Credit Department, Central Bank
Mr. Premaratne	Rural Credit Department, Central Bank
Dr. Wimal Hettiarachchi	Director of Economic Research, Central Bank
Dr. Gamini Fernando	Money and Banking Division, Economic Research Department, Central Bank
Mr. M.B. Dissanayake	Banking Department, Central Bank
Mrs. N. Santiago	Banking Department, Central Bank
Mr. P. B. Jayasundera	Central Bank

OTHER GOVERNMENT OF SRI LANKA

Mrs. Sakuntala Kuruppu	Director, External Resources Department, Ministry of Finance
Mr. S. Vadugaiyah Pillai	General Manager, National Housing Development Authority

FINANCIAL INSTITUTIONS

Mr. Lakshman Watawala	Chairman, People's Bank
Ms. Rohini Nanayakkara	General Manager, Bank of Ceylon
Mr. A. Sarath de Silva	Deputy General Manager, Development Banking, Bank of Ceylon
Mr. J. B. V. Fernando	Credit Manager (Agriculture), Bank of Ceylon
Mr. Ranjit Fernando	General Manager, National Development Bank
Mr. Moksevi (Maksi) R. Prelis	General Manager/Director, Development Finance Corporation of Ceylon
Mr. M.J. de Silva	National Savings Bank
Dr. D.B. Rajapakse	General Manager, State Mortgage & Investment Bank
Mr. Gunapala Iddagoda	Deputy General Manager, State Mortgage & Investment Bank
Mr. Mettenande	Housing Development Finance Corporation
Mr. Frank M. DiMaio	Senior Director & General Manager, American Express Bank
Mr. S. Shanmuganathan	Director-Marketing, American Express Bank
Mr. D. Justin Meegoda	Managing Director, Merchant Bank of Sri Lanka Limited
Mr. D.A.S.S. Ganegoda	Director - Banking, Merchant Bank of Sri Lanka Limited
Mr. Ajith Devasurendra	Managing Director, MB Financial Services (Pvt) Ltd.
Mr. N. U. Jayawardena	President, Mercantile Credit Limited
Mr. Kiriwandeniya	President, Federation of Thrifts

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