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Loan Collections
and Servicing

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PREFACE

In Sri Lanka, effective loan collection and servicing are essential for the implementation of the Housing Guaranty loan program. Indeed, high rates of loan recovery are key to a successful housing finance system. This report is intended to assist the several financial institutions participating in the HG program in establishing consistent loan servicing techniques. Mr. Phillip Jones prepared this report based on a three week visit to Sri Lanka from February 22 to March 12, 1993.

Land tenure -- that is, clear title to property -- is also a serious problem in the establishment of a Sri Lankan housing finance system. As part of this same technical assistance, Abt Associates prepared a second report, *The Land Tenure Problem as a Constraint to Housing Finance*.

Grateful acknowledgement is made to the representatives of the several Sri Lankan institutions who were so forthcoming with their views and information, and to Howard Kane, USAID/Sri Lanka resident Housing Finance Advisor for his guidance on the assignment, his access to those institutions, and the support provided by his office.

John Miller
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ACRONYMS AND CURRENCY

ADB	Asian Development Bank
CBSL	Central Bank of Sri Lanka
GSI	Government of Sri Lanka
HDFC	Housing Development Finance Corporation
HG	Housing Guaranty
NHDA	National Housing Development Authority
Rs.	Sri Lankan Rupees
SMIB	State Mortgage and Investment Bank
USAID	U.S. Agency for International Development Mission to Sri Lanka.

In March 1993, US$1.00 equals approximately 45 Sri Lankan Rupees.

1. EXECUTIVE SUMMARY AND RECOMMENDATIONS

This assignment in Loan Collections and Servicing was undertaken to assist the financial institutions participating in HG-004 in establishing consistent loan servicing techniques. There is a great deal of confusion among the participants regarding the lending terms and conditions at the Apex and Sub-Apex levels. The initial understanding of the financial institutions was that they would make individual loans for 10 to 15 years to their borrowers and receive 20-year loans from the Central Bank (CBSL). They have now discovered that they will receive a separate CBSL loan for each loan they make, and for the same number of years. The understanding of USAID has always been that the financial institutions would receive longer-term loans, and that information was included in presentations made by USAID to all participants, including the CBSL.

The situation is illustrated with three scenarios, of which one presents the present situation, the second adds a grace period, and the third adds both a grace period and longer-term loans from the Central Bank.

In all cases the Gross Cash Flow is initially positive for the financial institution. But, even with 100% recovery the loan principal of their individual loans will not be repaid as fast as the financial institution will have to repay the loan principal to the CBSL. This means that the financial institutions will have to look to some other source of capital to repay the portion of the CBSL loans that have not yet been recovered from the individual borrowers. Adding a grace period but leaving the term of the CBSL's loans closely tied to the financial institution's loans to its borrowers, will give no opportunity for the financial institutions to make more long-term housing loans with these funds. They must be kept available to pay the CBSL.

The only viable solution is for the Central bank to make longer-term global loans to the financial institutions. The global loans from the CBSL would be supported by shorter-term loans made by the financial institutions, and the excess reflows of loan principal to the financial institutions should be reinvested into more housing loans, whenever there is a clear opportunity for such reinvestment. The reinvestment of the net reflows into more housing loans should be monitored by the CBSL.

1.1 Recommendation: Grace Period: The present lending terms and conditions will require participating financial institutions to temporarily use their own capital to repay a portion of the CBSL loans. This is due to the matching of the term of the loans from the CBSL with the term of the loans made by the financial institutions to their individual borrowers. The principal amounts will eventually be recovered by the financial institutions upon the maturity of their loans, or upon foreclosure and sale of the property in the event of non-payment.

It is recommended that the CBSL allow a Grace Period of three to five years, during which the financial institutions would be required to pay interest only, followed by a repayment period of 15 to 20 years. The exact length of the grace period should be the subject of specific negotiations between USAID and the Government of Sri Lanka.

1.2 Recommendation: Longer-Term Global Loans: In addition, the CBSL should make Longer-Term Global Loans to the financial institutions, rather than a separate loan for each individual loan made by the financial institutions. The global loans would be the total of the disbursements made by the CBSL during the grace period, and the single global loan at each financial institution would have a single repayment schedule.

1.3 Recommendation: Training in Loan Collections, Servicing, and Reporting: The participating financial institutions are presently using very different systems to record collections and service their loans from the CBSL. USAID should sponsor a specialized training course in loan collections, servicing techniques, and reporting for the participating financial institutions and the CBSL. This training course should be given during a one-week period in May or June 1993, during which the loan servicing personnel would attend daily three-hour sessions.

2. CURRENT LENDING TERMS AND CONDITIONS

The participating banks and financial institutions have begun to make loans for refunding by the CBSL and have found that the lending terms and conditions from the CBSL are going to be somewhat different than what they had anticipated when the program was being designed. Seylan Bank has made about 10 loans so far, while Hatton Bank has made about 120 loans. Both are at some stage of applying for specific CBSL approval of their loans. The Housing Development Finance Corporation (HDFC) has not yet been accepted by the CBSL as an eligible participating financial institution, but is preparing to make eligible loans.

The participating financial institutions have not previously analyzed and compared the flows of loan principal, probably because under their earlier understanding of the lending conditions there would always be an obvious faster return of their loan principal from their borrowers, compared with what they would have to repay the CBSL. They fully expected to reinvest the net loan principal reflows by making additional loans.

Unfortunately, under the present lending conditions, the principal of the CBSL loans must be repaid faster than the principal can possibly be recovered from the loans made to the individual borrowers. Not only can there be no reinvestment by the participating financial institutions, they will be forced to use their own capital to cover the principal repayment shortfall. Private financial institutions are unlikely to participate in the program under these conditions. The state-owned institutions may participate simply because they will see no other real alternatives.

The participating financial institutions are making loans at 20.5% annual interest with terms of about 8 to 15 years. The repayment terms and conditions are different at each institution. Some banks are making term loans with equal monthly installments of principal, to which is added the accrued interest since the date last payment, while HDFC is making level payment amortizing mortgage loans in which the borrowers make the same total payment amount each month. The level payment amount is slightly more than the initial interest required, thereby allowing a slight reduction of principal in the early months of the loan. As the loan is amortized the portion of each subsequent payment that is applied toward principal increases, until by the last payments almost all is going toward principal reduction.

The CBSL is making loans to participating financial institutions at 12.5% annual interest with level semi-annual payments with the same term as the loan the participating institution made to the individual borrower. Thus, for each borrower there are two sets of loan documents: one for the borrower's loan from the financial institution and one for the institution's loan from the CBSL. The two loans are for the same number of months, but the repayment conditions and resultant cash flows are different.

There are no grace periods between the CBSL and the participating financial institutions, nor are there any grace periods between the individual borrowers and the financial institutions. The present practice is to allow grace periods of 1, 3, or 6 months, but this has not been applied in any cases yet.

3. COLLECTION AND SERVICING PROCEDURES

3.1. Private Banks: Seylan Bank and Hatton Bank make their loans at the branch offices, where the loan control cards are kept manually. Seylan Bank makes a direct deduction from the borrower's required deposit account each month, while Hatton Bank generally requires the borrowers to come to the branch to make the payments. In both banks the possibility exists to make payroll deductions from the borrower's paycheck with the employer.

3.2. Government Lenders: HDFC makes the loans from its main office after receiving the applications that come in from its branches. Manual loan control cards are still used in parallel with a newly automated PC-based system. The account information is available as soon as the payment is recorded in the branch. Then the main office uses the payment information to update the loan control cards and data base. Eventually the manual cards will be eliminated and only the database system will be used.

The State Mortgage and Investment Bank (SMIB) makes loans through its system of lending representatives located in major towns. Loan payments are accepted in 24 specified branches of the Bank of Ceylon, which transfer the payments received every week to the SMIB head office. There, the amount of each payment is entered into the computer system, with specific reference to the dates the payments are received at Bank of Ceylon. The SMIB computer system, an IBM A-400 mini-computer, automatically apportions the funds among interest, principal, fees, and other charges.

Not all possible lenders were interviewed during this assignment. People's Bank is not participating in the HG-004 program. Bank of Ceylon will only participate by making wholesale loans to the NHDA, and the NHDA is itself experiencing difficulties that are being addressed by technical assistance from the Asian Development Bank (ADB).

3.3. Interest Calculation Techniques. In all of the systems now in use the individual loan payments are recorded on the date of payment and the interest is calculated by counting the number of days that have elapsed since the previous payment. This establishes the amount of the payment that will be apportioned to interest. Any funds remaining are then counted toward any late fees that may be due, and finally any remaining funds from the payment are used to reduce the principal balance of the loan. There are slight variations of this procedure at each financial institution.

This system of calculating interest will certainly lead to significant differences between the planned repayment schedule and the actual situation, even if each payment is made exactly on time. The difference is due to the different methods of calculating the level monthly payment. The lending officers typically look up the amount of the initial level monthly payment from printed tables which are derived from formulas that assume that interest is payable monthly, and that all months are the same length. This kind of a year has, in effect, 360 days instead of 365 days.

The problem arises when the interest payable is based on the actual number of days between each payment. The borrower will be paying more interest than is available from the level monthly payment amount, meaning that in any given year the 12 monthly payments will reduce the principal **less than they should**, which means that the last monthly payment may be much larger than expected in order to pay off the loan, or that possibly several **additional monthly payments** will be required at the end of the loan to pay off the balance. In both cases the balance of the borrower's loan will be higher than it would otherwise be if the original loan amortization schedule is followed. The problem is significant in the present context because the balance of the loans will be slightly higher than is shown in the accompanying graphs, thereby forcing the financial institutions to use even more of their own capital to repay the loans they will take out from the CBSL, under the present set of lending conditions.

A second related problem arises when the financial institutions round up the level monthly payment to the next higher multiple of 10 rupees. This makes for a nice round number to tell the borrower to pay each month, but it will also throw off the repayment curve. This practice may somewhat offset the effect of charging 365 days' interest, mentioned above.

3.4. CBSL Servicing Procedures. It is unclear how the CBSL will record and service its loans to the participating financial institutions. The office of the related CBSL group responsible for this task was being moved while this Assignment was being conducted, with the result that the CBSL staff was unavailable for detailed discussions of their procedures. By requiring such a high volume of documentation and other information the CBSL will require a large back office staff just to record and update the funding requests and subsequent payments that are presented by the banks.

3.5. Defaults and Late Payments. Given the small number of loans made to date there is no meaningful information on specific repayment and collections for loans that should be refunded through HG-004. However, the lenders consider their loan portfolios to be in good shape and with only a few problems.

A look at the recent experience of the HDFC will provide some insight into the capacity of the financial institutions to maintain control over their loan portfolios. This institution has an excellent PC-based loan control and reporting system that can be used as an example for other institutions. The first step is to maintain an accurate aging of the late payments and past due accounts. HDFC has some 3,000 outstanding mortgage loans, of which about 800 are in the 1-3 months past due category. The 4-5 month category is about 400, and the loans more than 6 months past due total around 150.

These past due loans amount to about one-third of the loan portfolio, which doesn't sound like a good situation. However, a closer look reveals very little change in the various categories from one month to the next. Borrowers are contacted whenever they are more than two months late, and there is constant contact until some resolution is made. Part of the problem is related to the internal timing of the payments, which may not be recorded late in

the month in time for the reporting by the end of the month. Overall, the HDFC's collection rate is above 90%.

SMIB has more than 30,000 loans, although its overall repayment rate is not as good as the HDFC's. SMIB's loans are all due on the 20th and 30th of each month, resulting in a huge congestion of account payments near those dates. New loans now being made by SMIB carry payment dates throughout the month.

The institution is now converting its loan control and reporting system from an older IBM System 36 mini-computer to a new IBM A-400 mini-computer. The new computer system has the capacity to track many more loans and also provide exceptionally detailed analysis of the performance of the loan portfolio.

4. GRAPHIC ILLUSTRATIONS OF PRESENT AND POSSIBLE SITUATIONS

Included as Annexes are illustrations of three lending scenarios. In each case a typical loan of Rs. 50,000 is tracked from the point of view of the financial institution and of the CBSL. Each case is based on a loan repayment schedule that shows the loan payments to the financial institution by the individual borrowers, and also shows the payments by the financial institution to the CBSL.

The situation is illustrated with three scenarios:

Case 1 (**Annex A**) is the present situation in which the CBSL makes a loan to the participating financial institution in the exact same amount and term as the loan the institution makes to an individual borrower. The main difference between the loans is the interest rate, which is 20.5% between the borrower and the financial institution, and 12.5% between the financial institution and the CBSL. The other difference is that the individual borrower pays monthly while the financial institution pays semi-annually.

Case 2 (**Annex B**) takes the same terms as Case 1 but allows a 3-year grace period in which the financial institution pays interest only to the CBSL during the first three years, then repays the loan over 15 years.

Case 3 (**Annex C**) changes the terms so that the loan to the individual borrower is 10 years while the loan from the CBSL to the financial institution is for 20 years, including a 3-year grace period followed by repayment over the remaining 17 years.

The presentation of the three cases is in the following order: first there is a portion of a Loan Repayment Table giving the terms and conditions and the first 36 months of the loans. Next is Graph 1 showing the Gross Cash Flow of the two loans, followed by Graph 2 giving the Loan Balances. Finally, Graph 3 shows the amount of Loan Principal Repayment that is due each year.

In all cases the Gross Cash Flow is initially positive for the financial institution. The second and third graphs show that the differing lending terms and conditions create flows of loan principal that are unfavorable to the financial institutions under the present conditions. Even with 100% recovery the loan principal of their individual loans will not be repaid as fast as the financial institution will have to repay the loan principal to the CBSL. This means that the financial institutions will have to look to some other source of capital to repay the portion of the CBSL loans that have not yet been recovered from the individual borrowers.

The initial source to cover the shortfall could be from the interest rate spread. However, the spread should only be used to cover current expenses, not to provide immediate additional lending capital for the institution. If the lending operation is profitable the financial institutions will improve their capital bases and lend more, but it would be inappropriate to

require them to cover mismatches in lending terms before the operation has been proven to be profitable and viable.

Graph 2 demonstrates that whenever the balance of the CBSL loan is less that the balance of the individual borrower's loan, the financial institution will have to make up the difference with its own capital. Graph 3 shows the amount of the shortfall. These illustrations do not take into account any provision for loan losses or late payments. Such losses will reduce the overall cash flow to the financial institutions without reducing their obligation to repay the CBSL.

Under favorable lending terms and conditions the financial institution should be able to reinvest any temporary net reflows of loan principal. When the term of the CBSL's loans are closely tied to the financial institution's loans to its borrowers there is no opportunity for the financial institution to make more long-term housing loans with these funds. They must be kept available to pay the CBSL.

In Case 2 the terms and conditions are more favorable to the financial institutions. In Case 2 the financial institution will be able to participate without having to use its own capital to cover the repayment difference that occurs in Case 1. **However, there is still little opportunity for making many more long-term loans.**

In Case 3 the financial institution MUST make more loans in order to keep its loan principal reflows fully invested in interest-earning assets. The illustration is deliberately made a bit extreme to show that by having the CBSL make 20-year loans which are then used by the financial institutions to make 10-year loans, the financial institutions will be encouraged to enter the program in the first place, and establish a permanent lending operation. They will be assured of having funds to relend. It is unlikely that private sector financial institutions will participate in a meaningful way unless it is clearly in their benefit to do so.

For each Illustrative Case there is first a loan amortization table for the first three years of the loans. This is only part of the entire spreadsheet from which the various balances and cash flows are extracted for the related graphs. There are three graphs for each illustration. The first graph shows the gross annual cash flow of the loan from the individual borrower and to the CBSL. The second graph shows the loan balances, and the third graph shows the amount of principal repayments.

Graph 1 of each case shows that the gross cash flow for the participating financial institutions is positive. That is, as long as the individual borrowers pay their loans on time there will be enough gross cash flow to repay the CBSL loan. However, gross cash flow is not the best measure of viability of this type of lending program. A better indication is the flow of capital, or loan principal, at each level.

Measuring the flow of loan principal will allow each participant to maintain a balance of assets and liabilities under varying lending conditions. The fundamental rule involved here

is to maintain more assets than liabilities, keep the assets employed earning interest at all times. and use the interest spread to cover all administrative costs. Graph 2 shows the relationship between the assets that are earning interest and the liabilities on which interest must be paid. The principal amount of long-term housing loans is gradually reduced when payments are received by the financial institution. The interest is used by the financial institution to pay its administrative expenses and the interest it owes on the money it borrowed to make the loans to the individuals. The principal portion of each payment must be used to repay the principal portion of the underlying loan from the CBSL. Any excess principal repayment must be reinvested into more loans that will earn interest again.

The differing terms and conditions of the two levels of loans create different cash flows and different patterns of principal repayment. In general what happens is that for level payment loans with higher interest rates the principal portion is returned slower (in the early part of the loan) than for a similar loan with a lower interest rate. Later in the loan period the principal is returned at a faster rate. This is perfectly illustrated in Graph 2 of Case 1, where the loan balance of the CBSL loan is lower than the balance of the loan to the individual borrower. This projected curve will always show that the balance reduces faster for the loan with the lower interest rate as long as the term is equal.

The Graph 3 in each case shows the amount of principal reduction that is required each year for both lending levels. This directly relates to the reduced loan balances shown in Graph 2.

The three graphs, taken together, will give the lender a good picture of the initial loans and their related balances, cash flows, and asset/liability match. However, there is no calculation in these illustrations of the effect of reinvesting the excess cash flows, such as would happen whenever more loan principal is returned to the financial institution than it has to repay to the CBSL. For now, it must be kept in mind is that **not only the cash flow must be positive** to the participating financial institutions, but the **flow of loan principal must at least break even.** If there is a negative flow of loan principal the financial institution will be forced to use its own capital to cover the shortfall. If the best case scenario shows a consistent negative flow of loan principal, the financial institutions can be expected to not participate in the loan program.

The way the program is presently established will require a significant, although temporary, negative flow of loan principal which will have to be covered by the proposed participating financial institutions. This makes in unlikely that private financial institutions will actually participate in the program unless there is a change in the lending terms and conditions.

5. ANALYSIS OF EACH CASE

5.1. Case 1: Present Situation. The lending periods are perfectly matched, leaving a loan principal shortfall that will have to be made up by the participating financial institutions during the life of their loans. This will remove incentives for the financial institutions to participate in the program.

Another difficulty that is sure to arise is the need to reschedule a loan to an individual borrower. What usually happens is that a borrower may fall behind by several payments. The financial institutions will send letters asking for the payments but by the time the branch personnel are talking with the borrower several months may have elapsed, during which time the borrower's loan balance has remained at the same level, plus the accrued but unpaid interest.

The typical recovery procedure is to try to get the borrower to come up with the cash and bring the loan up to date, but often the best solution is to add the unpaid amount to the balance of the loan and arrange for a higher monthly payment over the remainder of the term, or even to extend the term and have a lower monthly payment. This will allow the financial institution to salvage a loan without having to go through with foreclosure and the difficulties of selling the property in what may become a hostile environment. But, the temporary non-payment of the borrower's loan does not affect the need to repay the CBSL on time. The lack of any leeway in the present situation will certainly require even more of the capital of the financial institution to make good on the loans that experience difficulty.

5.2 Case 2: Add a 3-Year Grace Period. The basic Case 2 is the same as Case 1 except that there is a 3-year grace period during which the participating financial institution will pay interest only to the CBSL, followed by a repayment period of the same length as the initial loan to the individual borrower. This change will be more attractive to the financial institutions, but will still place a heavy reporting and servicing burden on the participating financial institutions and the CBSL.

The implication of the addition of a grace period is to allow the financial institutions to invest their excess principal reflows into new loans. This will also allow the financial institutions to develop some supporting internal reserve to cover non-performing loans. If this is good business for them they will make more loans, but if they have to use their own capital to repay the CBSL until their own loans are repaid, they are unlikely to participate.

A look at Graph 3 of Case 2, (Principal Repayment Comparisons) shows that in the first three years the principal reflow is positive to the financial institution, as would be expected. In years 4, 5, 6, and 7 the principal reflows are so close that there will be no net reflow of loan principal, which means there will be no new loans made in those years. In fact, the financial institution will probably keep the reflows from the first three years invested in shorter-term loans which will be repaid in time for the institution to use them is they are needed to meet the CBSL obligation in these middle years.

It appears that a longer Grace Period would be needed in Case 2 for it to be attractive to private financial institutions.

5.3 Case 3: Add a 3-Year Grace Period, and Make Longer-term Loan. The central idea of this illustration is to create an incentive for the financial institutions to participate by giving them the opportunity to reinvest their excess capital reflow into more loans, and certainly loans for housing purposes. The illustration shows an initial 10-year loan to an individual borrower that is supported by a 20-year loan to the financial institution by the CBSL. The initial 3-year grace period assures the financial institution that it will be able to reinvest the excess capital repayments, rather than search for its own resources for capital repayment. The cash flow is so strong that the financial institutions will have to roll over the capital reflows several times during the life of the loan from the CBSL.

This illustration points toward a program under which the CBSL could make a single line of credit available to each participating financial institution. They would be encouraged to develop a market niche where they will feel comfortable with the target clientele. Given the cash flow that will be assured to the financial institutions, which will not require new approvals from the CBSL for each new loan made with the reflows, the financial institutions will be able to establish a permanent staff to manage the program. This will assure USAID and the CBSL that the number of beneficiaries will continue to increase with minimal servicing requirements by the CBSL.

5.4 Reinvestment Risk. When there is a planned reinvestment of the net reflows of loan principal, a major risk to the financial institutions in that in the future they may be forced by market conditions to make loans at a lower interest rate than the initial rate, while their underlying loan from the CBSL remains at the initial rate set at the time of the initial disbursements. Their spread will decrease but their expenses will remain the same, thereby eliminating any profit or even causing losses. This risk can be minimized by the monitoring of the program, and possibly allowing some variation in the rate to the CBSL according to changes in market conditions over the years. If the risk is not properly addressed, the financial institutions will either repay the CBSL early, or reinvest the net capital reflows in short-term non-housing activities.

5.5 Summary of Illustrative Cases. Case 1 does not encourage the flow of lending capital into housing loans, and will only appeal to state-owned financial institutions that are not primarily concerned with normal banking concerns of liquidity, capital investments, real returns on investments, and maintaining a proper asset/liability balance. The reflows of loan principal to the CBSL will eliminate any reinvestment by the participating financial institutions into more housing loans.

In the early years of a program set up along the lines of Cases 2 and 3, the financial institutions will be encouraged to make more housing loans. The number of new loans will depend on the terms of the loans from CBSL. In Case 2 the capital flow in the first year is Rs. 561. This amount from about 90 similar loans totalling Rs. 4,500,000 will allow the

financial institution to make one new loan of Rs. 50,000. In Case 3 the capital flow in the first year is Rs. 1,699. This would require the capital reflow of about 30 similar loans totalling Rs. 1,500,000 to make one new loan.

The capital reflows in the second and subsequent years increase to allow the making of even more loans. During the period while there are principal reflows but not enough to make a new loan, the financial institutions should be expected to keep the loan capital at work earning interest as short-term investments such as Treasury Bills. The CBSL should require regular reporting from the financial institutions to assure that the capital reflows are indeed being used to make new loans for housing, with due allowance for short-term treasury activities by the financial institutions.

6. COMPARISON WITH ADB PROGRAM

The SMIB and the HDFC are also participating in a similar lending program through the CBSL with funding from an ADB loan. There has been some concern that the HG-004 program may be unattractive to financial institutions with access to the ADB program. According to information obtained from SMIB, the CBSL/ADB program lending conditions are as follows:

Interest rate to Beneficiaries: 20.5% (same as HG-004)

Interest rate to Institutions: 8.5% to 9% (12.5% for HG-004)

Income Limit: 55th percentile (50th for HG-004)

Grace Period: 5 years for participating institution (none for HG-004)

Repayment Terms: Global term loan of 15 years following grace period, with equal amounts of principal, plus interest on balance. (Level payment of principal and interest for separate loans at same term as each individual borrower loan made by institution for HG-004)

Counterpart Loan Capital: 25% (none for HG-004)

The ADB program is more attractive in the areas of interest rate spread, grace period, and by providing a global loan. The HG-004 program is more attractive by allowing a level payment back to CBSL, and with no counterpart requirement.

Each participating financial institution should perform its own analysis of the two loan programs. They will find that each program has strengths and weaknesses that will appeal in different ways to the financial institutions. The interest rate spread advantage is clearly with the ADB program, but the lower HG-004 spread still allows the institutions to cover their direct costs and hopefully make a reasonable profit on the operation. The higher spread with the ADB program will encourage institutions that are well-capitalized to participate. Undercapitalized institutions may not be able or willing to provide the ADB counterpart so would go with the HG-004 program.

Graphic illustrations of the CBSL/ADB program are included in this report in Annex D. The illustrations generally follow the same format as the illustrations for the HG-004 loans, except that the cash flows are adjusted to show two loans to individual borrowers, one made at the beginning and one at the end of the 5-year disbursement period. These two loans are supported by loans from the CBSL/ADB program at 75% of the amount lent by the SMIB.

The CBSL/ADB program requires the financial institutions to pay interest only on the global loan balance during the disbursement period, then begin making equal semi-annual

principal payments plus interest on the global balance starting six months after the end of the grace period. The illustrations show that the gross cash flow to the SMIB is always positive, while the loan principal flow goes strongly negative in the sixth year and remains negative until the eleventh year, even though the CBSL loan is only 75% of the amount of the individual loans. Not only will the SMIB have to provide 25% of its loans from its own capital, it will have to use even more of its capital to repay the portion CBSL loans until loan principal of its own loans begin to be repaid.

For the purpose of loan collections and servicing, the CBSL/ADB loan program will be similar to HG-004 at the level of the loans to individual borrowers. The main difference will be that the global loan from the CBSL will be easier to track and service.

The participating financial institutions will need to closely monitor the reflows of loan principal and consistently reinvest the principal into new loans while the capital flow is positive. Undercapitalized financial institutions may decide, however, to keep the net capital reflows invested in short-term securities that can be easily liquidated when the need arises to begin repayment of the CBSL loan.

7. AFFORDABILITY CONSIDERATIONS

The financial institutions usually allow up to 25% of family income to be used towards the monthly payment. A level payment loan of Rs. 50,000 payable over 15 years at 20.5% interest will require a monthly payment of Rs. 897. The minimum family income needed to qualify for this loan is Rs. 3,588, while the recently adjusted median family income in Sri Lanka is about Rs. 4,300. This loan would probably qualify for refinancing through the HG-004 program.

The present widespread practice of recording interest and principal will make it difficult or unlikely to change the practice and introduce a recording system based on the planned repayment schedule rather than as the individual payments are received and then counting the number of days since the last payment to calculate interest. Rather than change the existing systems, it may be appropriate to build in an adjustment to the HG-004.

The present practice is, in effect, a constant restructuring of the individual loans. Whenever the loan balance is not reduced according to the repayment schedule the final repayment date is extended for some period. Thus, the loan balances shown in the Graphs will be shifted to the right each time the balance stays at the same level from one month to the next. When the individual loans are funded by a loan from the CBSL, this extension of time for the loans will require the financial institutions to use even more of their own capital, so that their original loan to a borrower will still be outstanding long after the financial institution has repaid the CBSL.

This situation can be improved by requiring a slightly higher monthly payment from the individual borrowers. The amount of the increase may be in the range of Rs. 50 more each month. If the family repays without fail their loan will be repaid early. If they miss a few payments their loan may still be repaid on time, due to the slightly higher payment required each month. This adjustment to the repayment schedule may be the easiest solution to the loan tracking problem under present conditions.

In terms of affordability, this Rs. 50 per month adjustment would make the illustrative Rs. 50,000 loan affordable to a family with an income of Rs. 3,788 instead of Rs. 3,588.

8. TRAINING

8.1 Requirements. It is already apparent that the financial institutions and the CBSL will require technical assistance in the form of specialized training sessions in which they learn to service the loans that will be made at each level. The commercial banks are accustomed to making regular term loans and their servicing is based on lending conditions that are different for longer-term lending typically found in housing programs.

There is a high degree of technical competence in loan servicing in all of the participating financial institutions. The specific training they will require will be based on the final lending terms and conditions. In addition, specialized training in Asset/Liability Management and Fund Management will be needed in some of the financial institutions to improve their capacity to maintain specialized accounts of both the assets (loans and principal reflows) and their liabilities (the loans from the CBSL).

It is proposed that the HDFC act as the loan collections and servicing training center for the HG program. Their present system is appropriate for any of the Sub-Apex Lenders and can serve as a model that can be applied at all participating financial institutions. Standardizing the collections and servicing functions at each participating financial institution should make it easier in the future to introduce a secondary mortgage market, in which the financial institutions sell their interest in specific loans, thereby freeing up their own loan funds to make more loans for housing. This is strictly a side benefit of standardization for the present HG-004.

Specific training will be required for the tracking of the housing loans and for reporting to the CBSL. The CBSL should also participate in the training sessions so that its loan servicing personnel will understand the sources of the information they will receive during the lending program. The loans from the CBSL to the participating financial institutions will require a separate servicing system which will be included in the training sessions.

The training should be conducted by a two-person team consisting of a Collections and Servicing Trainer and an Administrative Assistant. The team can develop the training curriculum during a two-week period immediately preceding the week of the course. Materials will include the preparation of examples of loan situations likely to be encountered. The trainers will meet with the participants during the initial two weeks and make all related preparations for the presentation of the course itself.

During the week of the course the trainers will present the course materials and conduct the meetings. Following the daily training meeting the trainers will return to a different financial institution to work with individual participants and propose adaptations of the HG reporting system for use in each financial institution.

At the end of the training course the participants should be able to adapt the loan control systems used at their financial institutions to conform to the HG requirements. The

limited exposure to Asset/Liability Management provided by the trainers should encourage the management of the financial institutions to further develop their financial analytical capacity.

8.2 Training Outline

Title:	Training in Loan Collections, Servicing, and Reporting
Timing:	Five daily 3-hour sessions during one week for participants. Setup and documentation over three weeks by the trainers.
When:	Sessions should take place before many individual loans are made, preferably in May or June 1993.
Participants:	Loan collections and servicing personnel of financial institutions participating in HG-004. Institutions include HDFC, SMIB, Hatton Bank, Seylan Bank, SMIB, and CBSL.
Location:	Colombo. Main office of HDFC, or some other location offering access to facilities and conference room.
Topics:	Loan Control Systems Tracking Level Payment Mortgage Loans Aging Analysis of the Loan Portfolio Problem Loans, Late Charges, and Rescheduling Reporting Requirements Servicing Loans to CBSL Asset/Liability Management Reinvesting Loan Principal Repayments
Logistic Support:	Conference room for up to 25 persons Access to examples of actual loans 3 or 4 PCs to run simulations Access to copying machine Overhead projector
Personnel:	Principal Trainer in Loan Collections, Servicing, and Reporting (internationally contracted for three weeks full time) Administrative Assistant (locally contracted for three weeks full time)
Backup:	Housing Advisor, USAID/Sri Lanka Training Coordinator, RHUDO/Bangkok

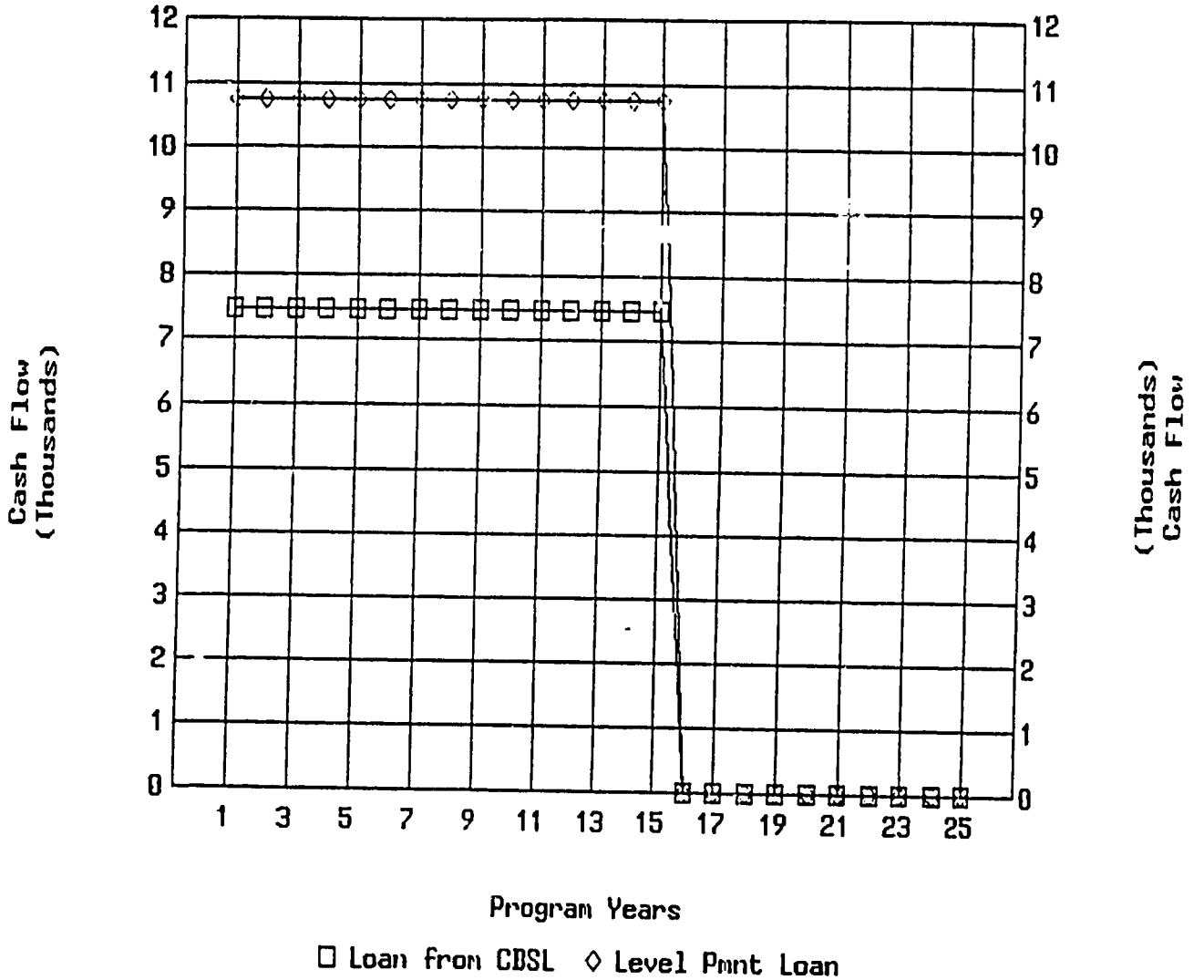
Illustrative Case 1: Present Situation

HG-004 Sri Lanka
T/A in Collections & Servicing

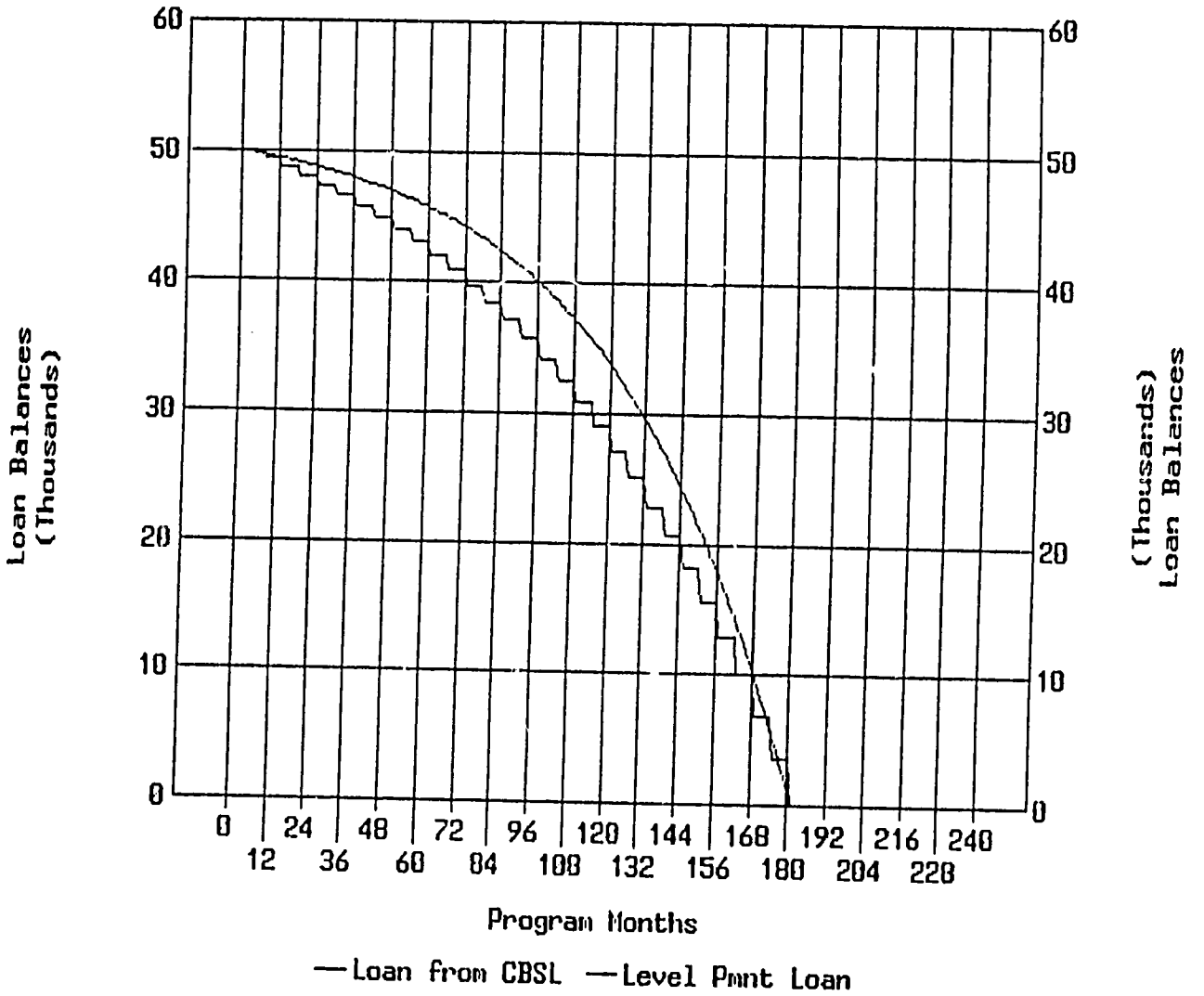
Amount: 50,000 Sri Lanka Rupees
Rate: 20.50% to participating banks from customers
12.50% to Central Bank from participating banks
Term: 180 months retail
180 months (+0 yrs grace) wholesale
Payment: 3,730 every 6 months — Level Semi-annual Payments
897 monthly incl. interest — Level monthly payments

1										
Program Month	Begin Balance	Prncpl Paid	Int. Paid	Total Paid	Ending Balance	Begin Balance	Prncpl Paid	Int. Paid	Total Paid	Ending Balance
0	50,000					50,000				
1	50,000	0	0	0	50,000	50,000	43	854	897	49,957
2	50,000	0	0	0	50,000	49,957	43	853	897	49,914
3	50,000	0	0	0	50,000	49,914	44	853	897	49,870
4	50,000	0	0	0	50,000	49,870	45	852	897	49,826
5	50,000	0	0	0	50,000	49,826	45	851	897	49,780
6	50,000	605	3,125	3,730	49,395	49,780	46	850	897	49,734
7	49,395	0	0	0	49,395	49,734	47	850	897	49,687
8	49,395	0	0	0	49,395	49,687	48	849	897	49,639
9	49,395	0	0	0	49,395	49,639	49	848	897	49,590
10	49,395	0	0	0	49,395	49,590	50	847	897	49,541
11	49,395	0	0	0	49,395	49,541	50	846	897	49,490
12	49,395	643	3,087	3,730	48,752	49,490	51	845	897	49,439
13	48,752	0	0	0	48,752	49,439	52	845	897	49,387
14	48,752	0	0	0	48,752	49,387	53	844	897	49,334
15	48,752	0	0	0	48,752	49,334	54	843	897	49,280
16	48,752	0	0	0	48,752	49,280	55	842	897	49,225
17	48,752	0	0	0	48,752	49,225	56	841	897	49,170
18	48,752	683	3,047	3,730	48,069	49,170	57	840	897	49,113
19	48,069	0	0	0	48,069	49,113	58	839	897	49,055
20	48,069	0	0	0	48,069	49,055	59	838	897	48,997
21	48,069	0	0	0	48,069	48,997	60	837	897	48,937
22	48,069	0	0	0	48,069	48,937	61	836	897	48,876
23	48,069	0	0	0	48,069	48,876	62	835	897	48,814
24	48,069	726	3,004	3,730	47,343	48,814	63	834	897	48,752
25	47,343	0	0	0	47,343	48,752	64	833	897	48,688
26	47,343	0	0	0	47,343	48,688	65	832	897	48,623
27	47,343	0	0	0	47,343	48,623	66	831	897	48,557
28	47,343	0	0	0	47,343	48,557	67	830	897	48,490
29	47,343	0	0	0	47,343	48,490	68	828	897	48,421
30	47,343	771	2,959	3,730	46,572	48,421	69	827	897	48,352
31	46,572	0	0	0	46,572	48,352	71	826	897	48,281
32	46,572	0	0	0	46,572	48,281	72	825	897	48,209
33	46,572	0	0	0	46,572	48,209	73	824	897	48,136
34	46,572	0	0	0	46,572	48,136	74	822	897	48,062
35	46,572	0	0	0	46,572	48,062	76	821	897	47,986
36	46,572	819	2,911	3,730	45,752	47,986	77	820	897	47,909

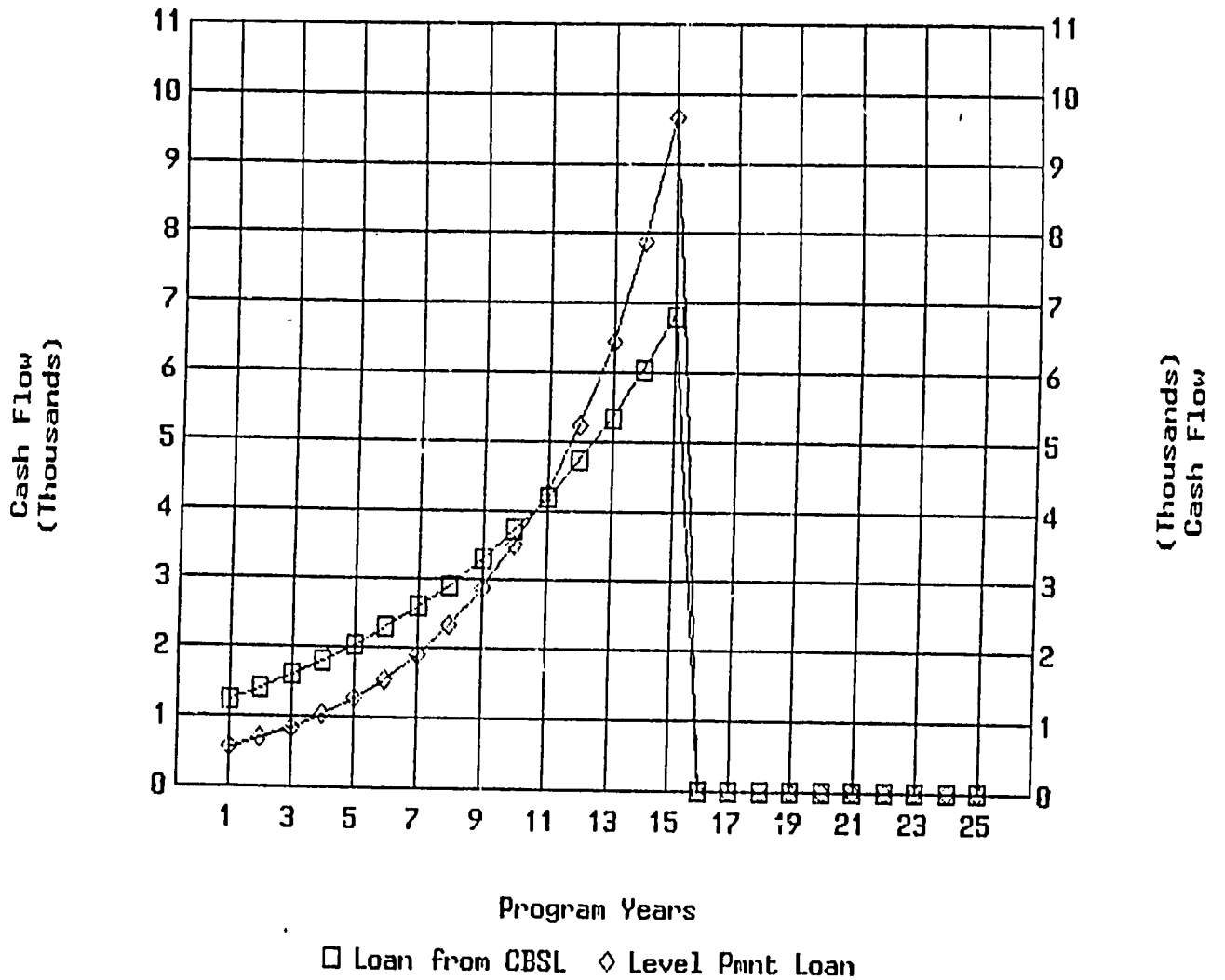
Gross Cash Flow (0 years grace)
HG-004 Sri Lanka



Loan Balances (0 years grace)
HG-004 Sri Lanka



Principal Repayment Comparisons
HG-004 Sri Lanka (0 years grace)



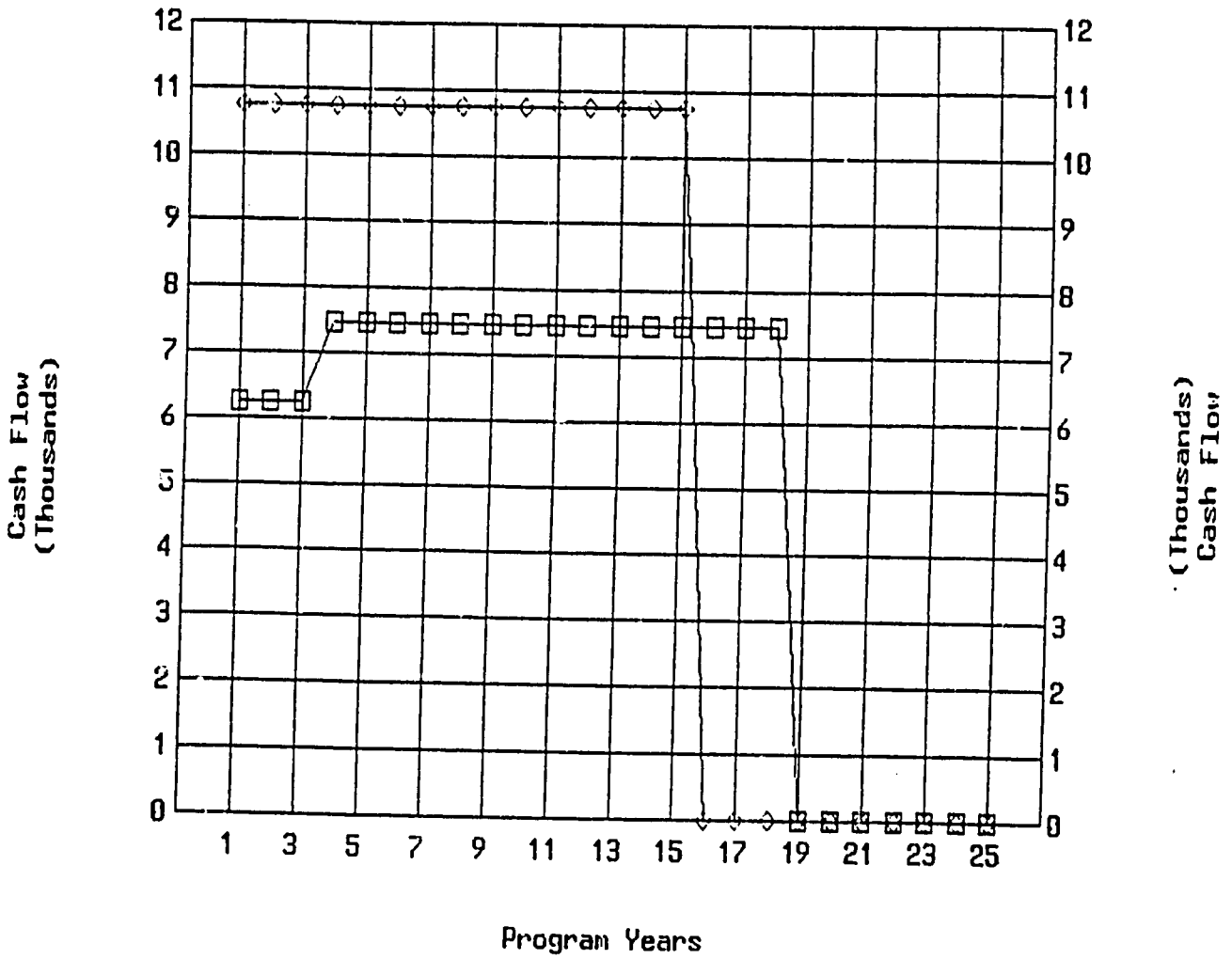
Illustrative Case 2: Add Grace Period

HG-004 Sri Lanka
T/A in Collections & Servicing

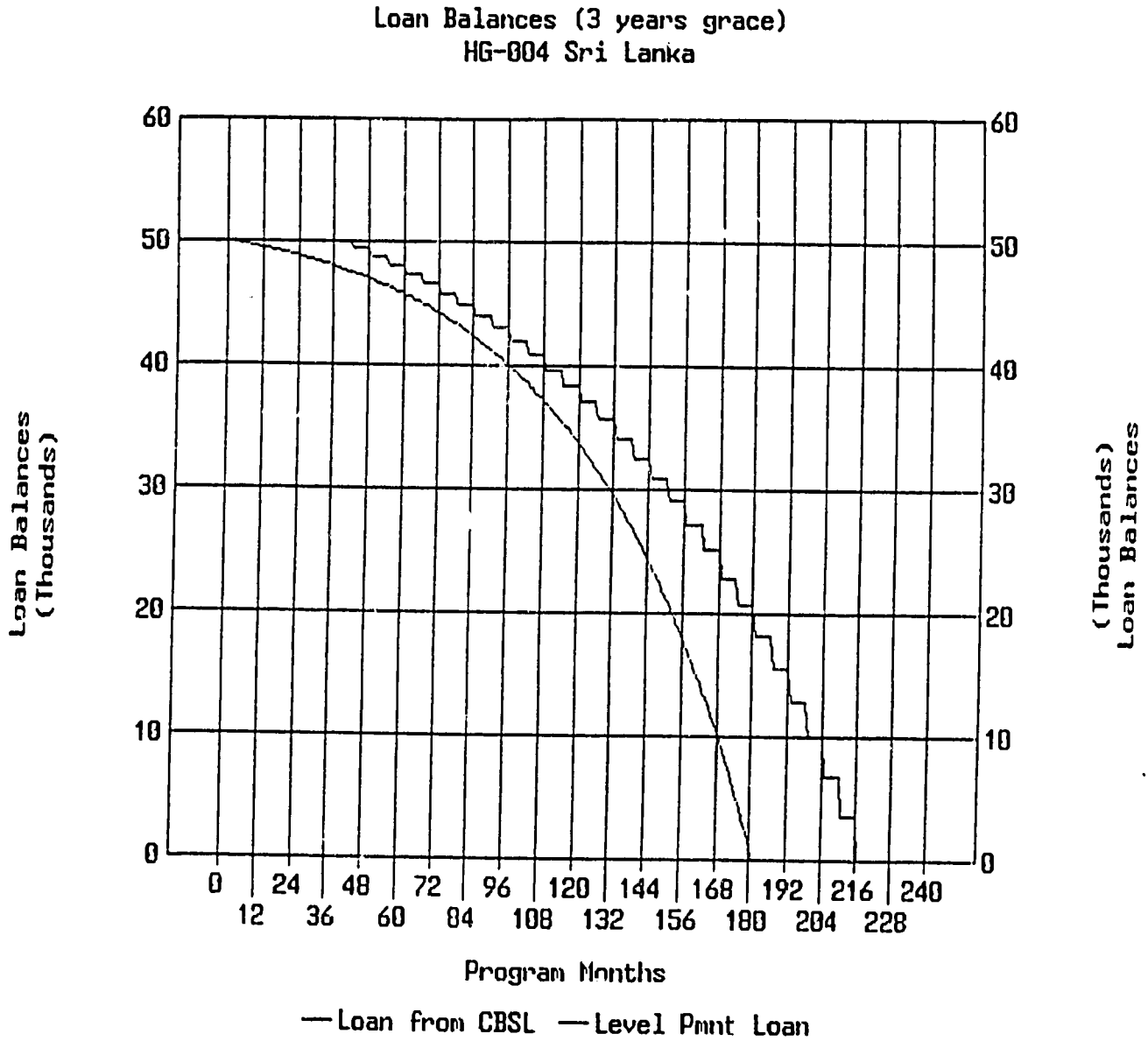
Amount: 50,000 Sri Lanka Rupees
Rate: 20.50% to participating banks from customers
12.50% to Central Bank from participating banks
Term: 180 months retail
180 months (+3 yrs grace) wholesale
Payment: 3,730 every 6 months — Level Semi-annual Payments
897 monthly incl. interest — Level monthly payments

Program Month	Begin Balance	Prncpl Paid	Int. Paid	Total Paid	Ending Balance	Begin Balance	Prncpl Paid	Int. Paid	Total Paid	Ending Balance
0	50,000					50,000				
1	50,000	0	0	0	50,000	50,000	43	854	897	49,957
2	50,000	0	0	0	50,000	49,957	43	853	897	49,914
3	50,000	0	0	0	50,000	49,914	44	853	897	49,870
4	50,000	0	0	0	50,000	49,870	45	852	897	49,826
5	50,000	0	0	0	50,000	49,826	45	851	897	49,780
6	50,000	0	3,125	3,125	50,000	49,780	46	850	897	49,734
7	50,000	0	0	0	50,000	49,734	47	850	897	49,687
8	50,000	0	0	0	50,000	49,687	48	849	897	49,639
9	50,000	0	0	0	50,000	49,639	49	848	897	49,590
10	50,000	0	0	0	50,000	49,590	50	847	897	49,541
11	50,000	0	0	0	50,000	49,541	50	846	897	49,490
12	50,000	0	3,125	3,125	50,000	49,490	51	845	897	49,439
13	50,000	0	0	0	50,000	49,439	52	845	897	49,387
14	50,000	0	0	0	50,000	49,387	53	844	897	49,334
15	50,000	0	0	0	50,000	49,334	54	843	897	49,280
16	50,000	0	0	0	50,000	49,280	55	842	897	49,225
17	50,000	0	0	0	50,000	49,225	56	841	897	49,170
18	50,000	0	3,125	3,125	50,000	49,170	57	840	897	49,113
19	50,000	0	0	0	50,000	49,113	58	839	897	49,055
20	50,000	0	0	0	50,000	49,055	59	838	897	48,997
21	50,000	0	0	0	50,000	48,997	60	837	897	48,937
22	50,000	0	0	0	50,000	48,937	61	836	897	48,876
23	50,000	0	0	0	50,000	48,876	62	835	897	48,814
24	50,000	0	3,125	3,125	50,000	48,814	63	834	897	48,752
25	50,000	0	0	0	50,000	48,752	64	833	897	48,688
26	50,000	0	0	0	50,000	48,688	65	832	897	48,623
27	50,000	0	0	0	50,000	48,623	66	831	897	48,557
28	50,000	0	0	0	50,000	48,557	67	830	897	48,490
29	50,000	0	0	0	50,000	48,490	68	828	897	48,421
30	50,000	0	3,125	3,125	50,000	48,421	69	827	897	48,352
31	50,000	0	0	0	50,000	48,352	71	826	897	48,281
32	50,000	0	0	0	50,000	48,281	72	825	897	48,209
33	50,000	0	0	0	50,000	48,209	73	824	897	48,136
34	50,000	0	0	0	50,000	48,136	74	822	897	48,062
35	50,000	0	0	0	50,000	48,062	76	821	897	47,986
36	50,000	0	3,125	3,125	50,000	47,986	77	820	897	47,909

Gross Cash Flow (3 years grace)
HG-004 Sri Lanka

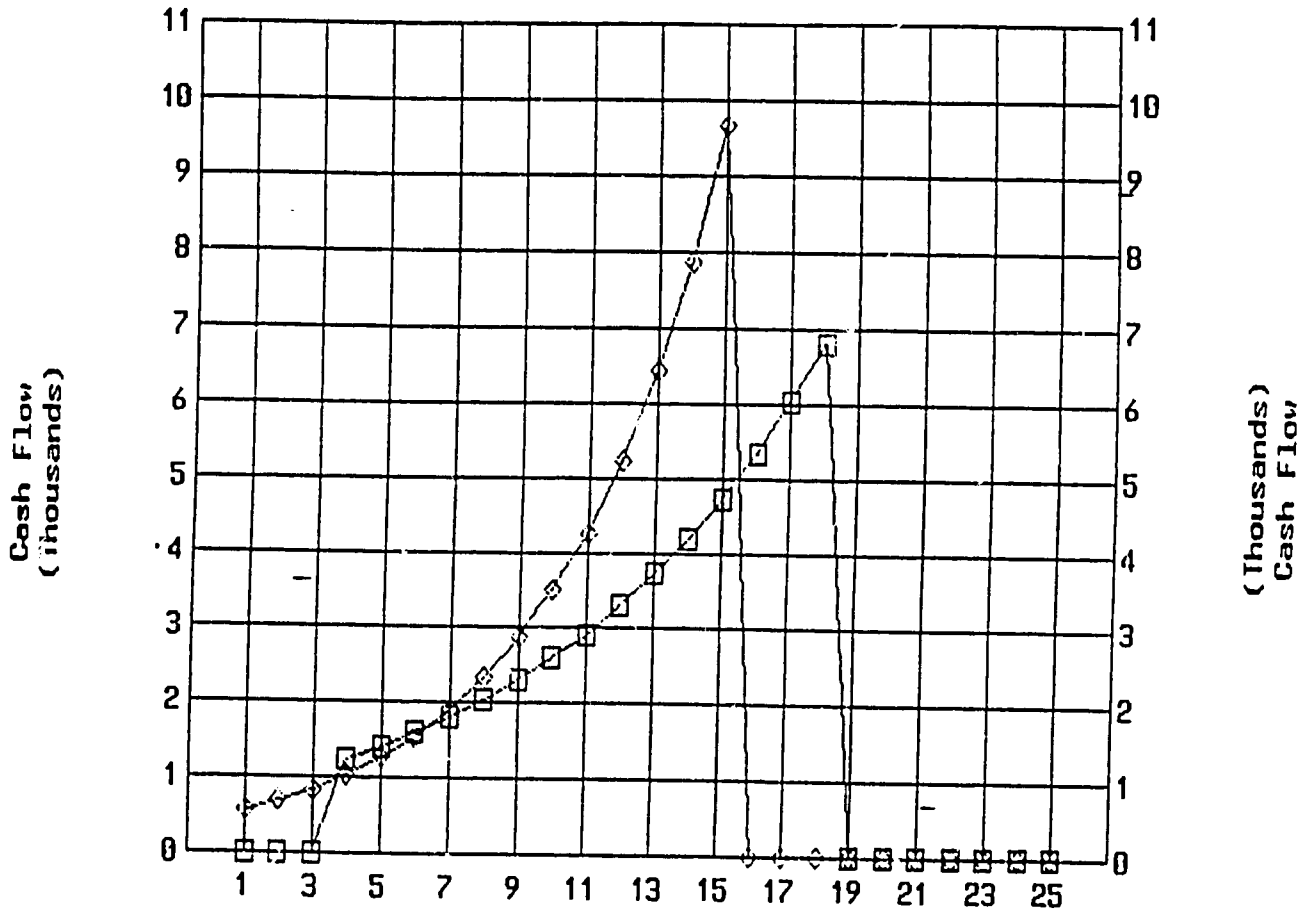


□ Loan from CDSL ◇ Level Pmnt Loan


Loan Balances (3 years grace)
HG-004 Sri Lanka
Loan Balances (Thousands)
60
50
40
30
20
10
0
0 12 24 36 48 60 72 84 96 108 120 132 144 156 168 180 192 204 216 228 240
Program Months
—Loan from CBSL —Level Pmnt Loan

25

Principal Repayment Comparisons
HG-004 Sri Lanka (3 years grace)



Program Years

□ Loan from CBSL ◇ Level Pmnt Loan

Annex C

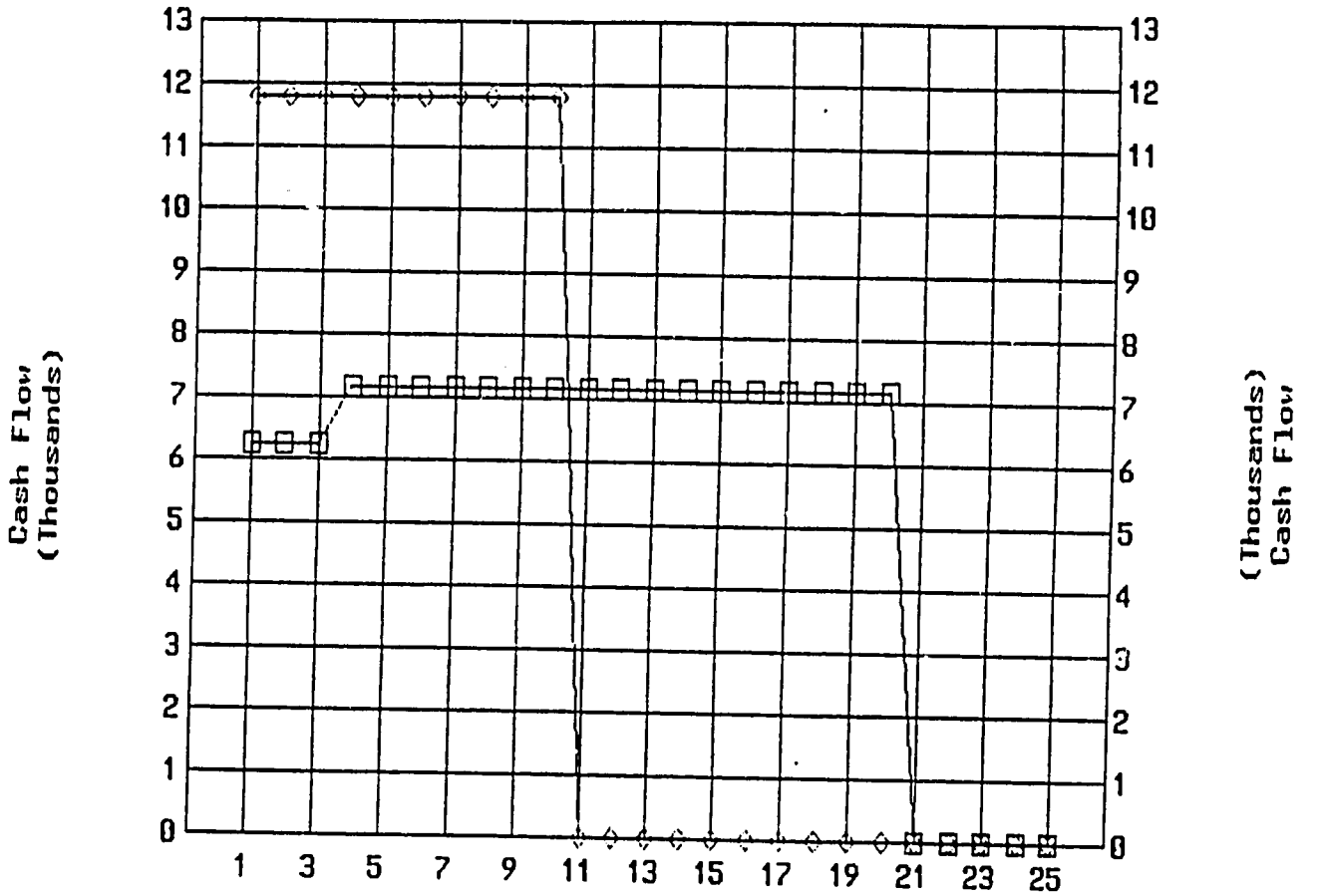
Illustrative Case 3: Add Grace Period and Longer-Term Loan

HG-004 Sri Lanka
T/A in Collections & Servicing

Amount: 50,000 Sri Lanka Rupees
Rate: 20.50% to participating banks from customers
12.50% to Central Bank from participating banks
Term: 120 months retail
204 months (+3 yrs grace) wholesale
Payment: 3,581 every 6 months — Level Semi-annual Payments
983 monthly incl. interest — Level monthly payments

0		Level Semi-annual Payments				Level monthly payments				
Program Month	Begin Balance	Prncpl Paid	Int. Paid	Total Paid	Ending Balance	Begin Balance	Prncpl Paid	Int. Paid	Total Paid	Ending Balance
0	50,000					50,000				
1	50,000	0	0	0	50,000	50,000	129	854	983	49,871
2	50,000	0	0	0	50,000	49,871	131	852	983	49,740
3	50,000	0	0	0	50,000	49,740	133	850	983	49,607
4	50,000	0	0	0	50,000	49,607	135	847	983	49,472
5	50,000	0	0	0	50,000	49,472	138	845	983	49,334
6	50,000	0	3,125	3,125	50,000	49,334	140	843	983	49,194
7	50,000	0	0	0	50,000	49,194	143	840	983	49,051
8	50,000	0	0	0	50,000	49,051	145	838	983	48,906
9	50,000	0	0	0	50,000	48,906	147	835	983	48,759
10	50,000	0	0	0	50,000	48,759	150	833	983	48,609
11	50,000	0	0	0	50,000	48,609	153	830	983	48,456
12	50,000	0	3,125	3,125	50,000	48,456	155	828	983	48,301
13	50,000	0	0	0	50,000	48,301	158	825	983	48,143
14	50,000	0	0	0	50,000	48,143	160	822	983	47,983
15	50,000	0	0	0	50,000	47,983	163	820	983	47,820
16	50,000	0	0	0	50,000	47,820	166	817	983	47,654
17	50,000	0	0	0	50,000	47,654	169	814	983	47,485
18	50,000	0	3,125	3,125	50,000	47,485	172	811	983	47,313
19	50,000	0	0	0	50,000	47,313	175	808	983	47,139
20	50,000	0	0	0	50,000	47,139	178	805	983	46,961
21	50,000	0	0	0	50,000	46,961	181	802	983	46,780
22	50,000	0	0	0	50,000	46,780	184	799	983	46,596
23	50,000	0	0	0	50,000	46,596	187	796	983	46,410
24	50,000	0	3,125	3,125	50,000	46,410	190	793	983	46,219
25	50,000	0	0	0	50,000	46,219	193	790	983	46,026
26	50,000	0	0	0	50,000	46,026	197	786	983	45,830
27	50,000	0	0	0	50,000	45,830	200	783	983	45,630
28	50,000	0	0	0	50,000	45,630	203	780	983	45,426
29	50,000	0	0	0	50,000	45,426	207	776	983	45,219
30	50,000	0	3,125	3,125	50,000	45,219	210	772	983	45,009
31	50,000	0	0	0	50,000	45,009	214	769	983	44,795
32	50,000	0	0	0	50,000	44,795	218	765	983	44,577
33	50,000	0	0	0	50,000	44,577	221	762	983	44,356
34	50,000	0	0	0	50,000	44,356	225	758	983	44,130
35	50,000	0	0	0	50,000	44,130	229	754	983	43,901
36	50,000	0	3,125	3,125	50,000	43,901	233	750	983	43,669

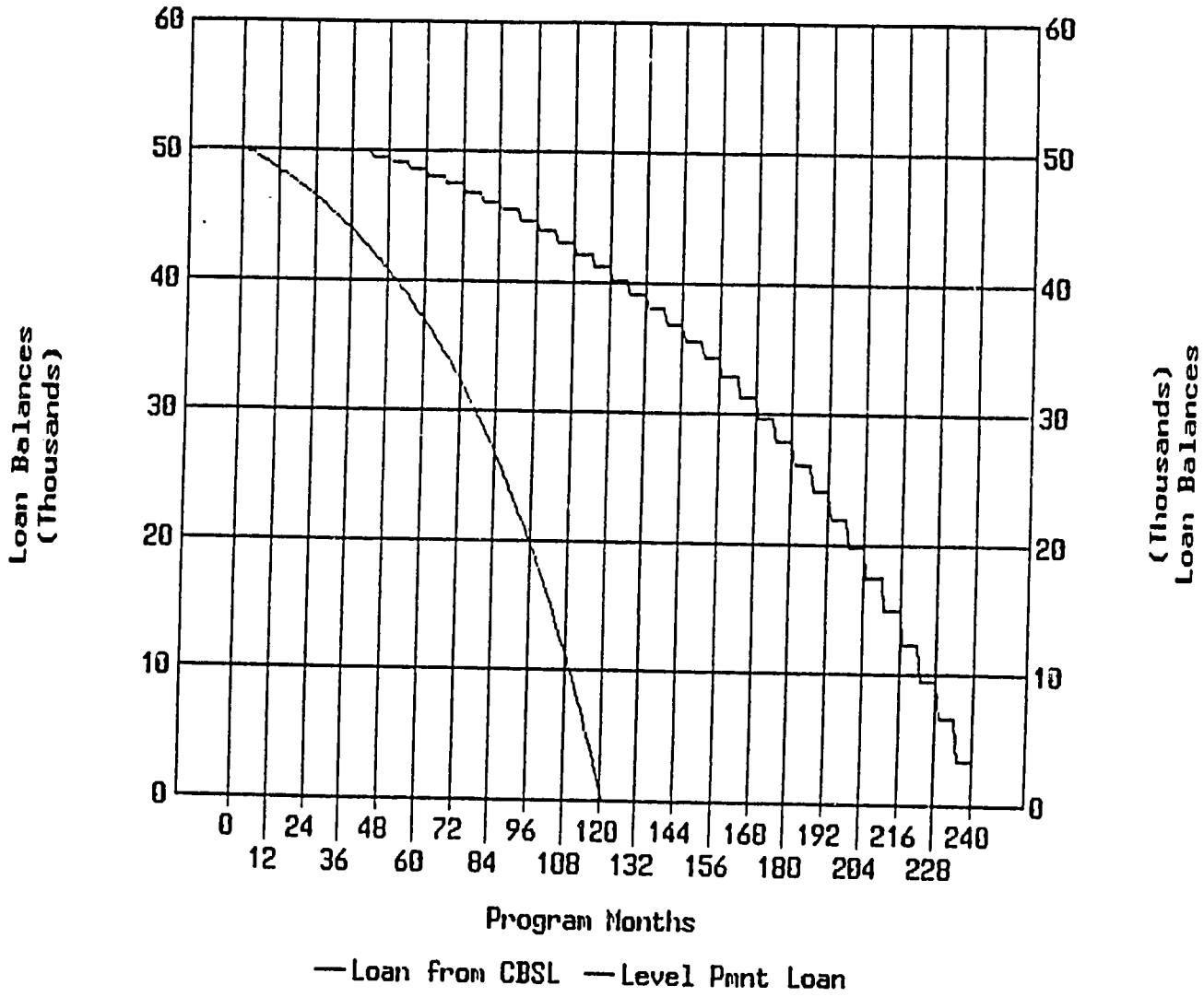
Gross Cash Flow (3 years grace)
HG-004 Sri Lanka



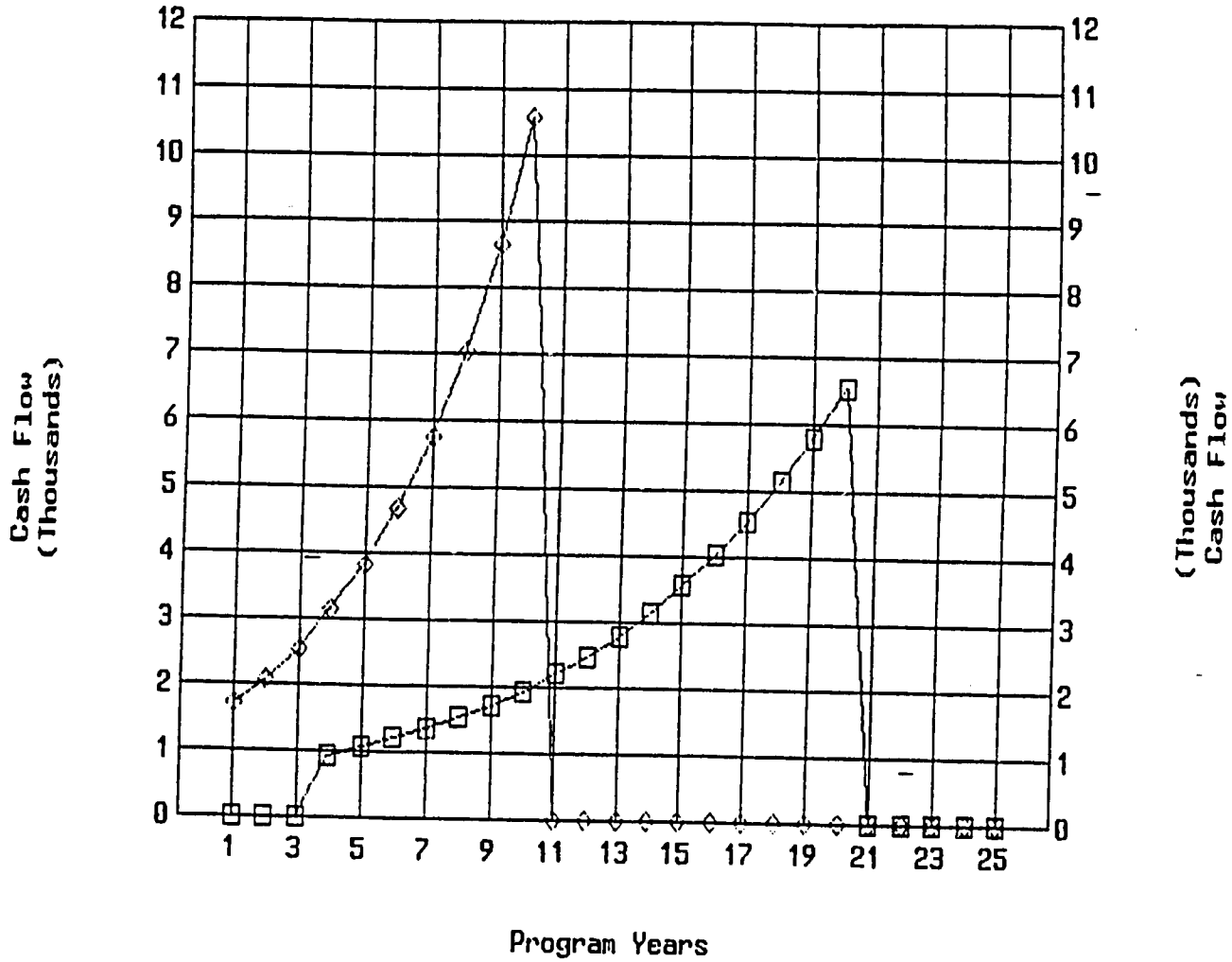
□ Loan from CBSL ◇ Level Pmnt Loan

28

Loan Balances (3 years grace)
HG-004 Sri Lanka



Principal Repayment Comparisons
HG-004 Sri Lanka (3 years grace)



□ Loan from CBSL ◇ Level Pmnt Loan

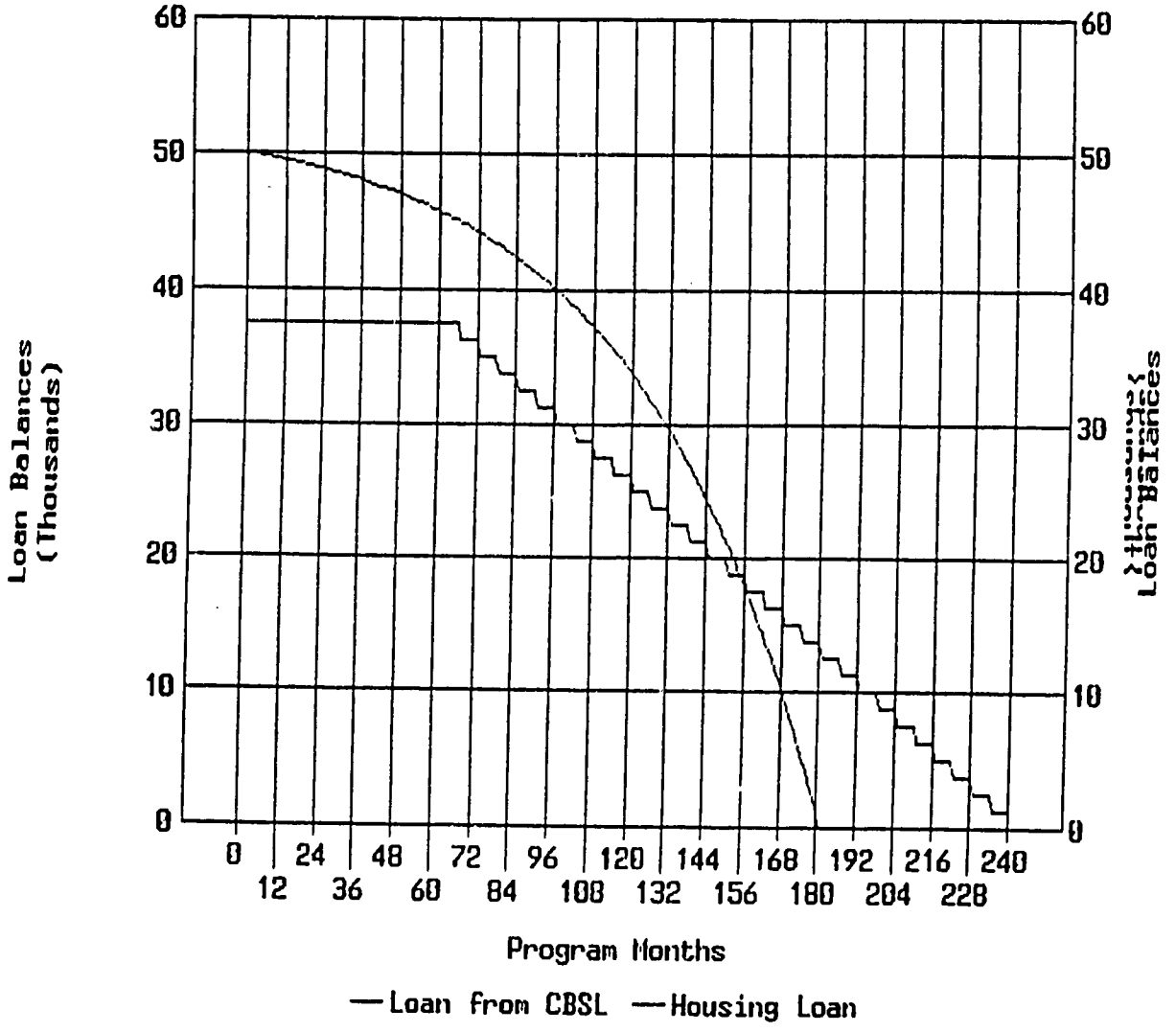
Illustrative SMIB Loan Under CBSL/ADB Loan Program

HG-004 Sri Lanka
T/A in Collections & Servicing

Amount: 50,000 Sri Lanka Rupees
Rate: 20.50% to SMIB from customers
9.00% to Central Bank (ADB) from SMIB
Term: 180 months retail
180 months (+5 yrs grace) wholesale
Payment: 1,250 every 6 months + interest 897 monthly incl. interest
75% coverage Level monthly payments

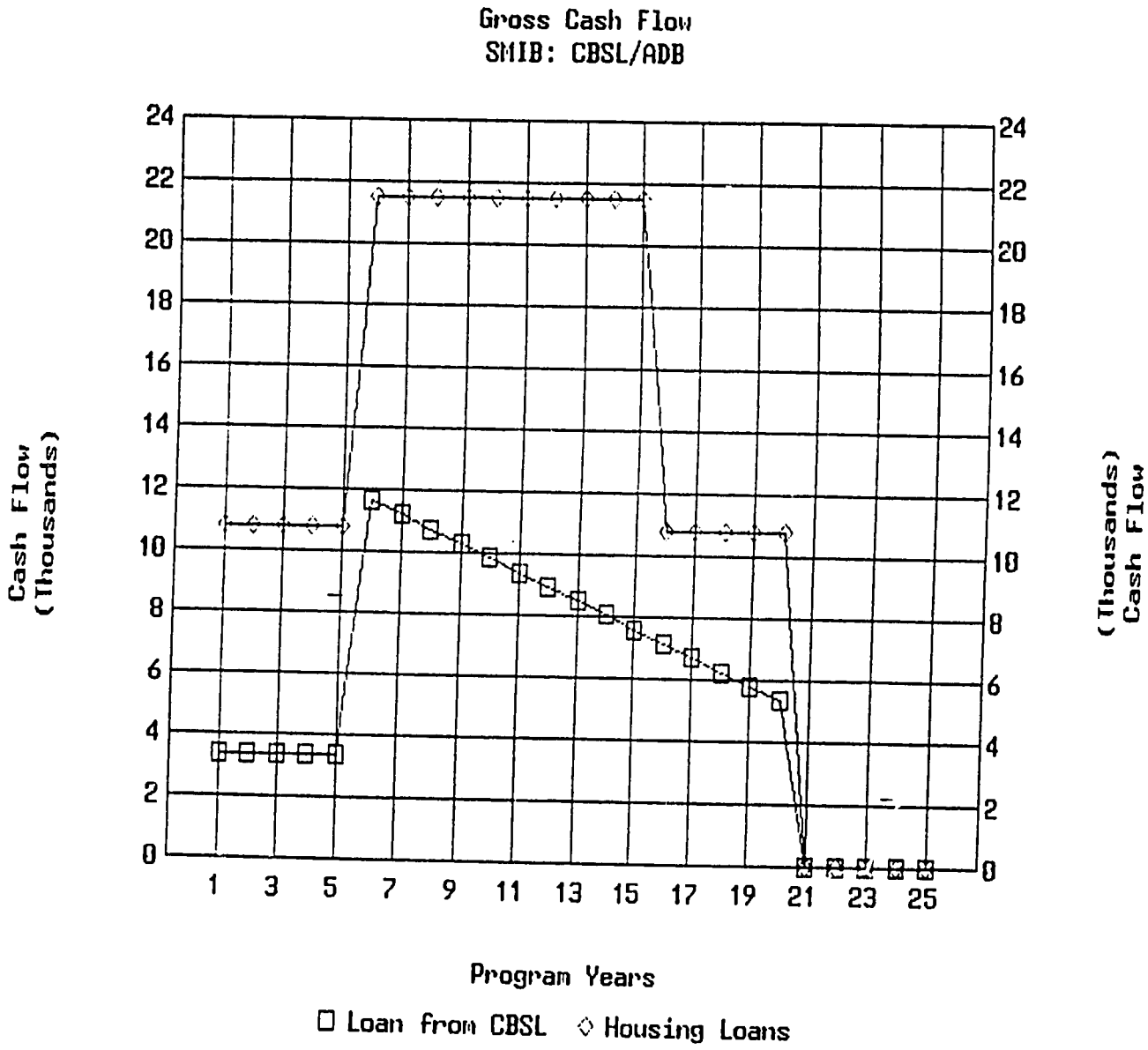
0										
Program Month	Begin Balance	Prncpl Paid	Int. Paid	Total Paid	Ending Balance	Begin Balance	Prncpl Paid	Int. Paid	Total Paid	Ending Balance
0	37,500					50,000				
1	37,500	0	0	0	37,500	50,000	43	854	897	49,957
2	37,500	0	0	0	37,500	49,957	43	853	897	49,914
3	37,500	0	0	0	37,500	49,914	44	853	897	49,870
4	37,500	0	0	0	37,500	49,870	45	852	897	49,826
5	37,500	0	0	0	37,500	49,826	45	851	897	49,780
6	37,500	0	1,688	1,688	37,500	49,780	46	850	897	49,734
7	37,500	0	0	0	37,500	49,734	47	850	897	49,687
8	37,500	0	0	0	37,500	49,687	48	849	897	49,639
9	37,500	0	0	0	37,500	49,639	49	848	897	49,590
10	37,500	0	0	0	37,500	49,590	50	847	897	49,541
11	37,500	0	0	0	37,500	49,541	50	846	897	49,490
12	37,500	0	1,688	1,688	37,500	49,490	51	845	897	49,439
13	37,500	0	0	0	37,500	49,439	52	845	897	49,387
14	37,500	0	0	0	37,500	49,387	53	844	897	49,334
15	37,500	0	0	0	37,500	49,334	54	843	897	49,280
16	37,500	0	0	0	37,500	49,280	55	842	897	49,225
17	37,500	0	0	0	37,500	49,225	56	841	897	49,170
18	37,500	0	1,688	1,688	37,500	49,170	57	840	897	49,113
19	37,500	0	0	0	37,500	49,113	58	839	897	49,055
20	37,500	0	0	0	37,500	49,055	59	838	897	48,997
21	37,500	0	0	0	37,500	48,997	60	837	897	48,937
22	37,500	0	0	0	37,500	48,937	61	836	897	48,876
23	37,500	0	0	0	37,500	48,876	62	835	897	48,814
24	37,500	0	1,688	1,688	37,500	48,814	63	834	897	48,752
25	37,500	0	0	0	37,500	48,752	64	833	897	48,688
26	37,500	0	0	0	37,500	48,688	65	832	897	48,623
27	37,500	0	0	0	37,500	48,623	66	831	897	48,557
28	37,500	0	0	0	37,500	48,557	67	830	897	48,490
29	37,500	0	0	0	37,500	48,490	68	828	897	48,421
30	37,500	0	1,688	1,688	37,500	48,421	69	827	897	48,352
31	37,500	0	0	0	37,500	48,352	71	826	897	48,281
32	37,500	0	0	0	37,500	48,281	72	825	897	48,209
33	37,500	0	0	0	37,500	48,209	73	824	897	48,136
34	37,500	0	0	0	37,500	48,136	74	822	897	48,062
35	37,500	0	0	0	37,500	48,062	76	821	897	47,986
36	37,500	0	1,688	1,688	37,500	47,986	77	820	897	47,909

SMIB Loan Balances
CBSL/ADB Sri Lanka

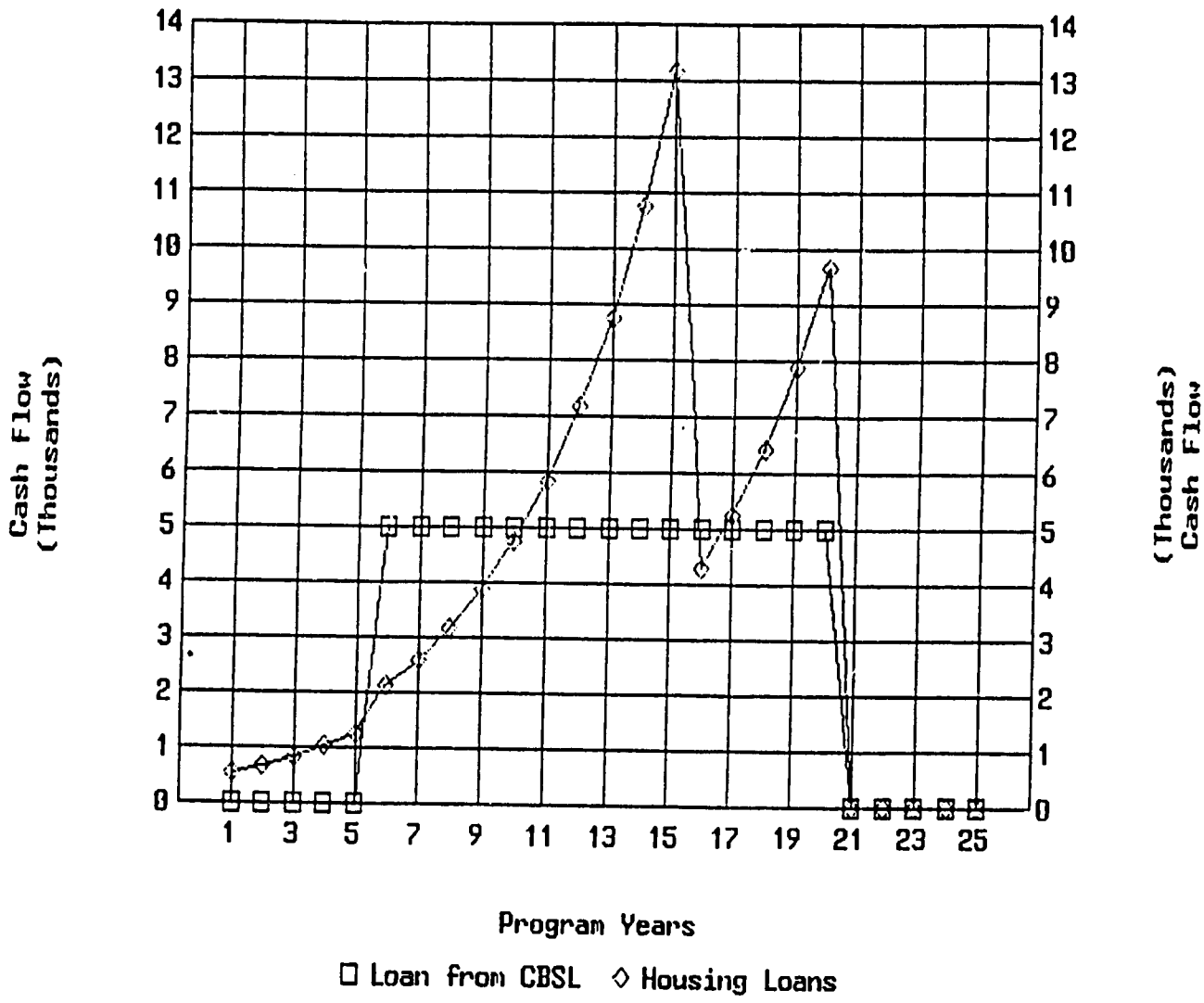


Cash Flow Projections

Program Year	P&I Central Bank	P only Central Bank	P&I Level Pmnt Loan	P only Level Pmnt Loan		
0						
1	3,375	0	10,760	561		
2	3,375	0	10,760	687		
3	3,375	0	10,760	842		
4	3,375	0	10,760	1,032		
5	3,375	0	10,760	1,265		
6	11,638	5,000	21,520	2,111	10,760	561
7	11,188	5,000	21,520	2,587	10,760	687
8	10,738	5,000	21,520	3,170	10,760	842
9	10,288	5,000	21,520	3,884	10,760	1,032
10	9,838	5,000	21,520	4,760	10,760	1,265
11	9,388	5,000	21,520	5,832	10,760	1,550
12	8,938	5,000	21,520	7,147	10,760	1,899
13	8,488	5,000	21,520	8,758	10,760	2,327
14	8,038	5,000	21,520	10,732	10,760	2,852
15	7,588	5,000	21,520	13,151	10,760	3,495
16	7,138	5,000	10,760	4,282	10,760	4,282
17	6,688	5,000	10,760	5,248	10,760	5,248
18	6,238	5,000	10,760	6,431	10,760	6,431
19	5,788	5,000	10,760	7,880	10,760	7,880
20	5,338	5,000	10,760	9,656	10,760	9,656
21	0	0	0	0	0	0
22	0	0	0	0	0	0
23	0	0	0	0	0	0
24	0	0	0	0	0	0
25	0	0	0	0	0	0


Gross Cash Flow
SMIB: CBSL/ADB
Cash Flow (Thousands)
(Thousands) Cash Flow
24
22
20
18
16
14
12
10
8
6
4
2
0
1 3 5 7 9 11 13 15 17 19 21 23 25
Program Years
Loan from CBSL
Housing Loans

Principal Repayment Comparisons
SMIB: CBSL/ADB



Annex E
Persons Interviewed

K.A.L. Premaratne	Director/Human Settlements and Secretary/Housing Finance Steering Committee, Dept. of National Planning, Ministry of Policy Planning and Implementation
Terence Savundranayagam	Director, Development Finance Department, Central Bank of Sri Lanka
E. A. Meththananda	Managing Director and Chief Executive, Housing Development Finance Corporation
Ranjani Jayasuriya	Deputy General Manager (Legal/Lending), Housing Development Finance Corporation
George Jelinek	Team Leader/Housing Advisor, Housing Sector Development Study, Ministry of Housing and Construction, ADB
Chandra Wijesckera	Advisor, Housing Sector Development Study, Ministry of Housing and Construction, Asian Development Bank
S. Yogagopalakrishnan	Assistant General Manager - Credit, Hatton National Bank Ltd.
N. Hapuarachchy	Senior Manager - Credit Supervision and Recoveries, Hatton National Bank Ltd.
Ruvini Thenabadu	Manager, Central Credit, Hatton National Bank Ltd.
G.T.B. Ekanayake	Deputy General Manager, Credit, Seylan Bank
Emil Anthony	Chief Manager, Branch Credit Department, Seylan Bank
Gunaoala Iddagoda	Deputy General Manager, SMIB
Kenneth Wren	Project Implementation Advisor, State Mortgage and Investment Bank, ADB
Richard M. Brown	Director, USAID
George Jones	Deputy Director, USAID
Howard W. Kane	Technical Adviser, Housing, USAID