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Acronyms and Abbreviations

ADB	Asian Development Bank
AML	Anti-Money Laundering
ASC	Agricultural Service Centers
ATMs	Automated Teller Machines
BOI	Board of Investment
CAPs	Capital Access Programs
CBSL	Central Bank of Sri Lanka
CDFI	Community Development Financial Institutions Fund
CECOBAN	Centro de Compensación Bancaria
CFT	Counterfinancing of Terrorism
CGAP	Consultative Group to Assist the Poorest
COFIDE	Corporación Financiera de Desarrollo
CRA	Community Reinvestment Act
CRBs	Cooperative Rural Banks
CRCS	Comprehensive Rural Credit Scheme
CRIB	Credit Information Bureau
DEL	Developing Enterprise Loan
FAQ	Fair Average Quality
FDI	Foreign Direct Investment
FedACH	Federal Reserve Clearing House International
GDP	Gross Domestic Product
GTZ	German Agency for Technical Cooperation
HH	Households
HMDA	Home Mortgage Disclosure Act
ICA	Investment Climate Assessment
ICICI	Industrial Credit and Investment Corporation of India Ltd.
ICS	Investment Climate Survey
ICT	Information and Communication Technology
IFC	International Finance Corporation
IMF	International Monetary Fund
IPHT	Institute of Post Harvest Technology
KSA	Kingdom of Saudi Arabia
LIBOR	London Inter-Bank Offered Rate
MFIs	Microfinance Institutions
MIS	Management Information Systems
MMBL	Money Transfer Ltd. (Subsidiary of Merchant Bank of Sri Lanka)
MTB	Money Transfer Businesses

NGO	Nongovernmental Organization
NRFC	Non-Resident Foreign Currency Account
NSB	National Savings Bank
PSB	Postal Savings Bureau
RFCA	Resident Foreign Currency Account
RTGS	Real-Time Gross Settlement System
SANASA	Samupakara Nayadena Samithi
SAS	ShoreBank Advisory Services
SBA	Small Business Administration
SBICs	Small Business Investment Companies
SEEDs	Savordaya Economic Enterprises Development Services
SIDA	Swedish International Development Co-operation Agency
SLBFE	Sri Lanka Bureau of Foreign Employment
SLIS	Sri Lanka Integrated Survey
SME	Small and Medium Enterprise
SWOT	Strength, Weaknesses, Opportunities, and Risks
TCCSs	Thrift and Credit Cooperative Societies
TTs	Telegraphic Transfers
UK	United Kingdom
US	United States
UAE	United Arab Emirates

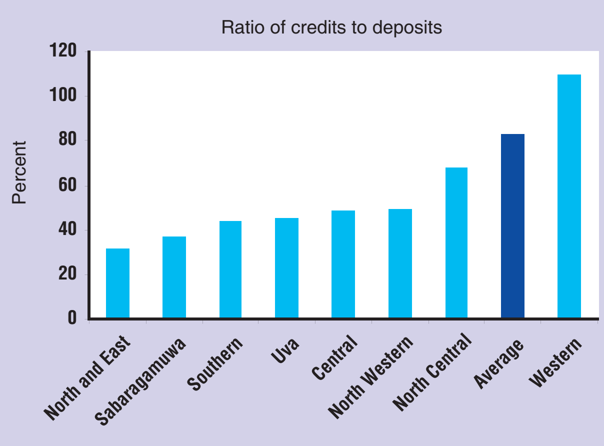
EXECUTIVE SUMMARY

Access to financial services is important to households and enterprises. An increasing body of economic literature provides evidence that greater financial depth contributes to economic growth and poverty reduction (see, for example, Levine, Loayza, and Beck (2000)). Efficient and deep financial markets facilitate investment and increase total factor productivity by reducing information and transaction costs, pooling and diversifying risk, and improving resource allocation. Financial instruments help households smooth lifetime consumption, manage their economic and social risks, and engage in business opportunities that can improve their livelihoods.

Can Sri Lanka's financial system promote growth and poverty reduction? Sri Lanka has undergone an important economic transformation over the last few decades, but its pace of economic growth and poverty reduction has not kept pace with the achievements in East Asia. Moreover, economic growth has been concentrated in the Western Province with the rural areas lagging behind. As a result, poverty incidence outside the Western Province remains high. Although the civil conflict is partly responsible for this record, a host of other factors have also held the country back. The 2004 Investment Climate Survey (ICS) of Sri Lanka indicates that the cost of finance remains among the most important constraints to enterprises and access to finance also constitutes an important constraint for some market segments, especially rural and small enterprises.[1] Most Sri Lankan households have access to some form of savings account and short-term credit, but their access to a wider range of financial products is more restricted. Despite a growing and more diverse set of financial institutions, there is an uneven provision of services across regions and market segments.

There is significant scope for financial deepening; private sector credit is very low at about 35 percent of GDP in 2004. Commercial banks remain the main players in the financial system with other areas lagging behind. Penetration of life insurance products, for example, is less than a third of levels found in China and India.

FIGURE 1
Commercial Banks: Net Savings Transfers from Rural to Urban Areas (percent, 2004)



Note: Figure is based on data from foreign banks and the five largest domestic commercial banks.
Source: Central Bank of Sri Lanka

The overall financial performance of the commercial banking sector has improved in recent years. The two state commercial banks, the main players in the system, are also undergoing restructuring plans that are helping reduce their nonperforming loans and performance disparities in relation to private sector banks. While these are positive steps, a long-term strategy that will allow the state banks to operate independently and isolated from political interference will still be necessary.

In addition, there are six regional development banks involved in rural lending, including agriculture and microfinance. Similarly, weaknesses in their lending portfolio led to a restructuring program that is still underway; levels of nonperforming loans have declined but remain above average levels for private banks.

Commercial bank financing is heavily skewed toward short-term products-61 percent of the total lending portfolio in 2004-and urban areas. The Western Province, with the higher concentration of economic activity, appears to receive net positive transfers from the rest of the country (Figure 1).[2] This net transfer of savings from poorer to more developed regions exacerbates existing economic and poverty disparities. Indeed, the 2004 ICS confirms that commercial banks, especially private commercial banks, play a very modest role in financing rural enterprises. Only 2 percent of investment is financed by private commercial banks. In urban areas, access to bank finance is also far more limited for small firms compared to large enterprises (Chapter 2).

A number of factors have discouraged more active lending by commercial banks to small enterprises, especially in the rural areas. Commercial banks do not have a large branch network in the rural areas, which hinders their outreach (Figure 2). Small businesses are geographically dispersed, and lenders usually face greater costs in identifying potential borrowers, conducting due diligence, and maintaining contact with the borrower after a loan has been made. Small businesses are generally less knowledgeable than their larger counterparts regarding what is required to qualify for bank financing and often lack formal financial records (2004 ICS).[3] Lack of market information and isolation constitute other important barriers to the success of small firms and reduce their creditworthiness.

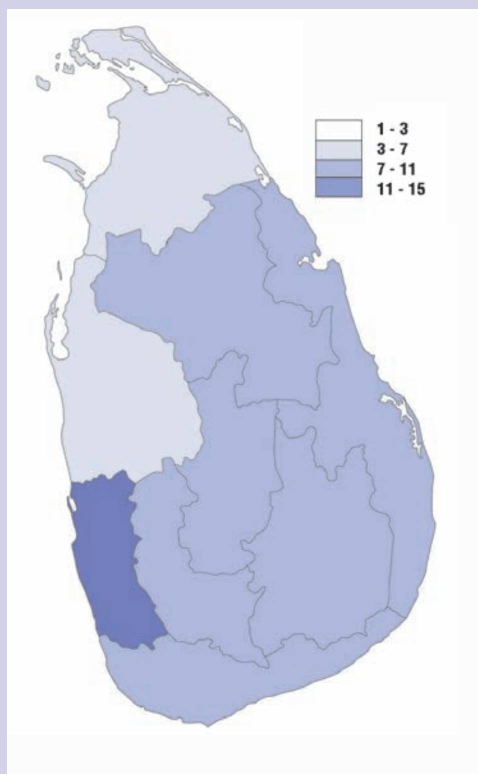
Risk assessments of small enterprises also demand specific expertise, which is often lacking at formal financial institutions. Present bank structures do not provide sufficient incentives or staff to increase financing to these market segments. The above problems are exacerbated in the agricultural sector due to high price volatility of agricultural produce and weather risks. In addition, most agricultural supply chains are weak, which increases the marketing and repayment risks of farmers.

There is a wide range of semiformal institutions that are involved in microfinance. Participation of private commercial banks in the microfinance sector is minimal. The two state banks' involvement in the sector is limited to government programs that provide subsidized loans for poverty alleviation and agriculture. Although semiformal institutions have made an important social and economic contribution by meeting the critical needs of poor households, microfinance suffers from several problems. First, microfinance

FIGURE 2

Commercial Banks: High Branch Concentration in the Western Province, Lower Outreach in Rural Areas

(Bank branches per 100,000 of population)



Source: Central Bank of Sri Lanka, Annual Report, 2003, and World Bank staff estimates.

providers offer a very narrow range of products (mostly short-term credit), and they barely offer risk management instruments. There seems to be a demand for microinsurance products, but these have been hardly developed. Second, the performance of many microfinance providers is very weak and highly dependent on continued donor subsidies or on captive funding, as in the case of Samurdhi Banks. Cooperative rural banks lack commercial orientation, partly due to public mandates that interfere with sound lending policies. Third, microfinance providers are not properly regulated or supervised.

The above findings suggest that despite Sri Lanka's achievements in the provision of financial services in some areas, there are still critical market segments that remain inadequately served, especially small and rural enterprises and farmers. Low-income households could also benefit from access to a more diverse set of financial products such as enhanced remittances and payment services, longer-term and better remunerated saving instruments, and insurance products. Sri Lanka remains a cash-based economy and the retail payment system infrastructure remains inadequately linked, especially in rural areas. Reportedly, a considerable share of remittances flows through informal conduits. Although specific data for Sri Lanka are not available, a survey of rural households conducted in India in 2003 revealed a high demand for insurance products.[4]

For the most part, government policies for addressing uneven access have focused on state ownership of financial institutions, subsidizing or controlling interest rates (especially in agriculture), and, at times, debt forgiveness programs. Despite their good intentions, these policies have not built the conditions for the market to expand services to underserved groups and have often exacerbated market misconceptions that some groups (such as small farmers) are not creditworthy. Responding to these challenges by establishing a new state bank for small and medium enterprises (SMEs) will duplicate the extensive infrastructure of public financial institutions. In addition, a new state bank is likely to face the same governance constraints that have undermined the performance of other public banks.

This report covers a wide range of challenges and possible solutions for promoting better access to financial services by households and businesses. It does not undertake a full evaluation of the microfinance sector in Sri Lanka given the extensive research on the sector conducted by other development partners.

Expanding Financing Opportunities for Small Businesses

Encouraging the formal financial sector to expand services to small businesses entails a concerted effort by the government, the banking system, and the business community. There are several areas where public interventions could encourage private banks to expand services to smaller customers. First, public policy should concentrate on developing a conducive environment for lending through macroeconomic stability and a supporting legislative and regulatory framework; in particular, creditors' rights should be strengthened. Recognizing that a considerable share of the commercial banking system remains comfortable with its corporate and consumer finance business and that entering new market segments entails higher risks, the government could motivate banks' participation into higher-risk markets by defraying their cost of entry-for example, through partial credit guarantees. In parallel, the government and financial institutions could partner in the development of new financial products better suited for small enterprises such as credit scoring, reverse factoring, and other export-financing products; continue their joint efforts to modernize the credit information bureau to mitigate market information asymmetries; and collaborate with the business community in the training and education of small entrepreneurs.

The proposed initiatives would reorient government from a direct market participant to a market facilitator. In this vein, the government should reevaluate whether there is a need for a new first-tier SME bank. Rather, it could consider the establishment of a small and lean second-tier (apex) institution that would focus on promoting financial market development for underserved customers, a function that the Central Bank has traditionally played. The rationale for this approach becomes stronger if it forms part of a longer-term strategy to gradually disengage from first-tier banking. Following a long and unsuccessful tradition of state participation in the banking system, some countries in Latin America have withdrawn from first-tier development and commercial banking and focused on a market facilitator role, often through a second-tier development institution. Mexico, for example, is closing some of its first-tier development banks and transforming others into second-tier institutions. Peru also closed its first-tier development banks in the early 1990s, following a hyperinflation period, but created a small second-tier development financial institution (Corporación Financiera de Desarrollo, COFIDE) that has helped develop new financial products, including export financing instruments.

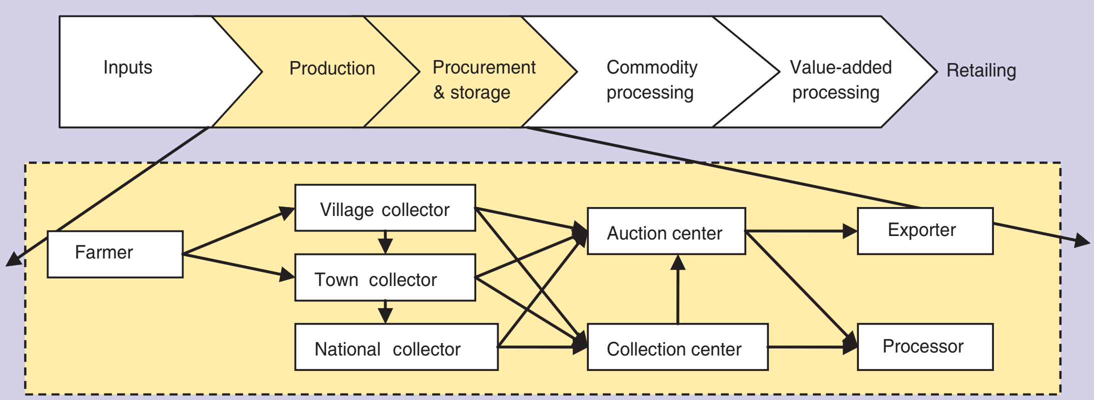
Improved incentives and a friendlier lending environment need to be accompanied by a stronger commitment from private commercial banks to allocate more human and financial resources to lending for small enterprises. As part of this commitment, commercial banks could partner with the government in disclosing more detailed information to the market on lending patterns. If considered necessary, current banking legislation already provides the legal basis for the Central Bank to mandate disclosure of lending patterns to various market segments.

New Financing Mechanisms for Agriculture through Supply Chains

Besides downscaling formal financial institutions, other complementary financial instruments need to be developed, especially in agriculture, which is exposed to higher risks and price volatility and where small producers are scattered, raising borrowing transactions costs. Linking credit to agricultural supply chains can mitigate market information asymmetries and transaction costs, but supply-chain finance in agriculture has not been used to its full potential in Sri Lanka.

With the exception of tea, most agricultural supply chains in Sri Lanka are fragmented and lack the physical infrastructure for storage and distribution; small farmers are isolated from markets

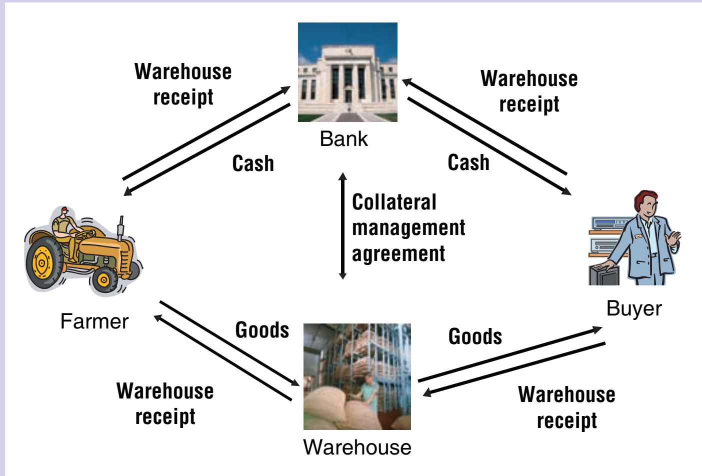
FIGURE 3
Sri Lanka: Poorly Coordinated Agricultural Supply Chains



Source: Rabobank (2005).

(Figure 3). These problems also affect the spices and fruits and vegetables sectors due to their higher-value addition and growth potential. Contract farming, for example, accounts for a small fragment of the production of fruits and vegetables due to the lack of commercial discipline by farmers and offtakers. A robust supply chain is necessary to make contract farming participants creditworthy and to link financing through it. Although a few projects in the spices and fruits and vegetables sector are underway, there is a formidable potential for the government and other stakeholders to help improve coordination of the sectors' supply chain and link new finance mechanisms through them.

Figure 4
Warehouse Receipt Financing: Process Flow



Source: Rabobank (2005).

Among the new credit structures, warehouse receipt financing could be developed for pepper, tea, and other major nonperishable commodities. As Figure 4 depicts, this lending instrument is secured by the warehouse receipt delinking financing availability from the farmer's credit risk. This mechanism is widely used in developed and emerging economies and can play the dual role of helping to stabilize post-harvest prices and supplying additional lending to small producers.

The establishment of Value Added and Agricultural Services Centers could also help integrate primary producers with product markets and financial institutions. In the spices, fruits, and vegetables sector, the government could further promote financing structures for contract farming by educating farmers on the benefits of honoring their contracts and encouraging stakeholders to develop contracts with better incentives for all parties (for example, through price-sharing mechanisms). There are also opportunities for developing new weather insurance instruments linked to credit products; such instruments are already being piloted in India.

Lessons learned from previous failed attempts to promote these instruments in Sri Lanka indicate that the government by itself cannot try to develop such market tools. However, it can support market development by establishing the enabling regulatory environment, fostering coordination among stakeholders, and engaging in various forms of public-private partnerships. In this vein, the government should also allow rural cooperatives to embrace new commercial concepts and permit a much needed rationalization and restructuring of the sector.

Enhancing the Outreach and Quality of the Rural Remittance Infrastructure

While the majority of Sri Lankan households have access to some form of savings account, other basic financial services are not available to the population at large. The retail payment system, especially in the rural areas, is inadequately developed and a considerable share of the remittance market is handled by informal networks. To the extent remittances are transferred through formal networks, the government's balance of payments benefits from the increased foreign-exchange reserves and the risks posed by informal operators are minimized. Equally important, the usage of formal financial institutions exposes migrants to a wide range of financial services (such as credit, savings, and insurance) that can help them manage their savings and economic risks better. The potential of the formal remittance infrastructure, however, is not being maximized, and the formal financial sector still incurs higher transaction costs than the informal sector.

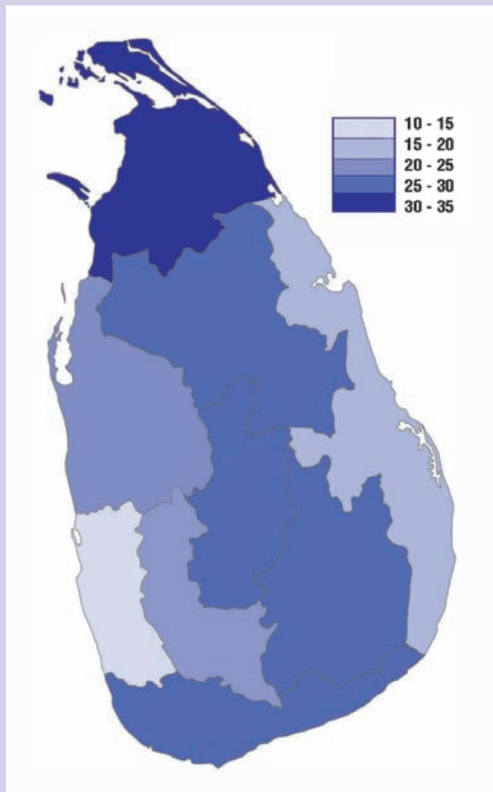
Most international attempts at constructing legal remittance policy requirements-including India, The Philippines, Thailand, and Pakistan-have not been effective. Hence, there is a need to invest in the quality and outreach of the infrastructure to facilitate remittance flows, especially the rural infrastructure since close to 65 percent of remittances are channeled to the rural areas. There are a number of options the government may wish to consider. Greater financial education of migrant workers is necessary. There is evidence that, despite the existing education of migrants, they do not have the knowledge level necessary to make informed choices among remittance alternatives.

Harmonizing electronic funds transfer systems and improving their efficiency could reduce the cost of remittances. Currently, major transfer agents and banks use their own (costly) proprietary systems to send remittances. If funds were channeled through a single low-value payment system, the cost per transaction could drop. The national platform that will soon be completed by Lanka Clear could open new opportunities for expanding interconnectivity among banks in a more cost-effective manner. Supporting connectivity between domestic institutions and cross-border retail payment systems has also the potential of providing low-cost, safe, and efficient remittance transfers. Measures, for example, have been taken to connect the postal network with foreign postal networks. Other bilateral financial initiatives could be negotiated with countries that are key source of remittances.

FIGURE 5

The Post Office: A Unique Rural Branch Network

(Post office branches per 100,000 of population)



Source: Sri Lanka Post and World Bank staff estimates

To promote greater competition among remittance agents and "last mile" delivery in rural areas, banks can also explore greater linkages with nonbank financial institutions, including microfinance institutions and Sri Lanka Post, which offers a vast rural infrastructure (Figure 5).

Leveraging the Post Office Network to Deliver Rural Financial Services

With nearly 4,650 outlets, the postal network presents a uniquely dense network, especially in rural areas. Figures 2 and 5 highlight the higher per capita branch density of the Sri Lanka Post compared to commercial banks, especially outside the Western Province. Sri Lanka Post has a long history of delivering financial services, mainly savings accounts and payment services (such as remittance, pensions, and utility bill collection) and these services constitute a significant part of the workflow of the post offices and retail network revenues. However, the business processes supporting post services are outdated. Financial services are provided on a fully manual and paper-based system, which results in delays, labor intensity, and a relatively high degree of inaccuracy. The development of other financial services (such as insurance and other long-term savings products) has not been tested.

The statutory agency agreement between the National Savings Bank (NSB) and the post office, which grants the former exclusive rights to the post office network for promoting its savings accounts, is currently unproductive. The remuneration formula does not allow the post office to expand revenues and strengthen its financial performance. At the same time, the NSB faces the challenge of modernizing itself and is not ideally positioned to upgrade the post office operations, conduct staff training, or provide incentives. Also, as a narrow state savings bank, it is not the most suitable partner to introduce a wide range of innovative financial services through the post office network.

Unlocking the potential of the post office will require a comprehensive strategy consistent with postal and financial sector policies and other efforts to promote better access to information and communication technology (ICT). The challenge is formidable because the post office has been trapped in a vicious circle of deteriorating level of service and lack of funding to modernize, but the opportunities for narrowing gaps in rural financial services are enormous. The modernization process could be initiated with existing and priority business lines (such as remittances), thereby allowing the institution to move up a learning curve and gradually engage in a broader set of standardized financial products and other e-services. At least two private banks have already expressed interest in expanding their services through the postal network.

The delivery of new products will entail the development of new partnerships with private financial institutions, auctioned off on a competitive basis, and winding down the unproductive exclusive agency agreement between the NSB and the post office. These partnerships will need to be carefully engineered and will involve profound organizational and cultural changes within Sri Lanka Post. Other international experiences, most recently in Brazil, suggest that it could take Sri Lanka Post several years to prepare itself for such challenges.

BOX 1

Summary of Priority Recommendations

Downscaling private commercial banks

The government

- Promoting a stable macroeconomic environment
- Strengthening the enabling environment for lending and the legal framework for creditors' rights, asset securitization, leasing, and movable collateral
- Collaborating with financial sector in expansion of credit information on small businesses and consumers
- Mitigating costs of commercial banks entering new high-risk underserved markets
- Monitoring and disseminating information on lending patterns to underserved markets

Commercial banks and the business community

- Modernization of Credit Information Bureau
- Development of a unified charges registry
- Greater commitment of financial and human resources to support small business lending
- Training of small entrepreneurs
- Disseminating more detailed information on lending patterns to underserved markets

Enhancing financing in agriculture through supply chains

The government

- Facilitating coordination among various stakeholders to strengthen supply chains
- Collaborating with private sector in development of international brands, most importantly "Ceylon Cinnamon"
- Developing a modern and commercially oriented legal framework for rural cooperatives and providing technical assistance to support their restructuring
- Developing the regulatory framework to support warehouse finance receipts
- Possible involvement in public-private partnerships (i) to improve logistics of supply chains and (ii) to develop new financial instruments (such as an indemnity fund for warehouse financing schemes)

Producers, private sector entities, and other financial institutions

- Establishment and operation of logistical support for supply chains (such as auction centers and storage facilities)
- Rationalization and restructuring of cooperative centers
- Development of Agricultural Support Centers
- Development of Value Added Centers
- Establishment and operation of warehouses and management of certification system
- Testing new weather insurance instruments, possibly linked to credit

Expanding the quality and outreach of rural remittance infrastructure

The government

- Sponsoring greater financial education of migrant workers
- Possible negotiation of bilateral initiatives with key remittance source countries

Commercial banks

- Investment in remittance technology
- More effective sharing of electronic payments systems platforms
- Partnering with nonbank financial institutions (such as microfinance institutions and the post office)

Leveraging the Postal Network to expand rural financial services

The government

- Developing a comprehensive strategy for Sri Lanka Post that will be consistent with postal and financial sector policies and policies to expand ICT services, and that will improve the post office's financial performance
- Facilitating technical assistance to modernize the post office
- Allowing the post office to partner with new and private financial institutions, and winding down the exclusive agency agreement with the NSB

Sri Lanka Post

- Collaborating with the government in the development of a comprehensive strategy for the post office
- Implementing organizational changes and strengthening its IT and human resources
- Developing agreements to partner with new institutions

Commercial banks

- Partnering with the postal network to deliver the "last mile" of service

Notes

1. The 2004 ICS of Sri Lanka is available at http://rru.worldbank.org/InvestmentClimate/.
2. Based on information gathered from foreign banks and the five largest domestic commercial banks, which hold 90 percent of the commercial banking system's assets, the ratio of net credits to deposits for the Western Province is 110 percent compared to 83 percent for the national average.
3. The 2004 ICS of Sri Lanka confirmed that fewer than 12 percent of nonfarm rural firms prepare financial statements and that more than half of these firms were less than 5 years old.
4. 73 percent of households indicated life insurance as their preferred product (World Bank 2004a).

CHAPTER ONE

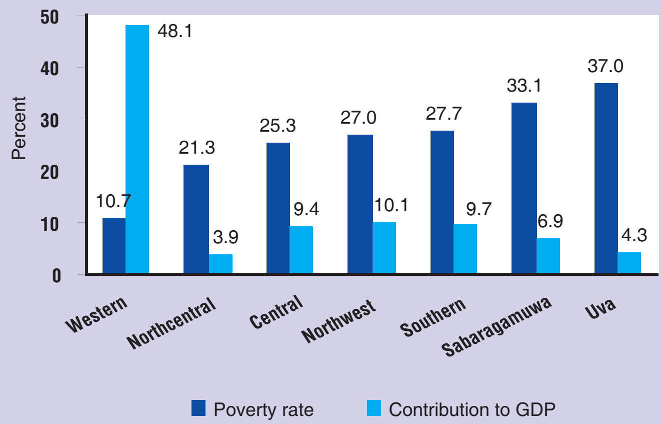
THE FINANCIAL LANDSCAPE AND UNDERSERVED MARKETS

1.1 Introduction

Access to financial services is important for households and enterprises. An increasing body of economic literature provides evidence that greater financial depth contributes to economic growth and poverty reduction (see, for example, Levine, Loayza, and Beck (2000)).[1] Efficient and deep financial markets facilitate investment and increase total factor productivity by reducing information and transaction costs, pooling and diversifying risk, and improving resource allocation. Financial instruments help households smooth lifetime consumption, manage their economic and social risks, and engage in new business opportunities.

FIGURE 1.1

Growth and Poverty Reduction Heavily Skewed toward the Western Province (percent, 2002)

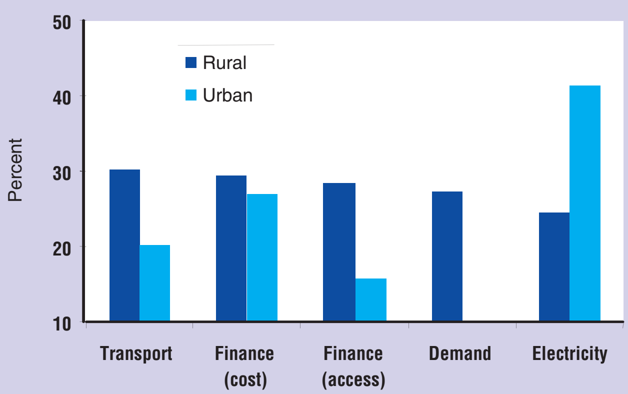


Source: Central Bank of Sri Lanka, Annual Report, 2003, and World Bank staff estimates.

Can Sri Lanka's financial system promote growth and poverty reduction? Sri Lanka has undergone an important economic transformation over the last few decades, but its pace of economic growth and poverty reduction has not kept pace with achievements in East Asia.[2] Moreover, economic growth has been concentrated in the Western Province with the rural areas lagging behind. As a result, poverty incidence outside the Western Province remains high (Figure 1.1). Although the civil conflict is partly responsible for this record, a host of other factors have also held the country back.[3]

FIGURE 1.2

Top Five Rural Constraints and their Urban Ratings

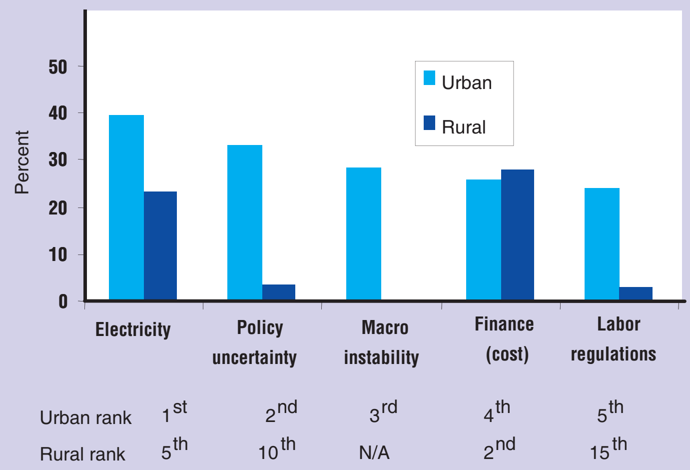


	Transport	Finance (cost)	Finance (access)	Demand	Electricity
Urban rank	9th	5th	12th	N/A	1st
Rural rank	1st	2nd	3rd	4th	5th

Source: Sri Lanka Investment Climate Survey (2004).

The Sri Lanka Investment Climate Survey (2004) indicates that the cost of finance remains among the most important constraints to enterprises and access to finance is also an important constraint for some market segments, especially rural and small enterprises (Figures 1.2-1.3). Most Sri Lankan households have access to savings accounts and short-term credit, but their access to a wider range of financial products is more restricted. Despite a growing number of financial institutions, there is an uneven provision of services across regions and market segments.

FIGURE 1.3
Top Five Urban Constraints – and their Rural Ratings



Source: Sri Lanka Investment Climate Survey (2004).

1.2 Composition of the Financial Sector

Over the last two decades, Sri Lanka's financial landscape has become more dynamic and diverse, but there is significant scope for financial deepening (Table 1.1). Private sector credit in 2004 was very low at about 35 percent of GDP, compared to 147 percent in China in 2003. Large fiscal deficits have partly contributed to this outcome by crowding out private sector credit and causing high real interest rates, although the latter have shown a decline in recent years (Figure 1.4).

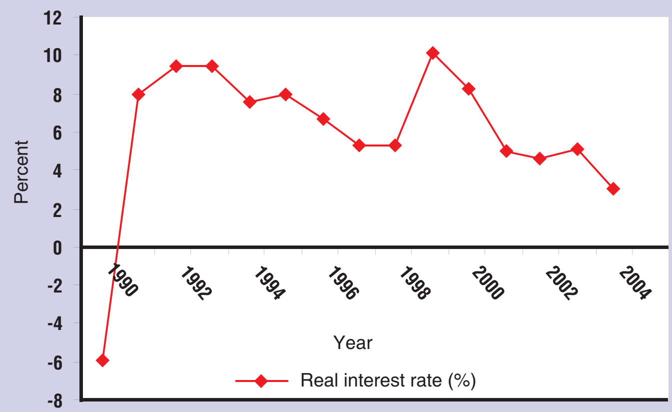
TABLE 1.1
Total Assets of the Formal Financial System, 2004

	SL Rs billion	% of GDP
Banking sector	1,478.7	82.2
Licensed commercial banks	1,161.4	64.6
Licensed specialized banks	317.3	17.6
Nonbank deposit-taking financial institutions	105.9	5.9
Registered finance companies	66.2	3.7
Co-operative rural banks	33.5	1.9
Thrift & credit co-operative societies	6.2	0.3
Other specialized financial institutions	122.5	6.8
Primary dealers	61.4	3.4
Leasing companies	34.4	1.9
Merchant banks	21.0	1.2
Unit trusts	4.2	0.2
Venture capital companies	1.5	0.1
Contractual savings institutions	608.2	33.8
Employees Provident Fund	379.4	21.1
Employees Trust Fund	51.8	2.9
Other provident funds	104.8	5.8
Insurance companies	72.2	4.0
Equity market capitalization	382.1	21.3

Source: Central Bank of Sri Lanka 2004.

Commercial banks account for a significant share of assets of the financial system, and the state presence is still dominant. The assets of the two state-owned commercial banks, the National Savings Bank and the State Mortgage and Investment Bank, constitute nearly 50 percent of the total banking system. There is a variety of other nonbanking financial institutions that mainly cater to consumers and small and medium enterprises (SMEs), but the market share of these institutions is very modest. There are 24 finance companies mainly involved in leasing, financing of SMEs, and consumer finance. In addition, there are a few companies specialized in leasing, and one factoring company, that compete with commercial and finance companies offering corporate and personal lending and other fee-based services. They are, however, too small to exert a substantial competitive pressure on the larger banks. A number of factors have stymied the growth of the leasing market (Chapter 2), while the factoring industry has been declining and has suffered from a general lack of understanding of its products and services.

FIGURE 1.4
Sri Lanka's High Fiscal Deficits Lead to High Real Interest Rates



Source: World Bank, World Development Indicators database

The insurance industry is highly underdeveloped, and there is extensive potential for growth. Penetration of life insurance products is less than a third of levels found in China and India (Table 1.2). Traditionally, the insurance industry suffered from a poor legal framework and extensive state ownership. A new legislative framework was enacted, restrictions to foreign entry were removed to encourage competition, and the industry has been fully privatized in recent years. These structural changes have considerably improved the sector's prospects, although it is still affected by the modest development of securities markets.

TABLE 1.2
Key Insurance Indicators for Selected Countries (2003)

	Insurance density (US$)		Insurance penetration (% of GDP)	
	Total	**Life insurance**	**Total**	**Life insurance**
South Asia				
Bangladesh	2.1	1.4	0.6	0.4
India	16.4	12.9	2.9	2.3
Pakistan	2.9	1.1	0.6	0.2
Sri Lanka	12.5	5.3	1.3	0.6
Other Asian countries				
China	36.2	25.1	3.3	2.3
Indonesia	14.5	6.4	1.5	0.7
Japan	3,771	3,003	10.8	8.6
Korea, Republic of	1,243	874	9.6	6.7
Philippines	14.6	8.6	1.5	0.9
Singapore	1,621	1,300	7.6	6.1
Vietnam	6.7	4.1	1.5	0.9

Note: Insurance density and penetration measure premium per capita and as percent of GDP, respectively.
Source: Swiss Reinsurance Company (2004).

Retirement schemes mobilize a considerable pool of resources, but are not efficiently intermediated and are not contributing to financial sector development and economic growth. The most important retirement schemes are the Employees Provident Fund and the Employees Trust Fund, which administer assets close to 20 percent of GDP. Both are publicly administered and form part of the mandatory retirement scheme along with another 200 smaller private provident funds. Most of their assets, especially public provident funds, are invested in government securities. Bank deposits also constitute an important share of the portfolios of private pension funds. Allocations to corporate equities and debentures are very small. See World Bank (2005d) for a further discussion of Sri Lanka's retirement schemes.

Although the private equity market has become more vibrant since the cessation of hostilities in the North, equity market capitalization remains at very modest levels-15 percent of GDP compared to 49 percent in India.[4] Turnover as percent of market capitalization is also low at 28 percent compared to 117 percent in India.

Bank Domination of the Financial Landscape and Uneven Outreach

As Table 1.1 shows, the banking sector dominates the financial landscape. By the end of 2004, there were 22 licensed commercial banks (2 state-owned, 9 private domestic, and 11 foreign). The 2 state-owned commercial banks and the 4 largest private commercial banks accounted for 65 percent of banking assets, with the two state-owned banks amounting to nearly 50 percent. Foreign banks, operating mainly in niche areas, accounted for 11 percent of banking assets. In addition, there are 14 licensed specialized banks (accounting for 20 percent of banking assets), including 2 large development banks, the state-owned National Savings Bank, the State Mortgage and Investment Bank, 1 housing bank, 3 smaller savings-development banks and 6 regional development banks (also state owned). The regional development banks mostly cater to the rural sector. The National Savings Bank mobilizes a large pool of resources from the country but is only active in housing finance.

Improvements in financial trends of commercial banks: Until recently, Sri Lankan banks, especially state-owned banks, were struggling with problems of undercapitalization, high levels of nonperforming loans (NPLs), inadequate loan loss provisioning, low profitability, and high cost-to-income ratios. As a result of improved disclosure levels, tightened prudential regulations, and a more proactive supervisory approach, the performance of the banking sector appears to have turned around.[5] The NPLs levels have come down and capital positions improved across the entire banking system (Table 1.3). With a stronger financial standing, the commercial banking system will be better positioned to expand services, but the latter will also entail additional improvements in technological platforms to enhance operational efficiency.

TABLE 1.3
Banking Sector Indicators, 2000-2004

	2000	2002	2004
Nonperforming loans[a]			
State commercial banks	22.2	22.9	14.2
Domestic private banks	14.5	17.6	10.5
Foreign banks	14.3	7.6	3.3
Risk-based capital assets ratio[b]			
State-owned commercial banks	4.3	4.2	5.5
Domestic private banks	11.4	11.0	11.1
Foreign banks	12.2	21.6	12.4

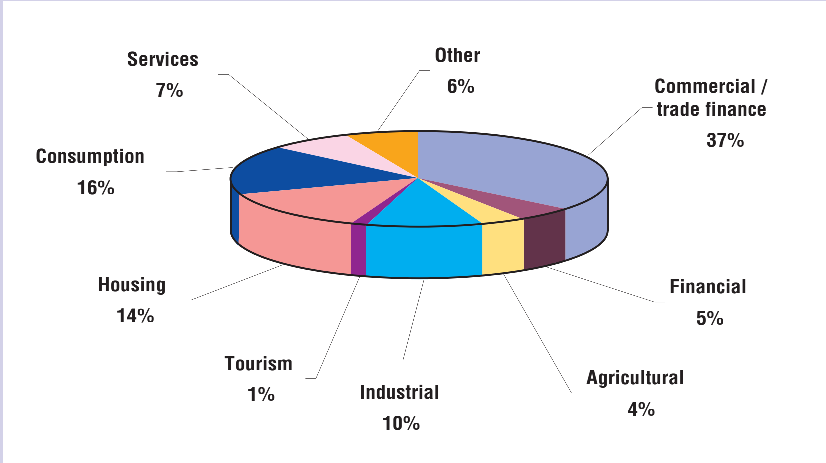
a. Gross loans as percentage of total loans.
b. Total capital over risk-weighted assets.

Source: International Monetary Fund (2005).

While the performance of the two state-owned commercial banks has also improved due to recent restructuring efforts, they must continue major organizational and operational changes in order to strengthen their financial management and reduce structural rigidities which negatively impact their cost structure. Given their large market presence, the banks' cost structure drives up intermediation costs for the overall system and discourages competition. Restructuring of the state commercial banks needs to be accompanied by similar efforts in the state-owned enterprises since this progress could easily revert if borrowing from state enterprises continues. New recapitalizations need to be carefully considered to avoid previous mistakes and directly linked with performance indicators as envisaged under the restructuring plan agreed with the Strategic Enterprises

FIGURE 1.5

Loans and Advances by Commercial Banks (2004)



Source: Central Bank of Sri Lanka, Annual Report 2004.

Management Agency (SEMA). These restructuring efforts could enhance performance over the short term. A longer-term strategy for the commercial banking system, including a new framework that will allow the two state-owned commercial banks to operate independently and isolated from political interference, would still be necessary in order to create a leveled-playing field and allow an efficient and competitive banking system to emerge in Sri Lanka.[6] The long-term strategy should consider divestment.

The former development finance institutions were also converted into commercial banks following global trends to address resource mobilization difficulties. In such a scenario, the plan to establish another specialized, state-sponsored SME bank becomes disconcerting.

Concentration in short-term lending products and insufficient geographic diversification: An analysis of the sectoral breakdown of loans and advances reveals that credit is mostly granted for trade finance, consumption, and housing (Figure 1.4). The industrial and agricultural sectors receive only 10 percent and 4 percent of total commercial bank financing, respectively. Financing is heavily skewed toward short-term products-61 percent of the total lending portfolio in 2004-due to the banking system's lack of access to long-term funds (Table 1.4). In the agricultural portfolio, the share of short-, medium-, and long-term credit was 60, 21, and 19 percent, respectively, for 2004. This contrasts sharply with the pattern found in more developed commercial banking systems, where long-term credit for agriculture is more widely available. In the Netherlands, for example, the shares of the agricultural lending portfolio of commercial banks allocated to short-, medium-, and long-term credit were 4, 16, and 80 percent, respectively, in 2004.[7]

TABLE 1.4

Commercial Bank Advances by Maturity (December 2004)

	Short-term	Medium-term	Long-term
Agriculture	60.1	21.3	18.6
Industrial	62.7	25.7	11.6
Tourism	42.3	24.1	33.6
Housing	25.8	30.4	43.8
Consumption	67.1	19.7	13.1
Average for all sectors*	61.2	23.9	14.9

* Average includes trade and finance.

Source: Central Bank of Sri Lanka, Annual Report 2004.

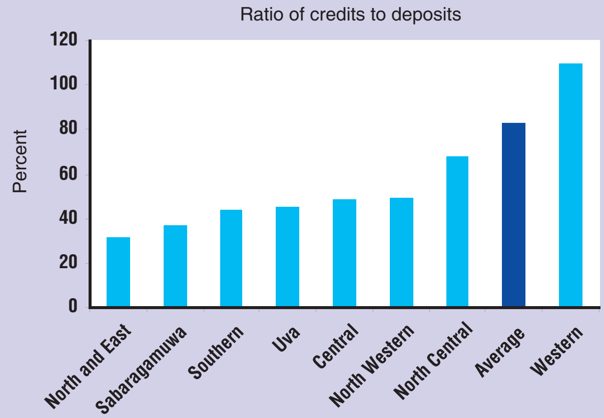
The Western Province, with the higher concentration of economic activity, appears to receive net positive transfers from the rest of the country (Figure 1.6). Based on information gathered from foreign banks and the five largest domestic commercial banks and foreign banks, which hold 90 percent of commercial bank assets, the ratio of net credits to deposits for the Western Province is 110 percent compared to 83 percent for the national average. The Northern and Eastern provinces stand at the other end of the spectrum; only a third of every rupee saved through the banking system is lent back to the region. This net transfer of savings from poorer to more developed regions exacerbates existing economic and poverty disparities.

Credit from commercial banks to rural enterprises is very modest, and credit to small enterprises in urban areas also trails available bank financing to their larger counterparts (Chapter 2). There are many obstacles that contribute to this unfavorable outcome, including lack of collateral, poor credit information, and inadequate banking products for smaller enterprises. It is also more difficult to monitor the performance of credits underwritten to geographically dispersed enterprises. Although Sri Lanka's commercial banks offer a remarkable branch network, branches are mainly located in Colombo and other urban centers. Figure 1.7 illustrates the sharp regional disparities for per capita density of commercial bank branches.

A cash-based economy: The payment system has improved tremendously during the recent past, but Sri Lanka still remains a cash-based economy. A strong payment and settlement system is necessary to

FIGURE 1.6

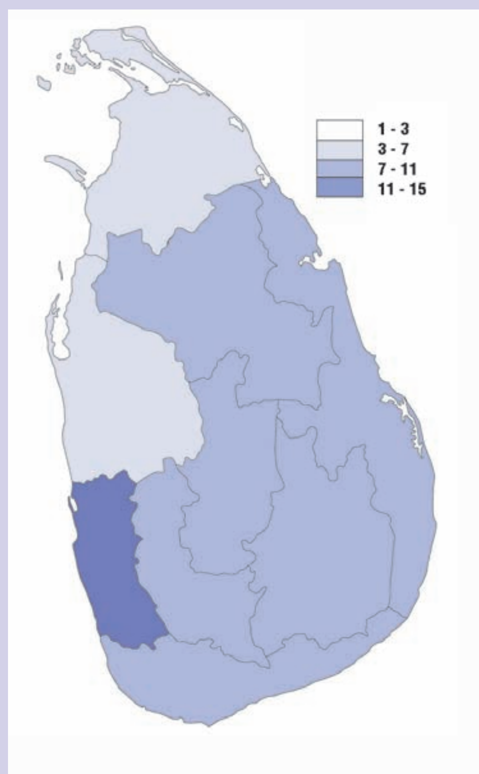
Commercial Banks: Net Savings Transfers from Rural to Urban Areas (percent, 2004)



Note: Figure is based on data from foreign banks and the five largest domestic commercial banks.
Source: Central Bank of Sri Lanka.

FIGURE 1.7

Commercial Banks: High Branch Concentration in the Western Province, Lower Outreach in Rural Areas (Bank branches per 100,000 of population)



Source: Central Bank of Sri Lanka, Annual Report, 2003, and World Bank staff estimates.

promote the stability and efficiency of the financial system, and several measures have already been introduced to this effect in the last few years. A real-time gross settlement system (RTGS) to settle large-value interbank transactions became fully operational in 2004. Sri Lanka became the first country in South Asia to have an integrated, automated payment and settlement system. Such improvements and advances in the payments mechanism have resulted in an increase in usage of noncash payments though the preference for cash payments remains high. Another recent development is the establishment of a check-imaging system to further improve the efficiency of retail payments. Such technological improvements can substantially reduce transaction costs by expediting check clearance, reducing exchange losses, and improving liquidity management. With this system in place before the end of 2005, the check clearing time is expected to come down from a range of 7-10 days to one-two days.

Despite these encouraging changes, the retail payment system infrastructure remains inadequately linked and costly technological platforms are duplicated among commercial banks. Also, branches and other points of service such as automatic teller machines (ATMs) are unevenly distributed across the country with a high concentration in urban centers. A substantial share of remittances is presumed to flow through informal channels. The World Bank (2005a) estimates that informal remittances could have reached about 45 percent of total private remittances in Sri Lanka in the mid-1990 (Chapter 4).

Semiformal Financial Institutions and their Role in the Microfinance Sector

A wide range of semiformal institutions are involved in microfinance, as well as a number of formal financial institutions (mainly publicly owned) and informal lenders. The semiformal category comprises mainly the National Development Trust Fund; 311 cooperative rural banks (CRBs) with about 1,196 outlets;[8] nearly 8,500 thrift and credit cooperative societies (TCCSs);[9] Savordaya Economic Enterprises Development Services (SEEDs);[10] about 1,000 Samurdhi Banking Societies (SBSs); and about 200 microfinance nongovernmental organizations (NGOs). The role and performance of these institutions is further discussed in Annex I.

TABLE 1.5

Patterns in Households (HH) Saving and Borrowing (percent)

Income quintile	1 (lowest)	2	3	4	5 (highest)	Average
HH who save with formal and semiformal institutions	71.1	73.8	76.9	80.7	88.1	79.2
HH with loans outstanding	25.4	23.2	28.1	29.7	30.0	27.5
HH who borrow from semiformal institutions	24.1	26.3	26.1	20.9	16.7	23.2
HH who borrow from formal institutions	40.8	40.5	39.4	44.8	56.6	45.4
HH who borrow from informal sources	35.1	33.8	34.4	34.2	26.7	32.4

Source: Sri Lanka Integrated Survey (SLIS, 1999-2000).

The main formal financial institutions participating in microfinance are the two state banks and the six regional development banks. State-owned banks primarily implement government programs for poverty alleviation and agriculture through subsidized loans. The recovery rate of these programs was relatively lower (65-70 percent) than credit programs funded from their own resources (80-85 percent).[11] *Participation of private commercial banks in the sector is minimal with a few exceptions.* In addition, there is a third category of informal lenders comprising savings and credit associations, input suppliers, traders, moneylenders, landlords, friends, and relatives.

Because of this diverse group of providers, nearly 80 percent of Sri Lankan households appear to have access to some form of savings service, including more than 70 percent of low-income households (Table 1.5). According to the Sri Lanka Integrated Survey (SLIS 1999-2000), around 27.5 percent of households borrow with no sharp differences in borrowing rates among different income groups. There are variations, however, in the finance providers and the purposes of the loans. Nearly 44 percent of loans drawn by the highest income quintile are used for a business or farm compared to only 26 percent for the lowest income group.[12] The highest income quintile seems to rely less on informal sources.

The relative role played by formal and semiformal institutions in microfinance seems to differ according to the source. Charitonenko et al. (2002) estimate that the microfinance market share of semiformal providers (measured in terms of loan numbers) is significantly larger than the share of formal institutions (Table 1.6);[13] these differences narrow when measured against lending amounts since formal providers tend to cater to the upper end of the microfinance market. By contrast, the SLIS (1999-2000) suggests that 40 percent of poor households borrow from formal institutions compared to about 25 percent who borrow from semiformal institutions.

TABLE 1.6
Formal and Semiformal Providers of Microcredit (December 2000)

	Average balance (SL Rs)	Percent of number of loans	Percent of amount of loans
Total formal	19,253	23.9	41.8
Bank of Ceylon	18,266	6.1	10.1
People's Bank	10,000	11.8	10.7
Hatton National Bank	41,031	0.6	2.1
Seylan Bank	22,000	0.3	0.5
Sanasa Dev. Bank	20,415	0.4	0.7
Regional Development Banks	40,000	4.9	17.8
Total Semiformal	8,443	76.1	58.2
SBSs	6,345	19.8	11.4
CRBs	8,570	35.0	27.2
TCCSs	11,258	15.3	15.6
SEEDs	7,991	4.9	3.6
Janshakthi	4,871	1.1	0.5
Total	**11,032**	**100.0**	**100.0**

Source: Charitonenko et. al (2002) and World Bank staff estimates.

Microfinance institutions have made an important economic and social contribution by filling critical needs of poor households. In the aftermath of the Tsunami that struck Southeast Asia on December 26, 2004, and which had a terrible impact on the population living on the coast of Sri Lanka, microfinance institutions played a supportive role by providing short-term emergency help. Many institutions rescheduled the loans of those affected, giving them time to rebuild their income. Some institutions also helped their clients by settling insurance claims and letting them withdraw their savings.

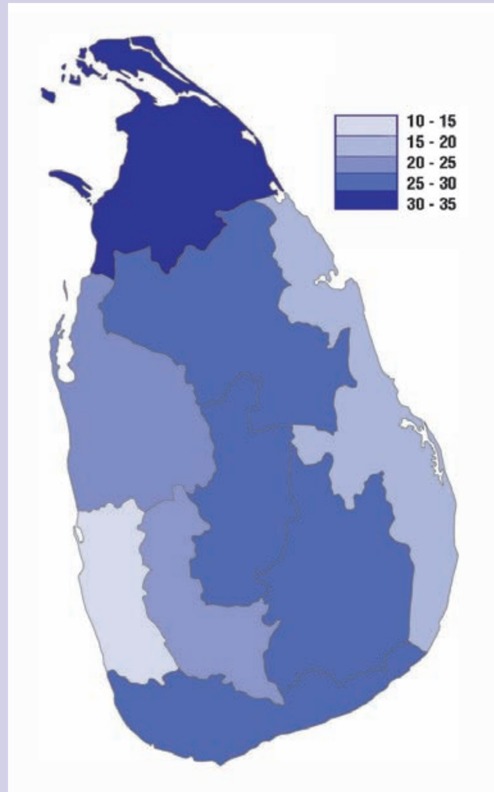
Notwithstanding their contribution, the sector presents a number of weaknesses. First, the range of financial products offered is extremely limited. Microfinance is largely short-term oriented; a modest share of the portfolio is allocated to loans with terms longer than a year.[14] Reportedly, there is a demand for microinsurance products, but these have barely been developed. Second, the performance of microfinance providers varies significantly and many of them have become even weaker in the aftermath of the Tsunami. Some of them use modern microfinance practices including market rates of interest, group contracts, and progressive lending and enjoy high rates of loan recovery. Other microfinance providers suffer from weak financial discipline and subsidized interest rates, which impairs their financial sustainability. Post-Tsunami donor support has exacerbated bad financial practices. Government interventions in the sector have not promoted sound financial practices either. The Samurdhi Banking Societies present a particularly troubling situation since they are linked to the government's safety net program and rely on a captive source of funding. Third, semiformal institutions are not properly regulated or supervised, which raises serious concerns due to the large amount of deposits that these institutions mobilize from the public. Fourth, coordination among donors remains very weak to the detriment of the sector's long-term viability.

In sum, the current microfinance landscape is plagued with a wide array of donor projects and government interventions that prevent the long-term viability of the sector. With the proposed increase in donor funding for the sector, there is an immediate need for improving donor coordination and agreeing on a common strategy for supporting the sector.[15] The strategy should pay special attention to the development of sustainable microfinance providers. Donors should also support the government in the formulation of a regulatory framework for the sector and in evaluating options to expand credit information to the microfinance sector. While government funded programs have achieved a wide outreach, they have benefited from subsidies that undermine other microfinance providers. The weak governance and lack of transparency of the Samurdhi banking system, is of particular concern. The Samurdhi banking societies should be transformed into separate and self-sustaining microfinance institutions that can serve the rural poor. See ADB (2003) and the forthcoming study by the Consultative Group to Assist the Poorest (CGAP).

FIGURE 1.8

The Post Office: A Unique Rural Branch Network

(Post office branches per 100,000 of population)



Source: Sri Lanka Post and World Bank staff estimates

Sri Lanka's Postal Network: A Long History in Delivering Financial Services

Benefiting from a unique and dense branch network, the Sri Lanka Post has a long tradition in providing financial services, especially in the rural areas (Figure 1.8). Its branch network outside the Western Province is about 3 times that of commercial banks; and in the Northern province it is nearly 6 times that of the commercial banks. Its financial services, however, are restricted to payments and savings accounts and have failed to keep up with new and modern technologies. At the same time, the Post has not explored the introduction of basic financial products that have not yet been popularized in Sri Lanka. Furthermore, the branch network in rural areas is highly underutilized.

1.3 Structure and Scope of the Report

The above findings suggest that Sri Lanka has made significant achievements in the provision of financial services in some areas, but there are still critical market segments that remain underserved, especially for small and rural enterprises. Low-income households could also benefit from access to a more diverse set of financial products, such as enhanced remittances and payment services, longer-term savings instruments, insurance products, and improved access to housing finance. The complexity and diversity of the needs suggest that various approaches have to be examined and that a broad range of institutions can be engaged in the delivery of financial services.

This report analyzes opportunities for expanding services to key underserved markets. Chapter 2 looks at the expansion of financing opportunities for small businesses. Chapter 3 complements the analysis of Chapter 2 by examining how to improve finance for agriculture through supply chains.

Chapter 4 focuses on delivery channels for rural remittances. Remittances to Sri Lanka have been growing rapidly, and the risks posed by informal networks need to be minimized. Moreover, linking migrants to formal financial institutions will yield additional benefits by exposing them to a broad range of financial services (such as savings, credit, and insurance) that can help them manage their economic risks better. Chapter 5 explores the potential role of the postal network in broadening access to financial services in rural areas. Chapter 6 summarizes the main findings of the report.

While this report covers a wide range of challenges and possible solutions for promoting better access to financial services by households and businesses, it does not undertake a full evaluation of the microfinance sector in Sri Lanka. Such an evaluation can be found in the extensive literature on the sector, including ADB (2003); Charitonenko and De Silva (2002); SIDA, KFW, and GTZ (2004); and a forthcoming study by the Consultative Group for Assisting the Poor (CGAP).

Notes

1. Among recent studies, Levine, Loayza, and Beck (2000) shows that the exogenous component of financial intermediary development is positively associated with economic growth. In a subsequent study, Beck, Levine, and Loayza (2000) find that there is a robust, positive link between financial development, GDP growth, and total factor productivity growth. Other empirical work includes Roubini and Sala-i-Martin (1992) and Pagano (1993).
2. Although Sri Lanka's per capita income in the 1960s was comparable to those in the Republic of Korea, Malaysia, and Thailand, its current per capita income is less than a tenth of Korea's, less than a fourth of Malaysia's, and less than half of Thailand's (Asian Development Bank and World Bank, 2005).
3. The Central Bank of Sri Lanka estimates that the civil conflict has cost the country 2-3 percentage points of GDP growth a year (Central Bank of Sri Lanka, 1998).
4. Data for Sri Lanka and India correspond to December 2003 and March 2004, respectively, which are the ends of their 2003 fiscal years.
5. Over the last few years, banking supervision has undergone a major transformation from an outdated approach to a modern risk-based supervisory system.
6. The econometric analysis in La Porta, Lopez-de-Silanes, and Shleifer (2000) shows that state ownership of banks is associated with slower financial development and, subsequently, lower growth of per capita income, especially through reduced productivity growth. The studies of Barth, Caprio, and Levine (2001) find that countries with greater state ownership of banks typically experience much higher interest rate spreads, less private credit, and less nonbank credit, after accounting for other factors that could affect financial development. In a few exceptional cases, the performance of public banks has been sound, primarily in countries with well-established public institutions, such as Germany.
7. Rabobank (2005).
8. Multipurpose cooperative rural banks have had a long tradition in rural areas, but their market share has been on the decline due to poor commercial orientation. Out of 311, only 174 cooperatives made profits in 2001. Indeed, the credit cooperatives operate under the Ministry of Cooperatives and are quasigovernment institutions. The ministry determines the lending interest rate, which is not a cost-

covering rate. Their multipurpose structure makes the consolidation of cooperatives more difficult, while the absence of an effective apex structure limits their access to product development and financial markets. See the "Draft Report on the Promotion of the Microfinance Sector in Sri Lanka" by SIDA, KFW and GTZ (2004).

9. Thrift Credit Cooperative Societies have reached the smallest farmers through their three-tier cooperative banking system. The tiers include a village level, district level, and an apex institution supporting the previous tiers. In 1997, the Sanasa Development Bank was formed, and it may now absorb many of the operations of the district unions and the apex institution.

10. Savordaya Economic Enterprises Development Services (SEEDs) was established in 1986 to promote financial and other services through village-based organizations.

11. Charitonenko et al. (2002).

12. According to SLIS (1999-2000) estimates, low-income households allocate loans for the following purposes: 26 percent for business or farm use, 26.6 percent for purchase or improvement of dwelling, 30.5 percent for household consumption, and the remaining for other personal needs.

13. These are some of the latest estimates on the microfinance sector based on a study by Charitonenko et al. (2002). The forthcoming assessment of the microfinance sector by CGAP will provide new data on the sector.

14. Semiformal institutions, for example, may provide one- to three-year loans for dwelling improvements.

15. Recent estimates indicate that donor funding for microfinance and rural finance in Sri Lanka for the next few years could amount to US$250 million.

CHAPTER TWO

Expanding Financing Opportunities for Small Businesses

2.1 Introduction

Recognizing the critical role that small enterprises play in Sri Lanka's economy and the importance of financing such firms, the government and other development partners for many years have extended funding opportunities for small businesses. However, access to finance remains uneven, and small enterprises are heavily dependent on government-affiliated financial institutions and on less formal funding sources. The small business sector is vital for continuing development in Sri Lanka, and access to financing is critical to the ability of such businesses to grow. Significant gaps in access still exist, making the system of finance vulnerable to changes in public policy or to interruptions in external sources of support.

This chapter describes the small business sector in Sri Lanka and how such firms are financed. It also identifies measures that the government, lending institutions, and the business community could take to move towards a more sustainable system of broadly available financial services for small businesses.

2.2 Financing Sources for Small Businesses and Gaps in Access

The existing evidence indicates that small businesses play a crucial role in Sri Lanka's economy and account for a significant share of the total employment. The ICS (2004) indicates that there are approximately 620,000 rural nonfarm enterprises in the country that employed 1.5 million workers (about 20 percent of the total labor force) and contributed about 12 percent of the country's GDP (Table 2.1).[1,2] The average size of these enterprises was estimated at 2.4 employees. Contrary to common perception, 53 percent of all rural enterprises are registered with the local government authorities and as many as 41 percent were engaged in production activities. The vast majority of firms, however, sell their goods locally. Only about one in ten rural nonfarm enterprises sell their output to a large domestic or international firm.

TABLE 2.1
Investment Climate Survey (2004): A Snapshot of Rural Nonfarm Enterprises
(percent, except where otherwise indicated)

Number of enterprises	620,000
Number of workers	1,500,000
Share of firms producing for domestic market	99
Sole proprietorship	98
Stand alone firms	59
Firms by sector	
Production	41
Trade	38
Services	21
Share of firms in Western Province	20
Average number of workers	2.4
Share of managers with university degree	2
Average firm age (years)	9
Share of firms registered	53
Value added per worker	Rs. 93,763

Source: ICS (2004).

Although comparable data are not available for small urban enterprises, the ICS survey (2004) found that about 30 percent of urban manufacturing enterprises had between 10 to 50 employees. (The survey did not cover urban manufacturing enterprises smaller than 10 employees.) A nationwide census of industries, conducted by the Department of Census and Statistics (DCS) in 2003/2004, also confirmed the importance of small enterprises. The DCS survey found that there were as many as 121,426 establishments with less than 10 employees, comprising 92 percent of all manufacturing establishments. These accounted for 27.5 percent of all manufacturing employment.

TABLE 2.2

Investment Climate Survey (2004): A Snapshot of Urban Enterprises in Key Manufacturing Sectors

(percent, except where otherwise indicated)

Indicator	Small firms (10-50 employees)	Average firm
Firms by sector		
Garments	5	21
Rubber products	11	9
Food and beverages	33	40
Industrial equipment	7	7
Textiles	44	22
Firms with export orientation	35	62
Median number of permanent workers	26	90
Share of managers with university degree	15	45

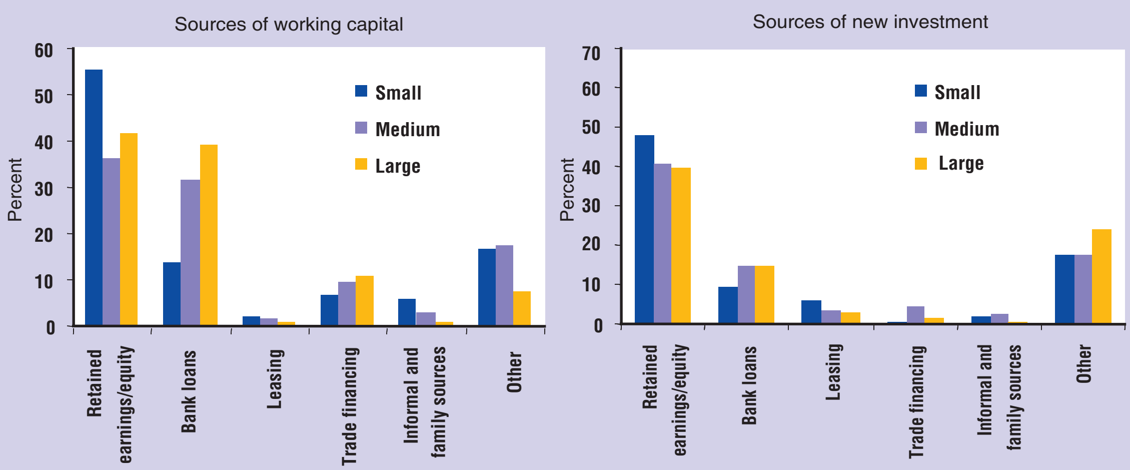
Source: ICS (2004).

Despite the existence of a diverse mix of institutions to provide finance for small businesses (including state and private commercial banks, regional development banks, and microfinance institutions), the services of these institutions vary greatly, and gaps in access remain. As noted in Chapter 1, rural firms surveyed in the ICS (2004) indicated that cost and access to finance constitute the second and third most important obstacles to doing business, respectively. Urban manufacturing firms also ranked the cost of finance as the fourth most important constraint. A separate survey on SMEs conducted by the ADB in 2003 found that 64 percent of all enterprises cited the availability of credit to be a serious constraint to expanding their businesses; and 73 percent cited the interest rate on loans to be a constraint.[3] More than 50 percent of such firms viewed access to equity capital as a major or significant constraint.

In urban areas, access to external finance varies greatly with firm size according to the ICS (2004).[4] See Figure 2.1. The use of bank lending for working capital is far more limited for small firms than for medium and large firms, with small firms showing greater dependency on internal funding. Only 14

FIGURE 2.1

Small Urban Firms Face Greater Difficulty in Accessing External Funding *



*Bank financing for new investments of firms with less than 20 employees is less than 8 percent and retained earnings 78 percent.
Source: ICS (2004)

percent of working capital for small firms in Sri Lanka is financed by bank loans compared to more than 30 percent for medium firms.

Bank financing becomes even more restricted for new investments, a phenomenon that is common to most other countries. About 11 percent of new investments of small firms in Sri Lanka are financed through bank loans (Figure 2.1). Small firms in Sri Lanka reveal greater demand for leasing services compared to larger firms, which could reflect greater constraints accessing bank finance.[5]

TABLE 2.3

Selected Financing Indicators for Urban Enterprises (percent)

	Small (10-50 employees)	Medium (50-150 employees)	Large (150+ employees)	Average
Firms with audited financial statements	72	97	90	86
Firms with a loan	41	56	48	47
Interest rate	16*	15	12	14
Value of collateral as percent of loan size	109	109	100	106
Composition of collateral				
Land and buildings	48	61	42	50
Machinery	23	23	27	24
Tangible assets	12	7	14	11
Other	17	9	17	15

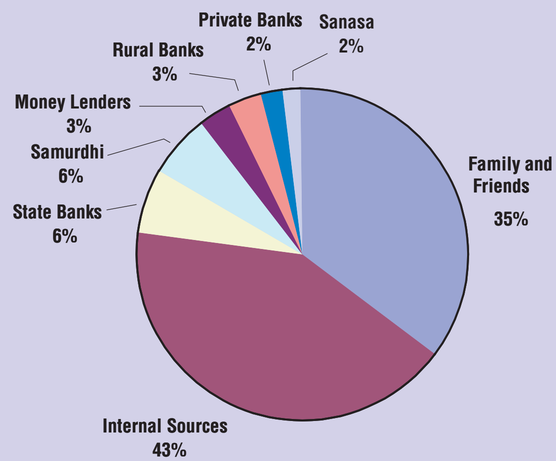
*Interest rate for firms with less than 20 workers surpasses 17 percent.

Source: ICS (2004)

For rural firms, private commercial banks play a very limited role. Only a few private commercial banks offer specialized products and services to rural businesses. The ICS (2004) estimates that less than 12 percent of nonfarm rural firms apply to these institutions for loans, while 41 percent apply to state commercial banks and Samurdhi Banks. Trade finance appears to be an important source of working capital, with nearly 31 percent of enterprises purchasing goods on credit. Access to formal finance is especially restricted for investment purposes (Figure 2.2). Internal resources and family and friends provide nearly 80 percent of investment financing. Public financial institutions and NGOs contribute a very small share of investment finance.

FIGURE 2.2

Financing Sources of Investment for Rural Nonfarm Enterprises



Source: ICS (2004).

Collateral is often critical to the availability of finance. Almost a quarter of loans to rural enterprises requires collateral, and land is offered in 75 percent of these transactions (Table 2.4). When loan applications from nonfarm rural enterprises are rejected, lack of collateral is by far the most important reason.[6] Indeed, the probability of a nonfarm rural firm applying for a loan from a public or private commercial bank is associated with the amount of land the firm holds under formal title. The ADB (2003) survey on small and medium enterprises also identified insufficient or undervalued collateral as the third most important reason for not borrowing from a bank, after interest rate costs and complicated loan application procedures.[7] Unfortunately, there are many obstacles to using land as collateral in Sri Lanka as discussed below.

2.3 Challenges in Expanding Financing Access

While the Sri Lankan government has strengthened the environment that enables financial institutions to expand financing for small enterprises, a number of regulatory, institutional, and market barriers remain. In particular, we observe

- A weak regulatory environment;
- Inconsistencies in government policies; and
- Numerous challenges faced by banks in serving small entrepreneurs.

Inadequate Regulatory Environment and Associated Institutional Gaps

The most critical regulatory weaknesses and institutional problems preventing lending to small enterprises include: (i) deficiencies in debt recovery legislation; (ii) incomplete land ownership and titling; (iii) absence of efficient charge registries over movable collateral; (iv) limited availability of credit information; and (v) a weak regulatory framework for asset-backed securities. In addition to these obstacles to accessing credit, equity financing sources are very limited.

Deficiencies in the debt recovery legislation. Predictable and efficient procedures for lenders to gain access to pledged collateral in the event of default are important to encourage lending. In 1990, the Sri Lankan government provided private banks with access to the parate process that permits lenders to acquire and sell secured property without having to go through the judicial system. In practice, the system has not functioned well. Lenders complain that court injunctions obtained by borrowers disrupt the parate process, while some small enterprises complain that the parate process has often been misused. Court injunctions, however, seem to be less frequently used by small enterprises relative to larger firms since they have less resources to contract lawyers to interrupt the parate process. A modernized legal framework for insolvency could help to establish procedures that would accelerate court proceedings and provide a better balance between the rights of debtors and creditors.

Incomplete land ownership and titling. Being able to demonstrate a clear title to land can be critical in qualifying for a small business loan because banks frequently require collateral. While the government has begun to transfer ownership of land to farmers and the private sector, the process is far from complete, particularly in the rural areas. Also, where ownership has been transferred, land often remains subject to restrictions on such uses as sale, leasing, mortgaging, and inheritance and thus on collateral use. According to the ICS (2004), fewer than 60 percent of rural households who report owning land have both title and exclusive rights to the property's use. Another one-fifth of rural landowners have titles that restrict their rights, and 23 percent of all rural landowners lack any title. These restrictions are

TABLE 2.4

Selected Financial Indicators for Rural Nonfarm Enterprises (percent)

Current account in commercial bank	33
Financial statements	12
Enterprises that wanted to apply for formal loan during the past 5 years	52
Of which enterprises that applied for loan	58
Reasons for not applying for formal loan	
Easier to access informal sources	30
Interest rates too high	39
Lack of collateral	12
Unavailability of bank	11
Did not apply because of bureaucracy	8
Approved formal loan	25
Collateral required	73
Cosigner required	60
Value of collateral as percent of loan*	
Main reasons for rejected formal loan	36
Insufficient or lack of collateral	9
Lack of cosigner	

*In 75 percent of cases, land is required as collateral.

Source: ICS (2004).

compounded by poorly functioning land administration systems. Most private land records take the form of deed registrations that record transactions. Each time a piece of land is used as collateral, a lengthy search for all deeds recorded during the last 30 years must be undertaken to provide title to land. Records are often poor, which results in frequent disputes.[8]

Absence of efficient charge registries over movable collateral. Lack of efficient registries where any liens on movable property are recorded hinders the ability of small entrepreneurs to provide much-needed collateral to qualify for bank financing. Current registries have limited access to modern information technology, which impairs their functionality and national integration. It is difficult and time consuming for a lender to retrieve information to verify that the potential borrower has unencumbered ownership of property which he or she may offer as collateral.

Limited availability of credit information. While the government of Sri Lanka has made a good start in facilitating the gathering of credit information about potential borrowers and in making it available to prospective lenders, more remains to be done. Jointly owned by the Central Bank (49 percent of equity) and more than 80 financial institutions, the Credit Information Bureau (CRIB) receives and shares information on selected financial transactions.[9] The Bureau shares with shareholders reports on the credit experiences of potential borrowers, providing those institutions with a valuable tool for underwriting loans. Currently, however, the CRIB can only collect information on loans above SL Rs 500,000 and loans above SL Rs 100,000 that have become at least six month delinquent. The statute also restricts sharing information with the Central Bank and CRIB shareholders (World Bank 2004b).

Present constraints make CRIB reports less valuable than they otherwise could be. The CRIB does not capture information on the smaller transactions that may represent the bulk of credit experiences for many small entrepreneurs. By excluding data on loan delinquencies of less than six months, the CRIB denies its clients access to information that could be extremely useful in making underwriting decisions and in supporting credit scoring techniques. The government is proposing a series of critical amendments to the CRIB Act that would allow a much wider range of institutions to become members and would not restrict sharing of information to shareholders. New institutions could potentially include factoring companies, large retailers, and public utilities, thus expanding widely the range of credit history information available on consumers and small enterprises. In parallel, the government is planning to phase down its equity participation.

Absence of asset-backed securities. Sri Lanka lacks the legal and regulatory structures that would support the creation and sale of securities made up of financial instruments. Securitization can provide financial institutions with an important additional source of capital that can be used to support further lending. By attracting different types of investors, asset-backed securities can foster the development of additional classes of financial instruments, including longer-term loans.

While securitization of small business loans has been slower to emerge than securities backed by mortgages and certain consumer-based loans, examples of small business loan securities have begun to appear. The disparate character of small business loans, the limited amount of information about their credit performance, and high documentation costs have all been cited as reasons limiting the securitization of such loans (JP Morgan 2003). Despite these hurdles, pilot small business loan securitizations have taken place or initiatives have been announced recently in Singapore, South Africa, and India.

Limited equity financing sources. In Sri Lanka, equity sources to help fund businesses are limited. Venture capital can be particularly important for firms with substantial growth prospects and for businesses that operate in emerging industries such as information technology. However, the reach of venture capital firms is limited and uneven. A 2004 mapping exercise by the International Finance Corporation concluded that smaller companies that do not possess reasonably lengthy records of good performance find it difficult to raise equity, and that venture capital sources are highly concentrated in the Colombo district.[10]

Inconsistencies in Government Policies

Some government practices tend to undermine the goal of creating a sustainable system of private finance for small enterprises. The government's dominant role in the banking sector has led to a dual system, with state-owned commercial banks and specialized lending institutions competing with the private sector. The scale of state-affiliated institutions and the way in which they have operated displaces lending that might otherwise be available from private sources. Historically, state-owned banks have often provided much of their lending at subsidized rates, creating a competitive barrier to entry for private banks. These lending programs have often been accompanied by lax attention to repayment obligations. In the past, recovery rates for small business loans by state-owned banks have ranged from 65 percent to 70 percent for loans made under subsidized programs and from 80 percent to 85 percent for loans made with the banks' own funds. The periodic forgiveness of delinquencies by state-owned banks in the past inevitably undermines the development of a culture of repayment. This further discourages private banks from extending credit to borrowers who might have become accustomed to having their debts forgiven.

More recently, a license was issued for the creation of a new state bank for small and medium enterprises (SMEs), with its own branch network to support direct lending. The business strategy for the SME bank is still evolving. This proposal, however, has raised numerous concerns. Responding to market gaps by establishing a new public bank will duplicate the structure and systems of existing public financial institutions. The new entity is also likely to suffer the same governance constraints that have undermined lending practices of other state banks.

Policy makers lack important information on current lending activity. While the Central Bank of Sri Lanka collects and reports data on total assets, deposits, and credit advanced by banks, neither the government nor other parties have comprehensive and comparable data from all financial institutions describing their current lending activity by the size, type, and location of borrowers. The absence of such information makes it impossible to know with confidence what coverage banks are now providing for small businesses, what gaps in services still remain, how particular institutions are responding to specific credit needs, or how to reallocate resources in the future.

Challenges Facing Banks and Gaps in Knowledge among Small Businesses

In Sri Lanka, commercial banks seem to face higher costs and risks when lending to small businesses, while the latter often do not know what is needed to qualify for bank financing and lack critical market information. Small businesses are geographically dispersed, and lenders usually face greater costs in identifying potential borrowers, conducting due diligence, and maintaining contact with the borrower after a loan has been made. Small entrepreneurs are generally less knowledgeable than their larger counterparts regarding what is required to qualify for financing, which imposes a greater burden on financial institutions during the loan application process. Small entrepreneurs often lack formal financial records and have much more limited track records. The ICS (2004) confirmed that only 12 percent of nonfarm rural firms prepare financial statements (Table 2.4) and that more than half of these firms are less than five years old. In urban areas, fewer small enterprises maintain financial statements than their larger counterparts (Table 2.3). The ADB 2003 survey of small and medium enterprises suggests that the owners of such firms recognize their skill gaps and would be willing to pay to strengthen their expertise. About 25 percent of all surveyed entrepreneurs reported a willingness to pay for business management training, if it were available; about 20 percent would pay to have a business or market plan prepared.

Lack of market information and isolation from supply chains constitute important barriers to the success of small firms. Inadequate market information can cause businesses to sell into local markets where prices may not be optimal or to miss opportunities in markets where growth prospects are greater. Many owners of small businesses recognize their lack of market information to be a serious obstacle (ICS 2004). More than 27 percent of nonfarm rural business owners cite low market demand as a major or severe problem but the underlying problem in many of these cases could be a general lack of market information (Figure 1.2). The ADB survey on SMEs (2003) found that nearly 60 percent of the owners viewed market opportunity to be a serious barrier to their growth.

The above findings are consistent with the experience of other countries and the development finance literature (Bannock and Partners (1997) and Malhorta (2005)). Schiffer and Weder (2001) sampled firms across a number of countries and found that there was a negative relationship between the size of a business and the risk it might pose for a lender. Among the reasons were the more uncertain nature of capital needs of small firms, greater vulnerability to market changes, and limited management capabilities. These features of small businesses can exacerbate the general information asymmetry that is likely to exist between a prospective borrower and a lender.

2.4 Measures to Expand Financing Opportunities for Small Enterprises: The Government's Role as Market Facilitator

Historically, the government has mainly sought to address financing needs of small enterprises through the creation of state financial institutions. By acting as a direct lender, the government could channel capital to targeted populations, but the poor performance of some of these portfolios exacerbated the perception among private institutions that small businesses constituted a riskier sector, added inefficiencies to the financial system, and imposed an additional cost on the state. Future public policies need to explore alternative paradigms.

There is a need for the state to play a more proactive role as market facilitator, rather than a market competitor. First, the state can continue to support improvements to the enabling environment for credit provision. Second, it can develop programs to reduce the risks associated with banks entering new markets and partner with them in the development of new financial products. Third, it can encourage greater disclosure of bank lending to underserved markets.

Strengthening the Enabling Environment for Lending

The government should continue to strengthen the legal and institutional infrastructure to support small business financing. A number of reforms are already under consideration.

- *Accelerate the provision of clear land titles.* To enhance access to collateral, the government needs to remove restrictions on the use of transferred land (sales, leasing, and mortgages and collateral), make the land titling registration system efficient, and clear existing landownership records. Initial steps towards the development of a land titling registration system are underway, and its financing is being supported by a World Bank loan.

- *Develop an efficient registry of charges over movable collateral.* In an environment with restrictions to land use, movable capital stock could be pledged as collateral. In Sri Lanka, however, there is no automated and unified registry of charges over movable collateral which restricts this lending opportunity. Among emerging economies, Eastern European countries have led the way in the establishment of such registries. Bulgaria, Hungary, Romania, and the Slovak Republic have all introduced efficient registries during the last decade. The experience of these countries indicates that the specific structure of the registry can differ, but a minimum set of standards is necessary. To assist countries with the establishment of efficient registries of charges over movable collateral, the European Bank for International Development has reviewed numerous country experiences and prepared some guiding principles, which are summarized in Box 2.1.
- *Facilitate procedures for dealing with delinquent borrowers.* The legal framework for debt recovery is in need of review. This could include examining ways to improve the exercise of parate powers and reduce the scope for judicial interventions that unduly delay the process. The review should also consider whether more flexible tools could be created to deal with failing or insolvent enterprises, in order to provide creditors with the option of allowing such firms to continue to operate where there is a realistic chance that the business could eventually return to profitability.
- *Expand the availability of credit information.* The proposed legal amendments to the CRIB Act constitute a positive step. They will help to make more credit information available on small enterprises and will permit more institutions to become CRIB members. Besides enriching its database, the CRIB plans to offer additional services that will facilitate lending to small enterprises and consumer, including credit scoring.[11]

  The draft amendments to the CRIB Act also envision possible partnerships with other international and more developed credit bureaus that could assist with technical training and technology. International operators, however, are likely to be more interested in partnerships that involve small equity participations. In India, for example, the newly operational Credit Information Bureau is jointly owned by the State Bank of India (40 percent), the largest housing finance corporation (40

BOX 2.1

Guiding Principles for Unified Charges Registry Over Movable Collateral

- The system should permit charges on all kinds of assets. It should be centrally administered and publicly accessible.
- A regime for secured credit should provide for effective publicity of charges, enabling the creditor to ascertain existing charges on the asset and enabling third parties to discover that the creditor has a prior right on it.
- The registry should provide an easy method for determining the order of ranking between competing rights claimed in the same asset.
- A failure to publicize a charge should mean no security right can be effective against third parties.
- The system for registering and accessing information should be simple, fast, and inexpensive. Reliance on modern technology should make it possible to obtain searches within a few minutes of the request.
- The register should be accessible by all citizens and businesses. Various contact points throughout the country should be made available.
- The system and the method of recording, storing, and accessing information should protect against error, abuse, and fraud.
- The registry should be managed transparently as a public service. Independent audits should be conducted regularly. The registry, whether public or private, should be required to report regularly to a supervising authority and demonstrate that it is complying with the law.

Source: European Bank for Reconstruction and Development (2004).

percent), and some of the largest international credit bureaus, including Transunion (10 percent) and Dun and Bradstreet (10 percent). (See World Bank 2004b.)

- *Facilitate the development of asset-backed securities.* The government is preparing a draft law to facilitate the issuance of asset-backed securities and is also considering changes to the leasing act.[12] The development of a secondary market in asset-backed securities could provide banks with another source of capital to supplement their deposit base. Asset securitization could also become a less costly funding source for nondeposit-taking leasing companies, thus allowing them to play a greater role on investment finance of small enterprises. Leasing companies that do not take deposits have been highly dependent on bank financing, often at unfavorable rates since they are perceived as competitors by banks.

  The success of this market will also depend on the development of an efficient contractual savings sector. Most occupational pension schemes have not engaged professional investment managers, and for the most part, have been reluctant to invest in instruments other than government securities and bank deposits. Public provident funds with assets surpassing 20 percent of GDP face tight portfolio restrictions. In particular, the investment policy of the Employees' Provident Fund, the larger of the two public provident funds, limits equity and corporate debt investments to 2 percent and 10 percent, respectively, of total assets (World Bank, 2005d).

Sharing Risks with the Private Sector to Promote Market Development

The government could consider a variety of instruments to defray the risks and costs of developing new market financing tools for small enterprises.

Partial credit guarantees. Through partial credit guarantees, the government could reduce the risk that private banks face when entering new markets segments for small enterprises. Such schemes can induce banks to expand their lenders' risk frontiers and serve new targeted borrowers.

While it is difficult to assess their net impact, evidence suggests that well-crafted guarantee schemes can result in lending to small enterprises that would not otherwise have taken place. One comprehensive review of guarantee schemes around the world found that at least 85 countries had a small business loan guarantee scheme in place at the time and concluded that between 30 percent to 50 percent of the loans made under properly designed guarantee programs represented net additional lending (Bannock and Partners 1997).[13] Citing schemes in Egypt, Colombia, and the Philippines, among other countries, the authors concluded that particularly when they were accompanied by a training component, guarantee programs could contribute to a deepening of the financial services sector by introducing lenders to a wider range of potential small business borrowers than they would otherwise have had contact with. Based on all available evidence, the authors concluded that "long-term benefits, including those of financial deepening, can be considerable and far-reaching, while costs can be controlled if schemes are well designed and implemented."[14]

International evidence indicates that successful guarantee schemes share several features (IFC 2003; Bannock and Partners 1997).

- *Clear program objectives and targeting underserved markets.* The program should embody objectives that are clearly understood and shared by government, lenders, and potential borrowers. All guarantee schemes only provide credit support for loans to firms below some minimum size and focus on traditionally underserved markets. Eligibility is usually based on one or some combination of three factors-most often the number of employees in a business, but also, at times, the capital invested in fixed assets, or annual sales. Most programs include minimum eligibility criteria for bank participation.

- *Risk sharing*. The government should assume a large enough share of the risk to induce lenders to make loans they otherwise would not have, but should leave banks with enough exposure to assure prudent underwriting and prevent moral hazard. IMF (2004) contrasts the loan guarantee programs of the Republic of Korea, which offered very substantial guarantees that sometimes continued over several years, with a scheme in Taiwan, in which banks bore a greater risk and therefore exercised greater care in evaluating the creditworthiness of borrowers.

A new risk-sharing facility in India for SMEs introduces an innovative element to control potential adverse selection effects (that is, the risk that banks will pass to the facility their worst loans). The risk sharing will be undertaken on a loan portfolio basis rather than on a loan-by-loan basis (World Bank 2004c). The guarantee will cover only 50 percent of the eligible portfolio; the remaining risk will be assumed by the underwriter.

- *Fee structure*. Guarantee fees should be fixed at a level high enough to cover the great majority, if not all, of the government's exposure, but not so high as to deter borrowers. Fees generally amount to between 1 percent and 2 percent of the loan value as an up-front fee, and between 1 percent and 3 percent annually as an on-going guarantee fee.
- *Honoring claims*. The guarantee agency must honor its obligations to pay out in the event of default on a timely basis. In Sri Lanka, guarantee schemes implemented in the 1990s were not successful since most claims were subject to lengthy disputes generating perceptions among lenders that the government was not going to honor its obligations.
- *Flexible and simple administrative arrangements*. Administrative requirements should be flexible so as not to increase lenders' costs.

If the government chose to provide a risk-sharing facility to promote financial inclusion of small enterprises, it would have to define the eligible market group. Evidence available suggests that firms under 50 employees have significantly less access to bank lending than larger firms. Access by formal financial institutions becomes even more difficult as firm size further declines. A government agency would have to be designated to manage the program, and administrative procedures that do not impose an undue burden on participating financial institutions would have to be put in place.

Create incentives for private equity investments in small businesses. As noted earlier, small firms in Sri Lanka frequently cite access to equity financing as a constraint. The government could support the small business sector by creating incentives for private investors to provide equity to such firms. Equity investments can reduce the debt burden that businesses would otherwise have to carry and can be accompanied by management assistance provided by the equity partner.

In a number of developed markets, a subset of private equity investors is beginning to focus on serving businesses that might otherwise be excluded, and governments have begun to play a role in promoting targeted equity investments. In the United States, a growing venture capital industry for community development has taken root, resulting in the creation of 68 investment funds that target small businesses that create jobs for lower-income people in economically distressed communities.[15] Since 2000, the number of community development-oriented funds has grown by more than 40 percent, and the amount of capital under management has more than doubled to US$870 million. Firms that received investments from community development funds increased their total employment by 99 percent and their employment of low-income persons by 149 percent since they first received venture funding.[16]

Many governments have played a role in promoting equity investments in small enterprises but not always with success. The key challenge is to craft the government's role so that public resources foster sound investments in firms that would not otherwise have had access to venture funding, while avoiding substituting the government's judgment for market assessments. The U.S. Small Business Administration provides an interesting example where the government shares the risk of equity venture funding but does not displace market judgments (Box 2.2).

BOX 2.2

U.S. Government Scheme to Support Equity Investments in Small Enterprises

The **United States'** Small Business Administration (SBA) provides equity capital to licensed Small Business Investment Companies (SBICs). SBICs are venture funds that target small businesses. The government offers SBICs the opportunity to issue SBA-guaranteed debentures to raise capital that supplements funds from private sources. SBICs can issue guaranteed debentured for amounts up to 300 percent of their private capital with a ceiling of US$100 million. They provide small firms with services similar to those offered by other venture funds, including expert management assistance. In their first 40 years, licensed SBICs provided more than $36 billion in financing for small businesses, amounting to between 5 percent and 15 percent of the total volume of venture capital financing in the United States in recent years. Firms that received SBIC-financed capital when they were small businesses have included Apple Computer, Intel Corporation, and Federal Express.

Source: ShoreBank Advisory Services (2003).

Defray some of the costs for private lenders that serve small enterprises. The government could encourage private banks to begin serving small businesses or expand their current activities by helping to defray some of the unique costs that they incur in entering this market.[17] *In addition, the government could support the education and training of small entrepreneurs to make them better qualified for financing and to assist them in responding to markets.* Although a wide range of suppliers representing the government, private sector organizations, and the donor community are providing business development services in Sri Lanka, the system is mainly concentrated in the Western Province and only a few suppliers appear to deliver effective and valuable services. Providers of business development services comprise, among others, the Ministry of Tertiary Education, Ministry of Rural Industries, Industrial Development Board, Sri Lanka Business Development Centre, Chamber of Commerce and Industry, and Sarvodaya. Public sector providers tend to be weak and Colombo-centric, while the majority of private sector suppliers are focused on the corporate sector and medium-sized enterprises. The ongoing SME project financed with an ADB loan also includes lines of credit to extend term finance to SMEs; and technical assistance and a matching grant mechanism to promote business development services for SMEs. Four banks have been participating in the program and all resources have been committed (US$60 million). No detailed data is yet available on the program's impact, but preliminary information suggests that the upper end of SMEs may have been the primary beneficiaries.

Providers of business development services have limited coverage, which indicates the need for enhancing the scope of their services and developing new products for small enterprises. Rather than delivering new services and training directly, the government could partner with banks and the business community to ensure that the education is relevant to the circumstances that small firms face and that the beneficiaries share in the costs.[18]

The aforementioned initiatives would reorient government efforts from direct market participant to market facilitator. In this vein, the government should reevaluate whether there is a need for a new first-tier SME bank. Rather, it could consider the establishment of a small and lean second-tier (apex) institution that would focus on promoting financial market development for underserved customers, a function that the Central Bank has traditionally played. Such an institution could undertake some of the services suggested above or other activities to promote financial inclusion in partnership with financial institutions. The rationale for this approach becomes stronger if it forms part of a longer-term strategy to gradually disengage from first-tier banking.

Following a long and unsuccessful tradition of state participation in the banking system, some countries in Latin America have withdrawn from first-tier development and commercial banking and refocused on a market facilitator role, often through a second-tier development institution. Mexico, for example, is closing some of its first-tier development banks and converting others into second-tier institutions (for example, Nacional Financiera). Box 2.3 summarizes Nacional Financiera's successful program with reverse factoring and its potential application to Sri Lanka. Peru also closed its first-tier development banks in the early 1990s, following a hyperinflation period, and transformed one of them (COFIDE) into a second-tier financial institution that works with commercial banks and smaller apex institutions supporting the microfinance sector. Among others, COFIDE has helped to develop new financial products for SMEs, including export financing instruments.[19]

BOX 2.3

Facilitating Supplier Finance for Small Enterprises: Mexico's Experience with Reverse Factoring

Factoring can be an important source of working capital, especially for higher-risk firms that have greater difficulty accessing bank finance. Factoring is a type of supplier financing in which a firm (supplier) sells its accounts receivables at a discount to a third party (factor). In some countries, especially emerging markets, the factor/lender buys receivables "without recourse," which means that the seller (supplier) is accountable in case a buyer does not pay its accounts receivables, and the seller (supplier) of the receivable retains the credit risk. In reverse factoring, a variation of this model, the lender/factor purchases only those account receivables from creditworthy buyers. This enables the SME supplier to transfer its higher credit risk and borrow from the factor on the basis of the superior credit risk of its buyers. The advantage of factoring is that it can operate even in countries with weak collateral or judicial systems.

To foster the growth of the factoring market, Nacional Financiera (a second-tier development bank) in Mexico has developed an electronic platform that offers on-line factoring services to SMEs. The program has connected 190 large, creditworthy firms (big buyers), more than 70,000 SMEs, and about 20 banks and finance companies, and is dealing with more than 4,000 factoring operations a day. Nacional Financiera maintains an Internet site with relevant information on each big buyer. The electronic platform provides a national reach and allows multiple financial institutions to compete for factor suppliers' receivables, which ultimately results in better financing terms for suppliers (SMEs). In addition, Nacional Financiera facilitates all legal work related to the transactions, which expedites transactions and reduces costs. However, it does not assume credit risks associated with factoring operations.

There is great potential for developing reverse factoring in Sri Lanka. A significant share of firms registered with the Board of Investment (BOI), for example, report using over 50 percent of local suppliers for their inputs and intermediate goods and services, many of which are SMEs. The large BOI firms could potentially be involved in reverse factoring arrangements and a second-tier bank or another apex institution could assist with the development of this program.

Source: Klapper (2005).

Greater Disclosure of Lending Patterns to Underserved Markets

Requiring that banks collect and report information on the size, type, and location of borrowers to which they advance funds can be a powerful policy tool to motivate changes in bank lending. Experience from other countries suggests that making such information widely accessible can help to alter the behavior of lenders by drawing public attention. The United States has a fairly elaborate system for collecting and disseminating lending information, which has evolved over the past 30 years. In the United Kingdom and Canada, information gathering is more recent (Box 2.4).

If the government devised a data gathering and dissemination scheme, it would need to decide which institution would be required to collect the data, the type of borrowers about which information would be gathered, and how it would be shared with the public. The data-collecting institution should endeavor to collect the data in a format that would be compatible with systems that

BOX 2.4

International Examples on Public Disclosure of Lending Patterns

The **United States** has had a system for collecting and disseminating data on lending patterns for more than 30 years. The Home Mortgage Disclosure Act (HMDA), first adopted in 1975, requires depository institutions and other housing lenders to collect data on the race, income, and location of people to whom they provide residential mortgage loans, as well as comparable information for applicants who did not eventually receive loans. In 1995 HMDA regulations were revised to require that depository institutions with more than US$250 million also collect and report information on the size and location of small businesses to which they provide loans, though in less detail than for mortgage data. Regulators in the United States can use HMDA data to help assess a financial institution's compliance with laws that require that banks serve a wide range of community credit needs (Box 2.5). HMDA's greatest impact, however, has arguably been through its use by third parties who have conducted and disseminated reports describing banks' lending patterns. In a milestone event, a study published in 1988 by an Atlanta-based newspaper using HMDA to document disparities in mortgage lending between neighborhoods with different concentrations of racial minorities generated considerable public debate and resulted in agreements by several banks to take steps to expand their lending in underserved communities. More articles soon followed in other cities that reported similar lending patterns, which generated comparable responses by banks.

In the **United Kingdom**, reporting on banks' services to economically disadvantaged communities remains voluntary, and for the most part, bank data on lending are aggregated and information on individual banks is not reported. (However, at least one bank has committed to publicly disclose information on its own lending patterns.) Although lending data have been reported primarily on an aggregated basis, the results have increased public pressure on banks to expand their services.

In **Canada**, the 2001 Bank Act created a new Financial Consumer Agency to collect and publish data on small business lending, including the number of loans of different sizes that are approved for each province. As originally conceived, data will not be gathered from individual banks on the race or ethnicity of the borrower, the size or type of business, or its location within a province.

Source: ShoreBank Advisory Services (2003).

financial institutions may already have in place to avoid imposing additional costs, and also should assure that safeguards protect the privacy of the banks' clients. The Central Bank would be the logical choice for this endeavor since it has experience in collecting and analyzing bank data consistent with appropriate privacy safeguards.

Some countries have gone a step further by adopting regulations requiring banks to make their services more widely available. In the United States, for example, the Community Reinvestment Act (CRA), initially adopted in 1977, requires that banks serve a broad range of their communities' credit needs. It does not set numerical lending targets and grants financial institutions considerable flexibility in how they satisfy their obligations, for example by partnering with other institutions. The independent regulatory bodies that oversee the safety and soundness of depository institutions are also responsible for administering the CRA and determining a rating. The Act requires that regulators consider a bank's CRA rating in reviewing applications for mergers or if they want to engage in such nonbank activities as insurance and brokerage services. Numerous studies have concluded that a significant share of the increased lending to lower-income citizens and communities in the 1990s is owed to the impact of the CRA in combination with greater disclosure on lending patterns (see Box 2.5). More recently, some reports have noted that the CRA's relevancy may be weakening because of structural changes in the U.S. banking industry.[20]

By contrast, Australia, Canada, and the United Kingdom have struck a different balance and have stopped short of recommending CRA-type legislation. Rather, they have recently put various voluntary schemes in place to encourage banks to expand their efforts on behalf of credit-deprived communities.[21] Although many of the UK programs are too recent to offer conclusive results, UK banks are showing signs of supporting the government's effort to achieve financial inclusion. The UK financial community, however, has emphasized that any solutions adopted must embody a long-term approach and take into account sustainability factors.

Establishing voluntary schemes that will foster financial inclusion together with requirements to disclose lending practices to underserved markets could be a more suitable policy approach for Sri Lanka to pursue. Until the 1990s, Sri Lanka's banking system was subject to numerous restrictive mandates (such as interest rate ceilings and lending targets) that adversely affected the banking system's efficiency and the market

BOX 2.5

The U.S. Community Reinvestment Act: Its Origins and Impact

In response to evidence that banks were systematically excluding lower-income and minority communities from retail lending programs, the U.S. government adopted the CRA in 1977. The Act creates an obligation on the part of federally insured depository institutions to meet the credit needs of their communities, including those of lower-income borrowers and neighborhoods, in a matter that is consistent with safe and sound banking operations. It requires that regulators consider a bank's CRA rating in reviewing applications for mergers or to alter their areas of operation.

Initially, attention from regulatory agencies was lax, but this pattern changed dramatically in the late 1980s when the U.S. Congress amended the CRA to require that regulators adopt a more rigorous system in evaluating banks' performance. Today, most large retail banks are assessed on three dimensions: a "lending test" which considers the distribution of a bank's home mortgages and its loans to small business and farms; an "investment test" which examines the extent of an institution's community development-oriented investments in its service area; and a "service test" which evaluates the availability and effectiveness of a bank's efforts to deliver retail banking services to low- and moderate-income families, including the distribution of its branches and ATMs. The regulator combines the results on these tests to arrive at an overall rating of the institution's performance as outstanding, satisfactory, needs to improve, or substantial noncompliance. In 1989, for the first time ever, the Federal Reserve denied an application by a bank to acquire a smaller lender based in part on an unsatisfactory CRA performance. Financial institutions responded to the changing environment by sharply increasing their efforts to serve credit-deprived populations.

Recent econometric studies have concluded that a significant share of increased lending to lower-income citizens and communities that occurred in the United States during the 1990s is directly attributed to the CRA and that CRA-related lending has not adversely affected the financial standing of banks. Apgar and Duda (2003) found that among financial institutions that are subject to the CRA, about 36 percent of their mainstream home purchase loans were made to CRA-eligible borrowers in 2000, compared to about 28 percent for lenders that were not subject to the CRA. Controlling for other factors, the report concluded that the CRA was directly responsible for about 2 percentage points of the increase in the share of loans provided to targeted borrowers. Over the 1993-2000 period, CRA-regulated lenders were found to have gained market share of the mortgage market aimed at lower-income individuals.

A separate study by Zinman (2002) found that the CRA appeared to increase the share of all small businesses holding bank debt by between 7 and 10 percentage points and the impact was not offset by decreases in non-CRA lending. The study demonstrates that small business lending increased more steeply during the 1990s among financial institutions whose regulators tended to be more stringent in conducting CRA evaluations. The report estimates that CRA-related small business lending in 1,370 counties may have increased aggregate payroll by nearly US$16 billion, while preventing 18,000 bankruptcy filings. The author concludes that his findings appear "consistent with a model where targeted credit market interventions can improve efficiency".

A comprehensive study by the Board of Governors of the Federal Reserve System (2000) indicates that the great majority of CRA-eligible loans that banks and savings institutions make are no less profitable than comparable non-CRA loans. Of 143 banking institutions responding to a Federal Reserve survey, 85 percent reported that the CRA-related small business loans they made in 1999 were profitable, and another 11 percent reported that they were marginally profitable. These rates were nearly identical to those reported for their overall small business lending operations. There is no evidence that the CRA has put the safety and soundness of regulated financial institutions at risk. Zinman (2002) found that CRA-induced lending had no adverse effect on bank performance as measured by profits, return on equity, or return on assets. Recent reports, for example, Apgar and Duda (2003), have suggested that the CRA's relevance may be weakening as a result of structural changes in the industry.

Sources: Apgar and Duda (2003), Board of Governors of the Federal Reserve System (2000), U.S. Department of the Treasury (2001), World Bank (2004d), and Zinman (2002).

segments they were trying to protect. Imposing regulations to promote financial inclusion could be misinterpreted as a reversal of financial sector policies. Also, there is risk that these policies could become overly restrictive with narrowly defined mandates as was the historical practice in Sri Lanka.[22] The U.S. CRA legislation is a unique example since it grants financial institutions extensive flexibility in the actions they take to meet their financial inclusion obligations and in ensuring that these actions are consistent with safe and sound banking operations.

2.5 Measures Financial Institutions and Small Enterprises Could Implement

Whatever policies the Sri Lankan government adopts to encourage banks to serve credit-deprived communities, the services that any group receives ultimately depend on the actions taken by financial institutions and potential borrowers. Banks in Sri Lanka could expand their reach to small businesses by developing targeted products, forging new partnerships, or supporting additional training or education for potential borrowers. In devising an outreach strategy, a financial institution should tailor its approach to match the institution's capabilities and its market position.

Develop tailored lending programs for small businesses. *Successful small business lending efforts by commercial banks in Sri Lanka and elsewhere suggest that a number of factors are critical to their success.* First, successful programs are typically initiated by the bank's senior most management and often as part

BOX 2.6

Examples of Small Business Lending Products

Czech Republic. Shortly after it was privatized and acquired by Erste Bank, Austria, the Czech bank Ceska Sporitelna initiated an SME lending program that utilized a credit line from the European Bank for Reconstruction and Development, plus technical assistance from ShoreBank Advisory Services (SAS). Ceska Sporitelna's senior management viewed their SME lending initiative to be, in part, a device for developing a retail banking orientation, as well as a means to overcome a previous negative experience in lending to small businesses. SAS helped the bank develop a cash flow-based core small business lending product along with new origination procedures and guidelines. With the bank's active cooperation, SAS trained 40 branch managers and more than 150 loan officers in the new product and procedures. Within the program's first three years, Ceska Sporitelna had disbursed more than US$47 million in loans to about 1,200 borrowers and was supplementing term loans with working capital loans and credit lines.

Republic of Georgia. United Georgian Bank developed a product that bridged the gap between larger-scale SME lending and microcredits. Beginning in 2002 with the assistance of EBRD, the bank implemented a "downscaling" program aimed at offering loans to micro and small enterprises. Building on a market-wide needs assessment, United Georgian Bank developed loan products targeted at small businesses (with a loan size between US$500 and US$30,000, with a maximum term of two years) that were underwritten principally on the basis of the business applicant's cash flow and his or her prior credit experiences. Within two years, United Georgian Bank had 1,385 small business loans outstanding (with an outstanding portfolio of US$2.5 million) and a low portfolio at risk (PAR over 30 days was less than 1 percent). The United Georgian Bank small business lending operation achieved profitability within two years.

United States. Wells Fargo bank launched a comprehensive small business lending effort in the early 1990s with processing guidelines and pricing that were substantially different from traditional commercial lending products. The "Business Direct" product relies on a combination of cash flow lending and collateral, and the bank employs a tailored underwriting scorecard to speed processing and to lower costs. In addition, the bank allows borrowers to make initial applications by mail or phone as well as in person, and it adjusted requirements for applicants to provide detailed financial statements. Wells Fargo adopted a risk-based pricing structure to compensate for what they expected would be a slightly higher loss rate among small business borrowers than among other corporate clients. Within the program's first ten years, Wells Fargo lent more than US$15 billion to 400,000 small business borrowers in the United States and Canada-more than 90 percent on an unsecured basis. The median sales of the borrowing firms were about US$325,000, and 70 percent of borrowers had five or fewer employees.

Sources: ShoreBank Advisory Services (2004) and Wells Fargo (2004).

of a conscious corporate strategy to broaden the institution's customer base. Second, successful programs have typically involved multiyear commitments by financial institutions that are prepared to absorb early expenses and to make necessary adjustments in order to achieve profitability. Third, successful programs generally have included the development of lending products tailored to small business and a strong training component for bank staff that have had little prior experience with the new borrower base or with alternative loan processing procedures. Box 2.6 below summarizes several examples of successful small business loan programs in the Czech Republic, Georgia, and the United States.

Small business loan products typically present unique characteristics and are accompanied by tailored risk management techniques. A recent World Bank analysis of SME loan programs in seven countries concluded that such schemes focused heavily on relationship-intensive banking, compared with traditional transaction-based lending (Malhorta 2005). This approach emphasizes looking to a business's cash flow to determine a client's ability to repay a loan, rather than relying solely or principally on collateral. Cash-flow analysis, in turn, places a premium on in-depth knowledge of the client and the business. Small business lending often involves advancing smaller loan amounts for shorter lending terms at the outset, with clients graduating to larger loans and longer terms, as they develop favorable repayment histories. Loan monitoring typically includes a schedule of frequent visits with borrowers, particularly shortly after the loan is disbursed and when the first repayments are due. *Increasingly, credit scoring is playing a role in small business lending as well, both as a means to streamline processing and as a risk-management device (Box 2.7).* Many emerging countries started with simpler "judgmental" scoring models, based on qualitative parameters, and later switched to more complex and powerful "statistical" scoring models.

Banks that have succeeded in small business lending have focused on the need to achieve sustainable financial returns, by controlling administrative costs and by pricing products appropriately to cover expenses and anticipated losses. One approach that some financial institutions have employed is to create a separate

BOX 2.7

The Application of Credit Scoring to Small Business Lending

Credit scoring has attracted considerable attention recently in small business lending as a means to better forecast the performance of loans, and as a way for banks to reduce the more costly and labor-intensive underwriting process.

In its most rigorous form, credit-scoring models attempt to correlate data that are available at the time a lending decision is made with information regarding the loan's subsequent performance to determine what factors best predict repayment and delinquency rates. By scoring loan applicants on the factors found to be predictive of loan performance, a lender may then choose to automatically accept or reject applicants whose scores are at one extreme or the other, while subjecting the remaining, much smaller pool of potential borrowers to a more rigorous individualized review.

The challenge in constructing scoring models for small business loans in an emerging market is that reliable data in directly comparable forms may be severely lacking. Institutions have attempted to compensate either by developing models that rely on findings from more rigorous analyses undertaken in other markets, or by seeking to pool data across lenders within a single market in the hopes of arriving at robust, predictive results. *Other institutions in emerging markets have started with simpler approaches, such as "judgmental" scoring models that are largely based on qualitative factors, and have gradually moved to more complex, quantitative models as they have been able to gather data.*

Latvia's Unibanka offers one example of how credit scoring can be applied to small business lending. Working with Bannock Consulting, Unibanka developed a loan approval scorecard for a new Entrepreneur Loan program that it launched following a mid-2000 decision on the bank's part to focus on SME lending. The scorecard assesses the financial capacity of potential borrowers by examining such factors as the firm's profit as percent of sales and its debt-to-equity ratio. Combining that information with assessments of the owner's character and the conditions in which the business operates-and applying only a 10 percent weighting to collateral-the scorecard arrives at an overall credit score. Using this device, Unibanka has reduced paperwork requirements for applicants, has been able to provide decisions within one day for loans of up to [illegible]30,000, and has been able to maintain portfolio performance with less than 2 percent of their loans more than 30 days in arrears. The scorecard also helped Unibanka apply risk-based pricing to its small business loans.

Sources: IFC (2001) and Caire and Kossman (2001).

organizational unit to manage its small business initiatives - akin to creating a "bank within a bank." This has permitted the parent institution to develop a separate profit-and-loss statement for the new business line, identify costs, and define pricing policies consistent with long-term profitability.

Create new partnerships to reach SMEs. Banks that lack an extensive branch network could seek opportunities to partner with other institutions in order to deliver finance products to small businesses that are geographically dispersed. Alternatively, a group of banks could form a consortium to deliver loans and related services.

Such partnerships are a common feature of community investment programs that U.S.-based banks have created to satisfy their CRA obligations. About three-fourths of banks' special lending programs involve some third party; 45 percent of the programs entail a partnership with a nonprofit organization; and 26 percent of the targeted lending schemes are undertaken through a consortium of financial institutions. In one-half of the cases, third parties assist in identifying potential borrowers or provide preloan education or counseling. About one in five partnerships provides underwriting assistance, and a like share of the third parties offer help with servicing loans.[23]

I*n India, a few banks are piloting innovative partnerships with microfinance institutions (World Bank 2004a).* Industrial Credit and Investment Corporation of India Ltd. (ICICI), for example, is funding "self-help groups" and is using local promoters to help organize these groups, especially in areas where it does not have an extensive physical presence. Promoters receive a salary that is linked to performance indicators, such as recovery rates. ICICI is also partnering with NGOs, microfinance institutions (MFIs), and local traders to deliver lending products to small farmers. The underwriting and servicing of the loan (management and collection) is undertaken by the local partner, but the bank retains the loan in its books. In addition, ICICI is piloting securitization of microloan portfolios. A few deals have already been completed in the state of Andhra Pradesh.

Support training and education for entrepreneurs. As noted earlier, banks face challenges in serving small businesses because these entrepreneurs often lack critical management and financial skills or market information. To meet these needs, Hatton National Bank, for example, provides training to farmers as part of its microfinance and small enterprise loan program. Banks can by no means be solely responsible for addressing these knowledge gaps, but they may have an important role to play by pooling their expertise and by working in partnership with the business community-perhaps with some financial support from the government. In the United Kingdom, the British Bankers Association has committed to work with the government's Treasury to develop a training program for small businesses (ShoreBank Advisory Services 2004).

While a number of programs to promote business development services have been implemented in Sri Lanka, they have tended to focus on medium enterprises rather than on small enterprises which face greater hurdles as discussed earlier. The broader business community can help small enterprises thrive by designing and delivering training programs that will help fill their gaps in skills and information. Larger, more established businesses could help small firms better understand markets by sponsoring product fairs to familiarize entrepreneurs with patterns of demand in different markets. They could also promote the creation of associations and cooperatives among small businesses to help foster peer-to-peer learning, to make it possible for them to achieve economies of scale in purchasing inputs, and, potentially, to form new business partnerships. There may be a role for government as well in supporting linkages between larger and smaller firms. In 1998, the U.S. government launched BusinessLINC to promote "learning, information, networking, and collaboration" (LINC) between large companies and small or minority-owned firms that operate in the same industry. The small firms benefit through technical assistance, enhanced market access, and potential business partnerships. Though the government initiated BusinessLINC, the private sector subsequently assumed responsibility for managing the program.

2.6 Conclusions

Small enterprises are important to the Sri Lankan economy, and more can be done to promote their financial inclusion. A few initiatives are already in progress, such as strengthening the Credit Information Bureau and revisions to the legislative framework for asset securitization and leasing. However, further measures can be taken to enhance the enabling environment for lending to small enterprises. Attempting to narrow market gaps by establishing another first-tier state bank has generated numerous concerns since the new SME bank is likely to face similar constraints to those encountered by existing public financial institutions. An alternative paradigm needs to be considered.

All stakeholders-private banks, the business community, and the government-could come together in developing a comprehensive medium-term strategy to facilitate greater access to finance by small enterprises. The strategy could promote public awareness of existing gaps by requiring that banks disclose more detailed information on their lending to various market segments. Greater transparency will draw public attention and could help to alter the behavior of lenders as the experience of other countries has shown. Banks could develop new credit products that will be better tailored to the requirements of small enterprises and less dependent on collateral. Banks without a dense branch network could also explore new solutions and seek partnerships with other organizations in order to target geographically dispersed enterprises.

In parallel, the government should work proactively to improve the enabling environment for lending, in particular lenders' rights. The government could also help defray some of the costs and risks associated with banks entering new markets, for example, with partial credit guarantees and small subsidies to facilitate development of new products targeted at small enterprises. Government could also collaborate in the development of more efficient trade finance mechanisms, and partner with banks and the business community in the development of technical assistance programs for small enterprises. Educating small entrepreneurs and facilitating their linkages to larger enterprises and markets will be critical in improving their creditworthiness and helping them understand available financing products and how to access them.

Finally, the success of the above measures will need to move in step with efforts to build a competitive banking system and improve the macroeconomic environment. A more competitive banking system will further encourage banks to move down market, while a stable macroeconomic and fiscal environment will be an essential condition for increasing lending to the private sector.

Notes

1. The Asian Development Bank and the World Bank, together with A.C. Nielsen and Sri Lanka's Department of Census and Statistics, conducted a survey of the rural and urban investment climate in 2004. The rural survey covered 1,327 nonfarm enterprises operating as stand-alone activities or within a household. These enterprises were selected from 147 rural communities spread throughout all provinces. Rural nonfarm enterprises were defined as any income-generating activity (trade, production, or services) not related to primary production (crops, livestock, or fisheries) undertaken within or outside the household unit. The urban survey covered 449 formal establishments in five key manufacturing sectors (garments, textiles, food and beverages, rubber products, and industrial equipment) and 94 firms in tourism and information technology. The sample covered the Western and other provinces. For further information on the scope of the survey, sampling methodology, and results, see ADB and World Bank (2005).
2. The sample was constructed with the assistance of the Sri Lankan Department of Census and Statistics, and it involved a two stage approach. Rural areas were defined as per the definition of the Sri Lankan Department of Census and Statistics. In the first stage, nearly 150 Grama Niladary (G.N.) divisions were randomly selected from among the 25 districts of Sri Lanka with probability proportionate to size using a systematic sampling method where the number of rural housing units in each district was used as a measure of size. About 12,000 G.N. divisions are classified as rural out of 14,000. In the second stage, a census of all buildings within the boundary of the selected G.N. divisions in the primary sample was undertaken. See ADB and World Bank (2005).
3. SME was defined as any enterprise with land and buildings between SL Rs 1 million and SL Rs 20 million.
4. The cost of finance also varies according to firm size. Small urban manufacturing firms (10-50 employees) in Sri Lanka face a 16 percent interest rate on average compared to 12 percent for large firms (more than 150 employees).
5. Leasing finances 7 percent of new investments for small firms compared to about 3.5 percent for large firms.
6. Only 5 percent of loan applications were rejected.
7. Nearly half of firms surveyed cited the interest rate or other costs as reason for not borrowing from a bank; about 20 percent cited insufficient or undervalued collateral; and another 30 percent pointed to complicated loan application procedures.
8. For further information on the poorly functioning land administration system, see ICS (2004).
9. Financial institutions include all licensed commercial banks, specialized banks, finance companies, and leasing companies.
10. Sri Lanka Higher Segment SME Sector Mapping Exercise, International Finance Corporation; February 2004. page 23.
11. Credit Bureau Development in South Asia; The World Bank, Finance and Private Sector Development, South Asia Region; September 26, 2004.
12. The draft law does not yet envision mortgage securitization.
13. A study of a well-established small business loan guarantee program operating in Canada concluded that between one-quarter and one-third of the loans made were "unquestionably additional" (Riding 1996).

14. The authors also conclude that to the extent a subsidy is required, "In the best schemes the subsidy element can be small in relation to the amount of additional lending to the targeted group, development gains, and the financial market deepening achieved" (Bannock and Partners 1997).

15. Website of the Community Development Venture Capital Alliance; www.cdvca.org.

16. Community development venture capital investments in the United States have compensated for the disproportionate concentration of traditional venture capital investments in urban areas. Whereas less than 2 percent of the traditional venture capital investments made in 2001 were in the nonmetropolitan counties that contained about 19 percent of all businesses, the share of community development venture fund investments going to nonmetropolitan counties slightly exceeded the share of all firms that are located there. (See Schmitt 2003.)

17. In the United States, for example, the Community Development Financial Institutions Fund (CDFI) provides small capacity-building grants to financial institutions that are dedicated to serving the credit needs of deprived communities.

18. Through the Small Business Service of the Department of Trade and Industry, the UK government provides limited grants to small businesses for capacity building, especially in technology. In an initiative announced in April 2003, the British Bankers Association committed to work with the Treasury to develop a training program for small businesses.

19. COFIDE became a second tier institution in 1992.

20. New electronic delivery channels and the elimination of restrictions on multiple and cross-regional banking are weakening the significance of the CRA (World Bank 2004d).

21. In the late 1990s, the UK government commissioned several studies on the financial exclusion of businesses and consumers in deprived areas, which led to the establishment of a social investment task force. The recommendations of the task forced contained five measures that are currently under implementation: (i) introduction of a community Investment Tax Credit; (ii) establishment of Community Development Venture Capital Funds; (iii) bank disclosure on lending to underinvested areas; (iv) greater latitude for investment in community development initiatives; and (v) support for community development financial institutions. See ShoreBank Advisory Services (2003).

22. In most emerging markets, regulatory regimes to encourage financial exclusion tend to become overly restrictive and disregard sustainability and efficiency considerations. Regulations in Brazil and Nigeria require banks to allocate some fixed share of their resources for lending to targeted populations (Woodstock Institute International Alert 2004). The Reserve Bank of India imposes especially detailed lending targets, which require that all domestic banks provide advances to priority sector borrowers equivalent to 40 percent of their net bank credit (32 percent of net credit for banks that operate in India). See Reserve Bank of India website (www.rbi.org).

23. Board of Governors of the Federal Reserve System (2000); table 12.

CHAPTER THREE

New Financing Mechanisms for Agriculture through Supply Chains

3.1 Introduction

Increased agricultural productivity could go a long way towards reducing poverty in rural areas. Unfortunately, agricultural productivity in Sri Lanka has stagnated during the last decade. Many factors have contributed to this poor outcome. Although agricultural policies sought to protect farming households, they unintentionally deterred crop diversification and new investments and encouraged many rural households to continue cultivating low-value commodities. Poorly structured supply chains have hindered more rapid agricultural growth in general and have diminished economic opportunities for small farmers in particular.

Inadequate access to finance has also constrained increases in agricultural productivity. Farming households, for example, have identified access to credit as one of the most serious constraints to crop diversification. Traditionally, the state has tried to meet these gaps through direct participation and subsidized schemes. The results have been mixed and often costly.

This chapter analyzes alternative market-based tools for helping to address financing gaps in agriculture, in particular through supply chains. Since all agricultural supply chains are unique and products need to be specifically tailored to them, this chapter will focus on tea and other two high-value sectors-spices, and fruits and vegetables. The remainder of this chapter is structured as follows. Sections 3.2 and 3.3 will provide an overview of the agricultural sector and agricultural finance, respectively. Section 3.4 will analyze the structure of the aforementioned supply chains. Section 3.5 will explore opportunities for improving the performance of and financing through supply chains, and Section 3.6 will conclude with some recommendations.

3.2 From Subsistence Agriculture to High-Value Crops

Agriculture continues to occupy a prominent position in Sri Lanka's economy. Despite a two-decade decline as a share of GDP, agricultural production amounted to 18 percent of GDP, 18 percent of exports (Table 3.1), and 34 percent of employment in 2004. The major crops are paddy and plantation crops-tea, rubber and coconut-which contributed 29 percent to agricultural GDP.[1] The rest of agricultural production is composed of forestry and fisheries, livestock, other field crops (such as potato and maize), spices, and fruits and vegetables.

For most agricultural households, farming remains a subsistence activity. Productivity for many crops has stagnated or shown modest increases, and Sri Lankan yields are substantially lower than those of other neighboring countries (World Bank 2003).[2] Diversification to higher-value crops such as spices and fruits and vegetables is taking place, but the rate of diversification differs across provinces and households. Wealthier households are devoting an increasing percentage of the cropped area to new agricultural products, among other reasons because they face fewer financing constraints.

TABLE 3.1
Agricultural Exports (2000-04) (SL Rs Million)

Period	Tea	Coconut products	Rubber	Cinnamon	Pepper	Fruits and vegetables	Other agricultural products	Total agricultural exports	Percent of total exports
2000	53,133	9,174	2,179	3,442	1,587	956	5,799	76,270	18
2001	61,602	7,348	2,129	3,784	532	975	6,883	83,253	19
2002	63,105	8,009	2,552	4,303	1,479	1040	9,194	89,682	20
2003	65,936	8,926	3,717	4,335	1,234	1284	7,636	93,069	19
2004[a]	74,897	11,453	5,155	4,728	934	1615	9,169	107,951	18

a. Preliminary estimates.

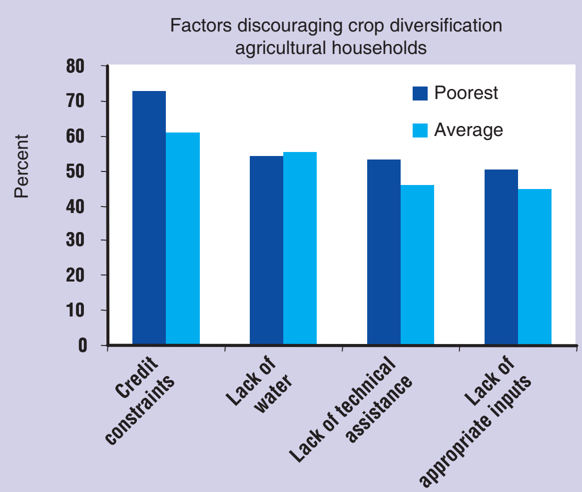
Source: Central Bank of Sri Lanka (2004) and staff estimates.

The sector has received extensive attention from policy makers during the last two decades, but most policy interventions have not fostered productivity growth. Traditionally, agricultural policies have shown a bias towards tea and paddy production.[3] Moreover, these policies have unintentionally discouraged diversification and have tied agricultural households to low value-added crops such as paddy production.[4] In the mid-1990s, the government introduced a package of policies that sought to enhance agricultural productivity, but little progress was made in its implementation.

Most agricultural supply chains are fragmented with multiple layers of traders that add little value. The sector also faces serious investment constraints. Among others, water delivery systems are weak; phytosanitary regulations remain very restrictive, which curbs access to new technology; and interventions in commodity prices have generated distortions. A focus on input subsidies (such as fertilizer and various credit schemes) has diverted scarce fiscal resources from more productive investments such as research and extension and maintenance of infrastructure.[5] There are still many legal restrictions on the transfer of public land to private holders, which limits the scope for crop diversification and precludes the use of land as collateral, especially for small farmers (Chapter 2). The involvement of a large number of government institutions in agricultural policy has also hindered the implementation of new policies.[6]

The above suggests that there is a need for improved coordination among government agencies in the formulation of a single national agricultural strategy that will seek to increase productivity and will promote diversification towards higher-value crops. The strategy will need to create a more stable and open trade policy regime, encourage the adoption of new technologies, promote the sustainable use of water, permit the full transferability of rights to land, and support improvements in rural infrastructure. As part of this effort, the government should collaborate with various stakeholders in strengthening coordination within key supply chains.

FIGURE 3.1
Credit Constraints: The Most Important Obstacle to Crop Diversification



Source: SLIS (1999, 2000).

Access to finance for agriculture remains a constraint and the strategy will need to examine new instruments to meet financing gaps. The SLIS (1999-2000) cited financial constraints as the most important obstacle to crop diversification, especially for low-income households (Figure 3.1.)[7] Historically, financial policies for the agricultural sector have focused on direct public participation in the financial system and subsidized credit schemes, including debt forgiveness. These programs have often been costly and discouraged private participation. The following section reviews in greater detail the status of agricultural finance.

3.3 Status of Agricultural Finance

In Sri Lanka, a wide variety of institutions-banks, cooperatives, microfinance organizations, traders, processors, and informal money lenders-are involved in agricultural finance, but for the most part, financial services are restricted to short-term advances. The availability and cost of finance varies widely across these institutions. Only the end of the supply chains appears to attract longer-term and more tailor-made credit. Small farmers largely depend on microfinance, rural cooperatives, and regional development banks. The two state commercial banks and a few private banks extend financing to small farmers but mainly through government-sponsored programs. Small farmers also borrow from input suppliers and traders, and resort to money lenders to manage unforeseen liquidity constraints. Leasing for agricultural machinery is underutilized, accounting for 3.6 percent of the total leasing market that is already small. Addressing overall constraints to the leasing market could help fill some of the voids in medium-term agricultural finance (Chapter 2). In addition, agricultural leasing could be expanded through greater linkages between suppliers of agricultural machinery and leasing companies.

TABLE 3.2

Comprehensive Rural Credit Scheme

Season	Loans granted (SL Rs. Million)			Average recovery rate
	Paddy	Other	All crops	
2003 Yala	478	145	623	91.0
2003-04 Maha	666	182	848	82.0
2004 Yala	365	191	556	80.9

Note: Only five commercial banks and rural development banks are participating in the Comprehensive Rural Credit Scheme.

Source: Central Bank of Sri Lanka (2004).

Public policies towards agricultural finance have not had a strategic long-term focus and have often introduced distortions in the sector through subsidized lending schemes and debt forgiveness programs. The Comprehensive Rural Credit Scheme (CRCS) provides lending at 8 percent to farmers, with banks receiving a 6 percent subsidy.[8] The primary beneficiaries of these schemes are paddy producers with much less emphasis placed on higher-value crops. Arbitrary forgiveness programs for agricultural loan debt have not promoted a good repayment culture and have discouraged higher participation in the sector by private commercial banks. In 1995, at a reported cost of SL Rs 6 billion, the government wrote off all past-due loans to farmers who had repaid 25 percent of the total amount owed to the CRCS.[9] Prior to the 2001 elections, the government waived repayment of loans amounting to about SL Rs 157 million.

Commercial Banking Sector

In Sri Lanka, commercial bank financing to agriculture and agrobusiness constitutes a small share of bank lending (5.7 percent of total lending underwritten for business purposes), even though agriculture's contribution to the economy was 17.9 percent of GDP in 2004. These figures may underestimate total agricultural lending since trade and export finance could presumably include financing for agricultural exports. Most bank lending seems to be allocated to tea, coconut, and some minor exports. Although precise data is not available, bank lending to small farmers appears to be low. Out of the 22 commercial banks, only the 2 state banks and 3 other private banks are involved in the CRCS program.

TABLE 3.3
Lending to Agriculture by Commercial Banks

	2002	2003	2004
Licensed commercial banks	17.7	19.10	19.80
Licensed specialized banks	N.A.	1.32	1.49
Specialized leasing companies	N.A.	0.49	0.60
Total	17.7	20.91	21.89

Source: Central Bank of Sri Lanka.

A number of factors have discouraged more active lending by commercial banks to agriculture, especially small farmers. These include deficient collateral systems, poor credit information, high transaction costs, insufficient branch density network in the rural areas, and inadequate expertise on agricultural risk assessments (Box 3.1). Most of these issues and their potential solutions were discussed in Chapter 2.

BOX 3.1
Key Constraints to Agricultural Finance by Formal Financial Institutions

Farmers' viewpoint

- Inadequate access to credit, especially term finance
- Inadequate credit to fund all necessary inputs
- Unavailability of timely credit
- Large amounts of paperwork
- Collateral requirements
- Limited or no risk management products

Commercial bank's viewpoint

- Lack of credit discipline, partly a result of public policies
- Remote clients difficult to service
- High transaction costs
- Lack of tangible security
- Poor marketing linkages
- Inadequate insurance cover
- Lack of adequate manpower to assess agricultural risks
- Poor supply chains, increasing marketing and repayment risks

The above problems are exacerbated by high price volatility of agricultural produce. In addition, agricultural supply chains are weak; this increases the marketing risks of farmers and thus credit repayment risks since the sale of the produce is the primary or only source of loan repayment. Direct farmer-processor linkages, contract farming tie-ups, and lending to farmers based on these structures could mitigate the marketing and default risks.

Regional Development Banks

Regional development banks have traditionally played an important role in financing medium and small farmers.[10] They have also been key players in the intermediation of various agricultural credit schemes sponsored by the state, including the CRCS and Forward Sales Contracts for Agricultural Produce. As shown in Table 3.4, regional development banks' lending to agriculture in 2003 was SL Rs 2.5 billion compared to a total of SL Rs 1.6 billion provided by all major semiformal institutions. These figures, however, likely underestimate total agricultural lending by regional development banks because of the use of pawning for short-term agricultural finance. Reportedly, large numbers of farmers resort to pawning despite its higher cost (at 17-18 percent interest) because it allows them to obtain same-day financing, whereas approvals for other loans, including subsidized credit programs (at 8 percent interest), entail significant delays and cumbersome bureaucratic procedures, and require collateral. This would suggest that farmers view access as a more important constraint than cost.

Unfortunately, public interference, including the debt forgiveness programs, led to very weak financial performance of regional development banks, which finally motivated their consolidation and restructuring. Following a more aggressive debt recovery program, their level of nonperforming loans decreased from 16-33 percent of their portfolio at the end of 2001 to 6.9-11.9 percent at the end of 2004, although more change is needed to meet adequate prudential standards. As the restructuring proceeded, the Central Bank reduced its majority equity participation to 20 percent by transferring its shares first to the Ministry of Finance and then to the Ministry of Rural Economy. The 196 branches of the regional development banks, mostly located in rural areas, could have been of interest to commercial banks considering expansion into rural areas. However, this opportunity for further restructuring was missed. Hence, despite some progress, the future of regional development banks is uncertain and they remain vulnerable to political interference. The geographical concentration of their lending portfolios also renders them more vulnerable to regional economic shocks.

Credit Cooperatives and Microfinance Institutions

Agricultural finance by credit cooperatives and microfinance institutions has been largely targeted to small farmers. As noted in Chapter 1, financial performance and credit practices differ markedly across institutions. In addition, they offer a narrow set of financial products, primarily short-term advances, and often lack the scale to broaden their package of financial services and invest in technological upgrades. *Multipurpose cooperative rural banks have a long tradition in rural areas and agricultural finance, but their market share has declined because of dwindling membership and poor commercial orientation.* They are quasi-government institutions operating under the Ministry of Cooperatives, which sets their lending interest rates below cost-recovery levels.[11] Their multipurpose structure makes their consolidation difficult, while the absence of an effective apex structure limits their access to product development and financial markets.

TABLE 3.4

Lending by Main Providers of Microfinance in 2003 (SL Rs Million)

	Co-op rural banks	Regional development banks	Thrift and credit co-op societies (SANASA)	SEEDS	Janashakthi Bank Hambantota	SANASA Development Bank
Total loans granted	4,206	8,133	2,921	1,250	432	1,161
Agriculture*	507	2487	563	170	359	7
Small industries	112	919	249	252	31	22
Building, electrification, water supply	1,877	-	1,080	452	-	250
Projects/commerce	396	732	302	209	-	521
Others/pawning	1,314	3,995	727	167	42	361

- Not available.

* Includes agriculture, animal husbandry, and fisheries.

Source: Central Bank of Sri Lanka.

3.4 Fragmented Agricultural Supply Chains

A well-organized supply chain is a precondition for creditworthy participants and the allocation of financing throughout the chain. In Sri Lanka, most agricultural supply chains are long and fragmented and lack the physical infrastructure for storage and distribution. Small farmers are disconnected from markets. Reportedly, supply-chain intermediaries add 15-25 percent to the price of nonperishable commodities and 75-100 percent to fruits and vegetables, with little value addition. The poorly functioning supply chains also seriously hinder crop diversification and expansion into higher-value products. This section analyzes the performance of three important supply chains: tea, spices, and fruits and vegetables. Tea and spices are the first and third most important agricultural exports in Sri Lanka, while fruits and vegetables show promise if a number of obstacles are addressed.

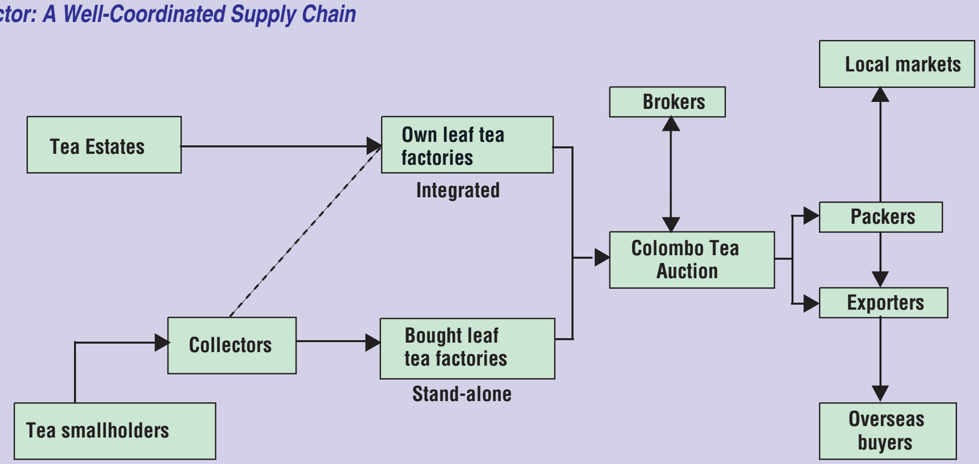
Tea Sector

Although the share of tea in total agricultural GDP has declined, it remains a major foreign exchange earner. In 2004, tea export revenues amounted to nearly 13 percent of total export revenues (Table 3.1). Sri Lanka is one of the six largest tea producers in the world and the largest producer of orthodox black tea. It is now the largest producer and exporter of retail consumer packets and tea bags to the international market.[12]

The tea sector performed better than other major subsectors in agriculture in the 1990s and continues to be a major employer in rural areas, with an estimated one million workers. Tea production is divided between estates or plantations and tea smallholders, with the former mainly located in the central mountainous area and the latter in the low country areas.[13] Smallholders cultivate about 45 percent of tea land but account for more than 60 percent of total tea production because of high productivity. Many of the poorly performing plantations were privatized in the 1990s, which led to improved productivity. Today, the government manages only 32 estates.[14]

Despite yield improvements in the 1990s, Sri Lanka falls significantly below other major exporting countries, such as India (31 percent lower) and Kenya (41 percent lower). Retaining Sri Lanka's share in the international tea market will require large yield gains. Plantation yields are particularly low despite significant improvements after privatization. Aging bushes in both the smallholder and plantation sector hinder improvements. In addition, the profitability of the plantation sector is squeezed by government-mandated annual wage increases unrelated to productivity gains. Low motivation among workers and failure to attract younger workers are adversely affecting productivity.

FIGURE 3.2
Tea Sector: A Well-Coordinated Supply Chain



Unlike other agricultural subsectors, the tea sector is highly organized and all stakeholders are represented through associations, which are coordinated by the Sri Lanka Tea Association. Figure 3.2 depicts the key features of the tea sector supply chain. Smallholders are represented by the Tea Small Holders Association, which has nearly 180,000 members. The association manages the tea development fund that provides a subsidy to smallholders for replanting and finances land expansion. The uptake for these grants in 2004, however, was lower than expected.[15] The fund is financed through a levy of SL Rs 2.5 per kilogram of tea exported and allocates resources to the Tea Research Institute, Tea Board, and Tea Small Holdings Development Authority. Regional development banks and microfinance institutions also provide financing to smallholders, mainly short-term credit for annual production. The combination of these financing sources appears to cover the needs of most tea smallholders for production as well as replanting and expansion. Plantations are vertically integrated and own their own processing factories. The larger tea plantations rely on commercial banks for financing, but commercial banks have been cautious about extending finance to many plantations because of their poor financial standing.

In the processing segment of the tea sector, there are three groups: (i) factories integrated with the estates and plantations; (ii) independent tea factories; and (iii) factories set up by tea smallholders. Many of these factories are outdated and the machinery is old. In 2001, the government established the Tea Shakthi Fund to expand the tea processing capacity and 11 new factories were set up. These factories are largely owned by tea smallholders who received financing from the Sri Lankan government. Greater processing capacity has increased competition. However, it would be prudent to conduct a market demand analysis before embarking on the establishment of additional factories since half of the factories in the low country seem to operate below capacity. Tea smallholders sell their tea to the processing factory at a price stipulated by the Tea Commissioner's Division.

TABLE 3.5
Lending to Agriculture by Commercial Banks

Factor	Problem rating	Remarks on problems	Potential solutions
Yield	Medium	Yields need to be improved.	Replanting schemes need to be increased. Management of larger tea estates could be strengthened.
Logistics	Medium	Poor infrastructure is a problem.	Road access needs to improve. Warehouses need upgrading.
Middlemen	Low	The supply chain is efficient.	If roads and logistics improve, the role of collectors will further diminish.
Processing technology	Low	New tea factories are operational.	The geographical location of factories could be improved to optimize use of capacity.
Distribution & marketing	Low	The Tea Association is well organized and facilitates certification and promotion.	Development of new products (flavored tea and packaging).

Source: Central Bank of Sri Lanka.

The law stipulates that 97 percent of all tea produced by the tea factories should be sold through one central auction-the Colombo Tea Auction.[16] The government has also established that certain percentages of the auction price should be allocated to smallholders and tea factories. The Colombo Tea Auction has provided price transparency and facilitated international buyer presence. This monopolistic structure, however, is encountering bottlenecks. Plantations have expressed concerns that the central auction does not allow them to maximize prices and would prefer to have the freedom to sell directly overseas. By comparison, tea smallholders are allowed to sell half of their bulk tea directly to overseas customers.

The tea sector is the most efficient and coordinated agricultural sector in Sri Lanka. This facilitates credit supply, both short and medium term, even for tea smallholders. Export financing by domestic and foreign commercial banks is available to large traders. Past government participation in the sector has facilitated coordination within the chain. Overly restrictive marketing policies, however, could increasingly become a bottleneck preventing better integration within the overall chain and hindering new financing from exporters to producers. (See Table 3.5)

The strong organizational structure of the tea sector and high commodity volume suggest that new financing instruments could be developed for small farmers, in particular warehouse receipt schemes. These instruments, which could diminish price volatility and the need for government intervention in the chain, are further discussed in Section 3.5.

Spices Sector

Sri Lanka has traded spices for more than 2000 years. Cinnamon and pepper (the "king of spices") are the two leading exports in the sector and both compare favorably with the spices of other large world producers (Box 3.2). Following a steady increase in exports earnings during the 1990s, cinnamon has now become the third largest export crop, next to tea and coconut. Other spices exported include cardamom, clove, nutmeg, and mace.

BOX 3.2

Cinnamon and Pepper-Leading Exports in the Spices Sector

Cinnamon: Cinnamon has become Sri Lanka's third largest export crop, but it is mostly exported in bulk form. *There is considerable potential for Sri Lanka to increase value-added exports from cinnamon instead of exporting it as a primary product.*

The preparation of the cinnamon quill requires expertise that has been passed on from generation to generation and has become an art unique to this country. Sri Lanka commands over 80 percent of the world production of true cinnamon. Its major markets are Central and South America, but it has partly lost its market share in Europe and North America to cassia, an inexpensive substitute for true cinnamon. Cassia is categorized under cinnamon in the Harmonized System (HS) coding, which places true cinnamon at a disadvantage since consumers are unable to distinguish between the two. According to industry sources, India is planning to grow cinnamon on a commercial scale and is already piloting projects. *There is a pressing need to develop the brand "Ceylon Cinnamon" and differentiate it from cassia by lobbying for a separate HS code.*

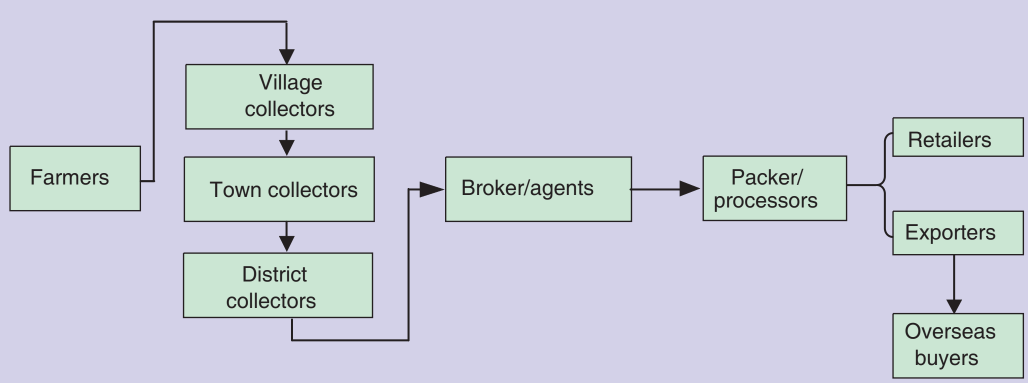
Pepper: *Pepper is Sri Lanka's second largest export crop.* Pepper is grown in the wet and intermediate zones mostly as a mix crop in smallholders' home gardens. The present area under cultivation is 29,666 hectares covering several districts. Export volume of black pepper is 4,000 to 5,000 metric tons per year, or about 3 percent of total world demand. An additional 1,000 metric tons per year is produced for local consumption.

The potential for additional production and income generation is considerable, especially if the spices sector were to move towards higher value-added products. Sri Lankan spices are marketed mainly as whole or ground spices. Derivatives such as oleoresins and essential oils and dry seasonings form only a small part of total exports. Moreover, in recent years, Sri Lanka has seen a reduction in both volume and value due to the marketing of light berries that command a lower price than mature berries. Growers would be much better off if they allowed the crop to mature before harvesting. In addition, pepper production could be increased by encouraging the plantation sector to cultivate pepper on existing land by inter-cropping as well as mono-cropping.

The spices sector needs to overcome a number of challenges in order to realize its potential market growth (Table 3.6). The primary challenge is the poorly organized supply chain, which in turn generates its own problems (Figure 3.3). Production is dominated by smallholder producers and some family owned plantations; no large estates operate in this sector. The key weaknesses in the supply chain are the layers of collectors and dealers. The activities of collectors-collection, regrouping, and multiple trading-drive up costs but provide limited value added. Financing for smallholders consists largely of short-term

FIGURE 3.3

Spices Sector: Weak Links between Small Producers and Final Markets



credits. Linking farmers to end users could create new opportunities for longer-term contracts, which in turn could support the provision of longer-term credit facilities to farmers based on sales contracts (for example, forward sales).

Cinnamon, pepper, and other spices are largely exported in bulk with almost no value addition in processing or branding. There is great potential to add value through processing and branding. The global trade in spices (excluding internal consumption) is worth close to US$5 billion and up to 90 percent of the produce is traded in processed forms. Value addition from processing ranges from 3 times to 30 times the price of the raw spice collected at farm level.

Like other agricultural sectors, the spices sector is negatively affected by uneven quality and a high percentage of post-harvest losses. To reduce these losses, the sector needs to improve the quality, consistency, and quantity of supply. For example, the sector lacks uniform grading and sorting practices that are acceptable and applicable to trade associations and the industry. Spice collectors use the same bag to hold all grades of the particular spice purchased, which leads to mixed product quality and additional costs from sorting. Separating spice grades at harvest is one way of rationalizing the supply chain. Reducing the role of collectors and dealers will also allow spices to move more quickly through the supply chain, thus reducing post-harvest waste from spoilage.

In response to the threat posed to its cinnamon exports by cassia, Sri Lanka should popularize the brand "Ceylon Cinnamon" as the only true cinnamon. Cassia commands a significantly lower price than cinnamon but carries the same HS code. Hence, there is an urgent need to lobbying for a separate HS code for true cinnamon.

Research and development and vocational training for farmers also need to be strengthened. Harvesting methods, for example, largely determine the market quality of the product. Therefore cinnamon peelers need to be well trained.

Finally, strengthening the supply chain is a precondition to increasing sector financing, both by direct credit from formal financial institutions and by supply-chain finance structures. The development of interprofessional organizations could help strengthen coordination within the supply chain, establish quality standards, and promote market transparency, all of which will result in better earnings distribution through the chain. Several initiatives are underway to connect end users (exporters and processors) to farmers by diminishing superfluous segments of the chain. The German Agency for Technical Cooperation (GTZ) is supporting some of these initiatives.

TABLE 3.6
Spices Sector: Key Problems and Potential Solutions

Factor	Problem rating	Remarks on problems	Potential solutions*
Yield	High	Yields and harvest methods need to be improved.	Provide training support to spice growers (especially for cinnamon).
Varieties	Medium	Certain varieties are not available in Sri Lanka.	Government should support development of high-yield varieties.
Procurement & logistics	High	Logistics are affected by the poor infrastructure.	Improve the road network and upgrade warehouses.
Middlemen	High	Many middlemen or so-called dealers are active in this fragmented sector.	Stronger coordination among stakeholders will diminish the role of middlemen.
Processing technology	High	There are hardly any value-added activities; processing is done abroad	Provide incentives for companies that establish processing facilities in Sri Lanka.
Distribution & marketing	Medium	Most spices are exported as commodities.	Like the tea industry, the spice industry needs to develop a brand in the world market.

* See Tabor, Abeyratne, and Epaarachchi (2000) and World Bank (2003) for further discussion of potential solutions.

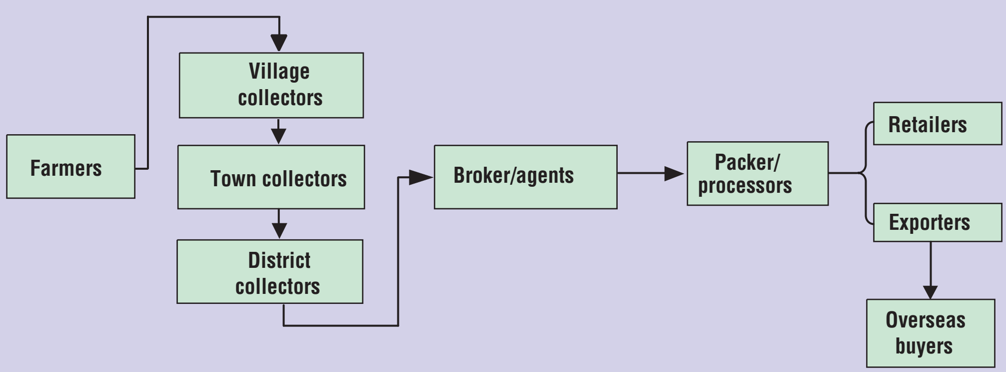
Fruits and Vegetables Sector

The fruits and vegetables sector in Sri Lanka has much untapped potential for development, largely because of the warm climate and fertile soils However, most produce currently is grown for local consumption (Annex 2). By comparison to the tea and spices sectors, the fruits and vegetables sector is the least organized and probably needs the most attention to improve its standing. Post-harvest losses are estimated at between 30-40 percent. The product range is more diverse than in other agricultural sectors.

The sector has seen rapid growth in recent years, albeit from a small base, because of rising domestic per capita income and a growing tourism industry. In the fruit portion of the sector, pineapples and tamarind are the main contributors to the economy. Pineapple exports have grown at an average of 10 percent per year. Vegetable exports, mainly to the Middle East and the Maldives, have been fluctuating. The sector as a whole is unable to penetrate into more sophisticated markets such as Australia, Europe, Japan, and the United States because of strict quality controls and freight disadvantages.

Supply chain structure. The fruit and vegetables supply chain is very fragmented (Figure 3.4). The sector is composed of a large number of small growers who, as individual suppliers, cannot influence the market price. Growers are mainly price takers and margins are predominantly determined by middlemen and collectors. Linkages between growers, processors, and exporters are weak.

FIGURE 3.4
Fruits and Vegetables: Unnecessary Layers in the Chain



Contract farming still accounts for only a small fragment of the production of fruits and vegetables. This is the result of a lack of commercial discipline; contracts are not honored by either the farmers or the offtakers and corporate buyers. When there is no alternative market for the produce, contract farming appears to work well, as in the case of gherkins (offtaker Sunfrost).

By and large, the fruits and vegetables sector lacks tailor-made financial products and medium- and long-term credits. Some initiatives have started to introduce contract farming combined with so-called forward sales as advance funding, but such initiatives have been targeted to a few farmers in pilot situations. Contract financing should be further explored. Under contract farming, the farmer (or farmer group) is obliged to grow a certain volume and quality for a specified offtaker (trade house or supermarket chain). Once the relationship between the farmer and offtaker has proven to be sustainable, contract financing can be introduced where financial institutions lend to farmers using the offtake contract as collateral.

TABLE 3.7
Fruits and Vegetables Sector: Key Problems and Potential Solutions

Factor	Problem rating	Remarks on problems	Potential solutions*
Yield	High	Yields need to be improved.	Support needs to be given to improve harvesting methods.
Varieties	High	Low-yield varieties are used and some varieties are not grown.	Government should support the high-yield varieties. Diversify product range with varieties that Sri Lanka can grow competitively.
Procurement & logistics	High	Extremely high post-harvest losses.	Establish commercial cooperative structures. Develop storage and processing facilities.
Middlemen	High	Too many middlemen erodes profits.	Integrators are required to manage the supply chain.
Processing technology	Medium	There are hardly any value-added activities. Processing is done abroad.	Processing is needed to make value-added production and overcome gluts of fresh produce.
Distribution & marketing	Medium	There is no brand development.	Interprofessional organizations can help develop marketing and brands.

* See Tabor, Abeyratne, and Epaarachchi (2000) and World Bank (2003) for further discussion of potential solutions.

Key issues and prospects. There are many problems faced by growers, processors, and exporters in the fruits and vegetables sector that affect the entire supply chain. In particular, the following issues and problems need to be addressed (Table 3.7):

- *There is limited knowledge of export markets,* specific products, and the time of year when Sri Lankan produce is competitive.
- *There is a lack of high-yield seed and fruit tree varieties.* The poor supply of planting material for cultivation hinders market expansion. Although the government has relaxed import criteria to some degree, further reforms are necessary.
- *Poor handling standards, infrastructure, and logistics lead to high post-harvest losses.* There are no commercial cold-storage facilities, seed-cleaning services, or storage facilities that can be rented by growers and collectors. In the absence of these services, farmers overflow markets after harvesting and prices plummet. The private sector needs to be aware that significant investments are necessary, possibly with some government support.
- *Lack of local product certification.* The sector has no quality criteria for pineapple or other fruits and vegetables. The government, for example, could play a pivotal role by helping develop a quality certification system that could be promoted in overseas markets.

A few initiates are underway to enhance the sector's development. The Sri Lanka Fruit & Vegetable Producers, Processors & Exports Association, for example, is trying to establish quality standards and pricing methods and develop a marketing system that links growers and exporters. The Department of Agriculture recently released several new varieties of high-yield fruits and vegetables and carried out several training programs on protected agriculture and post-harvest processing. The Institute of Post-harvest Technology has also developed new plastic crates for transportation and is conducting research to further strengthen post-harvest handling.

3.5 New Models and Financing Instruments for Agricultural Supply Chains

Financing structures along the supply chain could help expand credit availability for agriculture, especially to small landholders. Supply-chain finance, however, has not been used to its fullest in Sri Lanka because chains are mostly long and fragmented, with the exception of tea. This section discusses possible interventions and mechanisms for strengthening agricultural supply chains and developing new financing instruments linked to the chains. Some of these mechanisms (such as warehouse receipts and agricultural service centers) were piloted in the past with weak outcomes because of excessive reliance on the state and insufficient involvement of key market players. New efforts to develop financing structures along the supply chain should carefully consider preconditions for success. This section also explores risk mitigation instruments, in particular weather insurance, which could enhance farmers' creditworthiness and encourage them to invest more in their farms.

Developing a New Commercial Concept for the Cooperative Sector

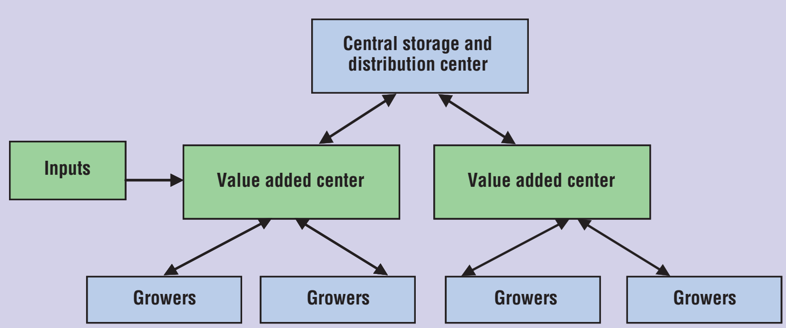
While efficient farmers' cooperatives could contribute to the closer integration of supply chains and agricultural finance, the performance of rural cooperatives in Sri Lanka has been weakening because of declining membership and inability to cultivate new markets. All in all, cooperatives have failed to develop a commercial orientation and have been subject to government influence, which has controlled their interest rate policy.[17]

The cooperative sector of Sri Lanka needs to be reformed into independent and self-sufficient farmers' organizations with a fresh commercial focus. This will require an overhaul of the cooperative legal framework. Following an unsuccessful attempt to reorganize the quasi-governmental cooperative sector in India, the government of India introduced a new legal entity-the "producer company." This type of company is effectively a farmers' cooperative based on commercial principles that reflect modern production and trade needs. A modernization of the cooperative sector will also entail (i) the establishment of more transparent and independent governance structures; (ii) a reassessment of their multipurpose operations; and (iii) a possible regrouping into more specialized cooperatives with a greater impact in specific market niches. A more robust governance structure and greater specialization and consolidation of smaller credit cooperatives will be necessary for credit cooperatives to gain better access to financial markets and tap new funding sources. The latter will enable credit cooperatives to widen their range of financial products, including medium-term finance for agricultural investment.

Value Added Centers

Value added centers can be farmer-owned and controlled business units that can help integrate primary producers in the market (Figure 3.5). For example, value added centers can act as collection points for fresh produce delivered directly from farmers and undertake preliminary post-harvest processing. They can be organized to serve a cluster of villages and linked to terminal markets or integrated with vertical supply chains at the retail end. These functions should enhance the value of farmers' products and stem the high degree of post-harvest wastage (estimated at 30-40 percent for the fruits

FIGURE 3.5
Forward and Backward Linkages of Value Added Centers



and vegetables sector). In addition, value added centers can facilitate inputs, such as seeds, agrochemicals, and fertilizers, and provide other extension support services, including advice on farming techniques. Subsequent investments can be made at the value added center to initiate branding of products.

Value added centers can facilitate short-and medium-term financing for irrigation, development, or farm machinery. Lending can be done directly by the center or financial institutions. The center's close knowledge of the farmer reduces its credit risks, while its scale allows it to gain better access to financing compared to individual smallholders. Financial institutions are also likely to regard farmers associated with the value added center as more creditworthy because the center enhances the value of the farmer's products.

Value added centers have been successfully implemented in the Indian states of Gujarat and Maharastra. In Gujarat, a value added center for fruits and vegetables was initially set up with an investment of US$0.68 million. Its introduction has cut post-harvest losses and raised the price of farmers' products due to quality improvements. Farmers associated with the center enjoy better access to credit from local financial institutions since having an assured market for the produce reduces the farmers' repayment risks. AGREXCO, Israel's largest exporter of fresh agricultural produce, has set up similar centers (jointly promoted by growers and the government) with extensive infrastructure support for post-harvest management and marketing, including export marketing. In Sri Lanka value added centers for spices and fresh produce could be even more effective if they were linked to auction centers (Box 3.3).

BOX 3.3

Sri Lanka: The Need for Auction Centers for Spices and Fresh Produce

Special auction centers should be set up in Sri Lanka for spices and fresh produce where there is already a critical mass of production. The auction centers would strengthen links within the supply chain and could yield substantial benefits for producers. In particular, they could lead to a more efficient price-discovery mechanism; a reduction in the number of intermediaries, marketing time, and post-harvest losses; and guaranteed payments to farmers within a given time frame. Buyers could also benefit from a steadier supply of produce and better storage, transportation, and quality certification. The centers could be established as public-private partnerships and would need to provide, among other things, basic infrastructure for storage, cargo inspection, and certification. Valuable lessons could be drawn from the existing tea auction mechanism. In particular, new auction centers should avoid some of the rigidities of the current tea system. Such rigidities include price interference and statutory requirements that force producers to participate in the system and prevent them from pursuing alternative marketing arrangements such as direct links to major exporters. Some international examples of successful auction centers for fresh produce are presented below.

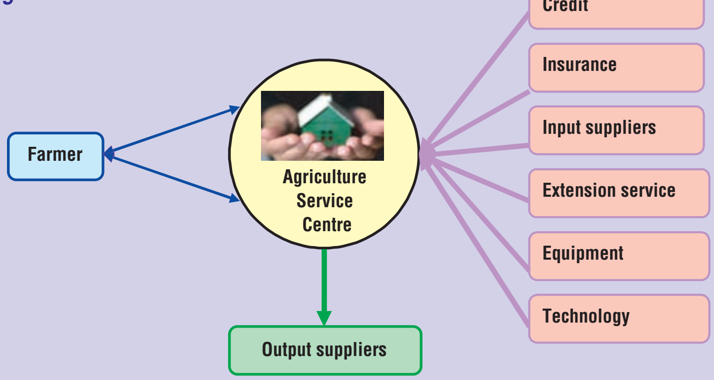
- ***Cooperative Flower Auctions (the Netherlands).*** The tradition of the cooperative flower auctions is more than 100 years old. The two largest centers are Flower Auction Aalsmeer and Flower Auction Holland. Aalsmeer is the "flower capital" of the Netherlands and home to the largest flower auction on earth. The complex covers some 250 acres. Three billion flowers and 400 million plants are auctioned annually from some 8,000 nurseries. There are five auction halls where 13 auction clocks operate simultaneously. The Holland Flower Auction is the second-largest flower auction. About 80 percent of the cut flowers and plants are exported. The Dutch cooperative auctions are privately owned and operated.
- ***Cooperative Fruits & Vegetables Auctions (the Netherlands).*** The two largest cooperative auctions for fruits and vegetables in the Netherlands are The Greenery and ZON. These auctions once operated by the clock, but they are now shifting to direct selling because of the increased concentration of buyers. Similar cooperative auctions are also operating in Belgium and Germany.
- ***National Dairy Development Board (India).*** The Board has cosponsored with the private sector an auction center in Bangalore, India, for sourcing fruits and vegetables from the region. The Board has helped establish standards and grades for products to be traded. Infrastructure costs (around US$35 million) have been shared between the private and public sector, but daily operations are managed by the private sector.

Agriculture Service Centers and Closed-Loop Financing

Agricultural service centers (ASCs) can be nodal units that help to integrate all stakeholders in the system (for example, input suppliers, farmers, and processors) and that provide efficient backward and forward linkages for small landholders (Figure 3.6 below). The farmer can focus on the task of cultivation and all necessary support services can flow through the service center and associated institutions. The agricultural service center, for example, can carry out some of the following functions: (i) advise on crop and cultivation practices and irrigation; (ii) advise on inputs; (iii) advise on post-harvest control and marketing; and (iv) facilitate or channel credit and insurance to farmers (Table 3.8).

The closed-loop financing model can reduce the risks and costs of financing farmers and thus increase overall credit supply. Banks, for example, can extend credit to the ASC, which on-lends to the farmer in the form of inputs. The ASC sells the farmer's produce; makes payment to the farmer after deducting the principal and interest; and repays the banks. This model cuts the bank's risks and transactions costs since the bank can lend to more established companies and underwrite larger credits. Farmers' repayment risks to the ASC are also minimized through its marketing services. Several variations of this financing model can be arranged.[18]

FIGURE 3.6
Agricultural Services Center Model



Financing can also be made available through securitization of farmer receivables. In this case, the ASC provides credit to farmers in the form of inputs, and the bank buys the portfolio of farmers' receivables from the ASC or input suppliers. This diminishes the banks' transaction costs because the ASC performs the documentation and due diligence.

This model was tried out in Sri Lanka in the mid-1970s but did not perform as anticipated. This was because the entire range of services offered by ASCs was supplied by government agencies and private sector involvement was totally lacking. Around 700 new buildings were provided by the government for ASC financing, and each of these centers was supported by a wide range of services including credit and savings facilities, extension services, input procurement (such as fertilizer and agro-chemicals), and produce marketing. Inappropriate physical location of the building, low standards for service delivery, and the inability of ASCs to respond to farmers' actual needs negatively affected the performance of this model. Such experiences suggest that the private sector should be allowed and encouraged to play a major role in the development of ASC financing schemes.

TABLE 3.8
Benefits of Agricultural Service Centers

		Product benefits	Procurement benefits
STAKEHOLDERS	Farmers	Assured supply Assured quality Improved yields	Enhanced net profit
	Agricultural input vendor	Better inventory management Enhanced interface with farmers Enhanced brand recall Effective farm extension and technology transfer	Opportunity to capture created wealth
	Processor	Superior quality produce Enhanced yields and lower commodity prices in long run	Unnecessary supply chain costs eliminated Improved quality of raw material Opportunity to grade and segregate product at lower cost

In India, for example, ASC structures for farmer financing have been set up under private *leadership*. Most of the sugarcane cultivation in the states of Maharashtra and Uttar Pradesh is undertaken under this type of structure. Some extension service providers-for example, Mahindra Shublabh, a subsidiary of the Mahindra & Mahindra Group that manufactures tractors-are operating like agricultural service centers; they provide a basket of services to farmers and tie credit providers to the model (Box 3.4).

BOX 3.4

Agricultural Services Center Models: Mahindra Shublabh in India

Mahindra Shublabh was established in 2000 to offer a broad range of financial and other services to farmers. These include (i) fee-based consulting services on crops and input supplies; (ii) high-quality input supplies; (iii) equipment rental; (iv) the facilitation of linkages with traders; and (v) input financing. Mahindra Shublabh has developed a relationship with ICICI bank, which provides financing to the farmers recommended by Mahindra Shublabh. The credit decision remains with ICICI bank, but loan processing, disbursement, and collection are conducted by Mahindra Shublabh on a fee basis (1.5 percent on recovered loans). At the end of the season, the output buyer deducts the credit amount from the sale and remits it to ICICI bank, thus preventing the diversion of the crop proceeds. This symbiotic relationship facilitates the sharing of information and decreases credit risk.

Source: Hess and Klapper (forthcoming).

Contract Farming and Financing

Contract farming and financing in the fruits and vegetables sector are not sufficiently developed in Sri Lanka, mainly because of the lack of commercial discipline. The government could help by educating farmers and other stakeholders on the benefits of honoring contracts. Contracts are also more likely to be honored if the contract structure promotes sharing of revenues and risks among farmers and off-takers. Once the relationship between the farmer and the off-taker (trader or supermarket chain) becomes sustainable, new bank lending can develop by using the off-take contract as collateral. Under well-established contract farming, medium-term financing (for example, to support investments in new technology or machinery) can also become available.

Warehouse Receipt Financing

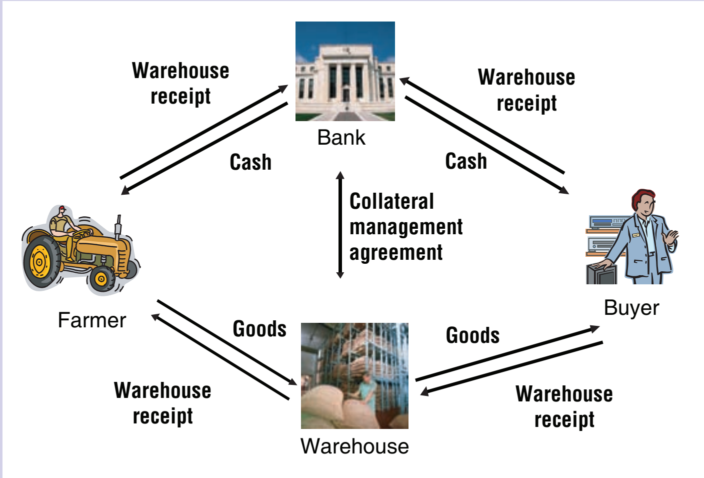
Warehouse receipt financing is a secured lending mechanism widely used in developed and emerging economies, and its application for agricultural finance in Sri Lanka should be seriously considered (Box 3.5). Warehouse receipt financing also can be used as a price-risk management instrument by farmers; low-cost finance allows farmers to hold a commodity after the harvest and sell it when market prices peak. In the mid-1990s, the Sri Lankan government tried to adopt a warehouse receipt system for paddy farming but with poor results. An experimental system was implemented in a major paddy growing area in the dry zone. The government, with close involvement of a commercial bank, arranged to store farmers' surplus paddy product in a centrally located storage facility. A receipt was issued by the storage facility that the farmer could use as collateral to obtain a short-term loan from the bank. The government was trying to solve the chronic problem of low post-harvest prices and also increase farmers' access to finance independent of their creditworthiness. However, the system failed for many reasons, including cumbersome implementation procedures, excessive state intervention, and the insufficient credibility of participating commercial banks.

In Sri Lanka, participants in a number of sufficiently developed and liquid markets of nonperishable commodities (such as tea and cinnamon) could benefit from a warehouse receipt lending system.[19] It could be started with one commodity and gradually expanded to others based on results. The new system would need to be carefully designed to avoid past mistakes, rely on market mechanisms, and allow the government to focus on creating enabling conditions. The following issues will need to be addressed.

- ***Regulatory framework.*** A warehouse receipt lending system can only work if supported by a robust regulatory framework that clearly defines the rights of various parties and permits easy transfer of the receipt.

BOX 3.5

Warehouse Receipt Financing: Process Flow



- Step 1: The farmer, company, or trader deposits the commodity in a warehouse operated by a designated warehouse keeper. The stored commodity is certified for quality and graded by a government approved valuer(s). The certificate issued accompanies the commodity to be deposited, which is then inspected by an agency authorized to certify the quantity deposited. The warehouse issues a warehousing receipt that specifies the quantity (as certified by the warehouse) and the quality (as certified by the accompanying quality certificate) of the commodity.
- Step 2: The farmer, company, or trader can request financing from a bank, which then takes possession of the warehouse receipt pending decision on financing. This is to ensure that the commodity stored is not subsequently tampered with.
- Step 3: The bank deputes an approved controller/assayer to draw samples from the stored commodity and bring it to a certified laboratory for testing.
- Step 4: The financing amount is fixed at a percentage lower than the market value of the commodity stored, after keeping an adequate margin based on the price volatility of the commodity. In the event that the quality tests do not confirm the quality stated on the warehouse receipt, financing is rejected.
- Step 5: The bank appoints a collateral manager who monitors the commodity stored, conducts periodic stock audits, and provides an indemnity cover and fidelity insurance for the transaction. The bank monitors the market value of the stored commodity based on the daily price from the most liquid spot market. If the market value is lower than the stipulated bank cover, a margin call is issued. The company/trader acquires an insurance cover for the commodity stored and the warehouse keeper purchases an insurance cover for the warehouse against theft, fire, and natural calamity.
- Step 6: The farmer, company, and trader can respond to the margin call within the stipulated time period by either depositing additional quantities of the commodity or prepaying part of the outstanding amount. If the company/trader does not respond to the margin call, the bank exercises the right to sell the commodity at the end of the stipulated period and recovers the outstanding amount.
- Step 7: At the end of the financing period the company/trader repays the outstanding amount (principal plus interest) and the bank hands over the warehouse receipt, thereby releasing the commodity and completing the transaction.

- ***Efficient warehouses.*** Development of a reliable and efficient warehousing commodity system is critical from the lender's perspective because improper storage or inaccuracies in the warehoused quantity/quality would reduce the security cover. Efficient warehouses are usually privately operated since they can avoid the operational restrictions that apply to publicly managed services. Previous Sri Lankan experiences with publicly owned and managed commodity warehouses were not successful.

  An efficient licensing procedure that guarantees minimum standards for the warehouses also needs to be in place. This procedure could be managed by the government or subcontracted to the private sector. The government of India, for example, has been examining the possible establishment of a warehouse receipt system, including the creation of a central warehouse registry and a central regulatory authority.

- ***Indemnity fund or bonding.*** An indemnity fund or bonding should also be in place in case a warehouse is not able to deliver the commodity. Most often, the indemnity fund is financed from a fee levied on customers. To support the operation of such a system in its initial stages and ensure that it has sufficient credibility with financial institutions and other market participants, the Sri Lankan government could contribute to the establishment of the indemnity fund through a contingent loan.

Warehouse receipt financing has been successfully used in many countries, including the United States, Japan, Brazil, Poland, and more recently Vietnam. The U.S. cotton industry began using electronic warehouse receipts in 1993, after it secured a small amendment to the United States Warehousing Act ensuring that states treated electronic warehouse receipts the same as paper receipts. Since enactment of the cotton amendment, over 90 percent of the cotton crop stored has been represented by electronic receipts. The availability of electronic receipts has sped up transactions of all types, including transactions with the Commodity Credit Corporation. In Japan, the Tokyo Commodity Exchange recognises warehouse receipts as a title of goods. Banks also finance commodities using the receipts as security. Brazil operates a system of financing based on warehouse receipts. This system is largely restricted to goods stored in bank-owned warehouses. See also World Bank (2005b).

Innovative Risk Mitigation Instruments

Farmers are continuously exposed to weather risk, which affects their ability to access credit. In Sri Lanka and many other developing countries, traditional crop insurance programs have not been successful. This type of insurance is costly because it tries to directly measure the crop damage in case of claim and is prone to numerous moral hazard[20] and adverse selection[21] problems. In Sri Lanka, the claim recognition system for crop insurance has performed poorly with frequent delays and settlement disputes.

New and innovative insurance mechanisms to cover weather risk are emerging around the world. Although some of these efforts have been tested on a small scale, preliminary results are encouraging. Weather insurance is based on relatively objective measurements as a proxy for loss (for example, a weather event such as temperature or rainfall that has a strong correlation with farm level losses). Objective indexes of weather risk permit better control of moral hazard issues, which facilitates reinsurance and substantially reduces administrative costs (Box 3.6).

BOX 3.6

Weather Index Insurance: Advantages and Challenges

Key advantages:

- Lower administrative costs. Indemnities are based on the realized value of the underlying index as measured by an independent agency, eliminating the need for underwriting and inspections of individual farms.
- Reduced moral hazard. Weather insurance is based on parameters exogenous to policyholders or farmers and thus minimizes opportunities for altering farmers' behavior.
- Reduced adverse selection. Index insurance is based on public information so there is limited scope for exploiting information asymmetries.
- Reinsurance. Insurers can more easily transfer the risk of correlated agricultural losses.
- Product bundling. Easily bundled with other financial products (such as credit).

Key challenges:

- There must be sufficient correlation between the index and financial losses.
- Insurers must have a sound understanding of the properties of the index.
- Historical weather data and good weather measurement stations must be available.

Source: World Bank (2005c).

In India, an interesting weather insurance product has been tested by BASIX (a group of five companies supporting livelihood programs) in collaboration with ICICI Lombard, a private sector general insurance company that has reinsured the risk with an international reinsurance company

(World Bank 2004a and World Bank 2005c). BASIX has started to offer castor and groundnut farmers drought insurance policies together with new loans in order to hedge its loan portfolio in areas where crop yields and repayment rates are highly correlated. ICICI Lombard has also underwritten excess rain policies to wheat farmers in Uttar Pradesh, and it is now working on weather insurance pilots for orange farmers in cooperation with the government of Rajasthan. Although the results are still preliminary and not fully conclusive, farmers who bought the policies appeared to value the quick payout compared to previous crop insurance programs sponsored by the state. Also, a number of farmers who purchased weather insurance policies through BASIX in 2004 were repeat buyers.

Other developing countries are also piloting or investigating weather insurance schemes. With assistance from the commodity risk management group of the World Bank, the Nicaraguan Institute for Insurance and Reinsurance (INISER) is ready to launch a pilot weather insurance program for the groundnut sector to facilitate lending for producers and investments in the sector. The pilot program will first concentrate on the regions of Chinandega, Leon, and Tipitapa. Some banks are considering the provision of credit to cover the premium in order to encourage proactive risk management by farmers. A couple of international reinsurers have already expressed interest in reinsuring these innovative products. In Ethiopia, two structures for weather risk management are being explored. At the producer level, the Ethiopian Insurance Company is planning a pilot weather insurance program for wheat farmers in southern Ethiopia. It would sell the products to cooperatives and small groups of farmers to protect them against crop losses due to weather risks and later reinsure the weather risk portfolio. At the macro level, the government together with several donor agencies is exploring the feasibility of weather insurance as a cost-effective way of funding emergency operations in cases where droughts affect several regions and overwhelm government budgetary resources. The development of the program, however, is facing some challenges since not all weather stations have quality historical data. See World Bank (2005c) for a review of developing countries that are exploring various forms of weather insurance schemes.

Similar risk management products could be considered and piloted in Sri Lanka. The products would need to be carefully tailored to specific commodities and weather risks.

3.6 Conclusions

In Sri Lanka, traditional public interventions in agricultural finance have led to poor results, discouraging further involvement of private financial institutions. Supply chains offer new avenues for making financing available to small producers. Unfortunately, most agricultural supply chains, including chains of the spices and fruits and vegetables sectors, are fragmented. By and large, small producers are disconnected from markets, which weakens their credit risk profile and access to finance. The tea sector is a notable exception to this pattern.

There is great scope for strengthening supply chains and developing new financing structures linked to the chains. These interventions mainly rely on market-based mechanisms. The government, however, can still play a pivotal role by bringing together various stakeholders within the chain and possibly promoting a number of public-private partnerships.

Notes

1. This includes fisheries and forestry which comprise 20 percent of agricultural GDP.
2. The World Bank (2003) study, for example, notes that average maize yield in Sri Lanka is about one-third of Thailand and neighboring Karnataka in India, and one-quarter that of China. The yield of rice paddy is half that of China. See World Bank (2003) for further information on the yields of other crops.
3. The Department of Export Agriculture of the Ministry of Agriculture, for example, does not include fruits and vegetables within its potential export-oriented activities.
4. While the country embarked in a trade liberalization process in the late 1970s and early 1990s, agricultural trade policy has been unstable, and for the most part has followed protectionist tendencies.
5. The total fertilizer subsidy for 2003 was estimated at SL Rs 2.48 billion.
6. About 20 ministries are directly or indirectly involved in the agricultural sector in addition to provincial councils.
7. The two highest income quintiles cited lack of water as the most important constraint with financial constraints rated as a very close second.
8. The central government covers the cost of the subsidy but the program is managed by the Central Bank.
9. For further information, see Daily News September 29, 2001.
10. Initially, these banks were district based but they were consolidated into six regional development banks in 1997.
11. Draft Report on the Promotion of the Microfinance Sector in Sri Lanka (SIDA, KFW, and GTZ 2004).
12. India is the largest tea producer, accounting for about 20 percent of total production. India, China, Kenya, Sri Lanka, Turkey, and Indonesia are the top six producers, accounting for 80 percent of total production. Other significant producing countries include Japan, Bangladesh, Argentina, Vietnam, Iran, and Malawi.
13. The Ministry of Agriculture defines a smallholder as a tea holding that is less than 20 acres.
14. In 1992, the government began the restructuring of the poorly performing plantation sector. The majority of the state-owned estates were clustered into regional plantation companies and management was subcontracted to the private sector on five-year leases. Management contracts, however, did not create the right investment incentives, and in 1995 the government decided to divest its controlling interest of the regional plantation companies and keep land ownership. By the early 2000s, the majority of these regional companies had been privatized or government participation had been reduced to a minority shareholding. Today, the government only manages 32 estates.
15. High- and mid-country farmers receive SL Rs 160,000 per hectare, while low country farmers receive SL Rs 150,000 per hectare of replanted area.
16. There are eight brokers operating the auction; they are paid through regulated brokerage fees.
17. The Institute for the Development of Agricultural Co-operation in Asia, Report No. 77, May 30, 2003.
18. The bank can also finance farmers by paying suppliers directly for inputs sold to farmers. Following the harvest, the farmer sells the produce to a processor or other entity associated with the agricultural service center. The service center repays the principal and interest to the bank, and the balance amount is credited to the farmer's account. Thus, the farmer is free from the complexities of arranging credit, and repayment risks for the bank are reduced. In some cases, the service center can provide security for the entire amount of the loan.
19. An efficient warehouse receipt financing system requires a developed commodity market that will offer liquidity without excessive transaction costs. Such a market provides an essential avenue for ready and efficient disposal of the security if necessary. In addition, availability of historical price and other trade information regarding the commodity is essential from the perspective of developing correct margin norms. In more developed markets, the presence of a commodity derivatives market offers the lender additional avenues for hedging the price risk of the commodity.
20. Moral hazard can arise when the insured can alter their behavior to increase the magnitude or likelihood of a loss.
21. Adverse selection can arise when the potential insured has better information than the insurer about the likelihood or magnitude of the loss.

CHAPTER FOUR

Enhancing the Outreach and Quality of the Rural Remittance Infrastructure

4.1 Introduction

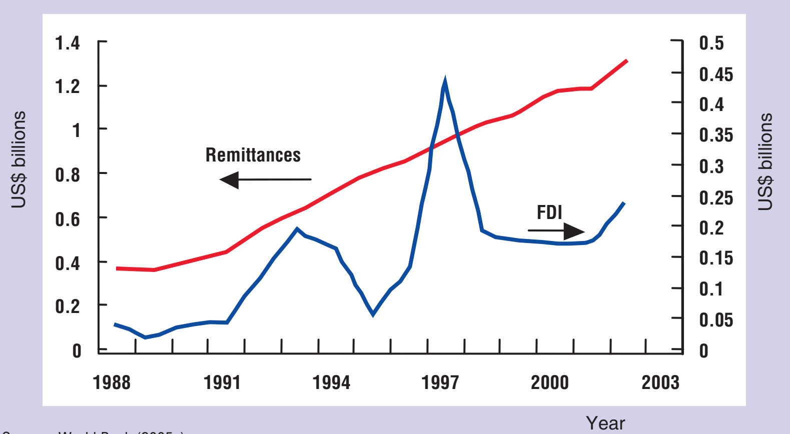
Migrant labor remittances into Sri Lanka are significant and rising. In 2004, recorded remittances from migrant labor were US$1.3 billion (Table 4.1). Together with Bangladesh (US$3.4 billion), India (US$23.0 billion), and Pakistan (US$4.2 billion), Sri Lanka was among the 20 largest recipients of remittances, making the South Asia region the second largest regional recipient of remittances in the world after Latin America and the Caribbean.

TABLE 4.1
Estimates of Migrant Workers Remittances Channeled through the Formal Financial Infrastructure (US$ billion)

	1999	2000	2001	2002	2003	2004	2003 (per capita US$)
Total	14.0	16.0	15.9	21.4	25.9	31.9	
Bangladesh	1.8	2.0	2.1	2.8	3.2	3.4	23.2
India	11.1	11.7	11.1	13.7	17.4	23.0	15.8
Pakistan	0.1	1.1	1.5	3.6	4.0	4.2	27.0
Sri Lanka	**1.0**	**1.2**	**1.2**	**1.3**	**1.3**	**1.3**	**67.7**
Sri Lanka: as percent of GDP	6.8	7.1	7.5	7.9	7.1	7.1	

Source: World Bank (2005a).

FIGURE 4.1
Sri Lanka: Formal Migrant Worker Remittances Surpass FDI Inflows (US$ billion)

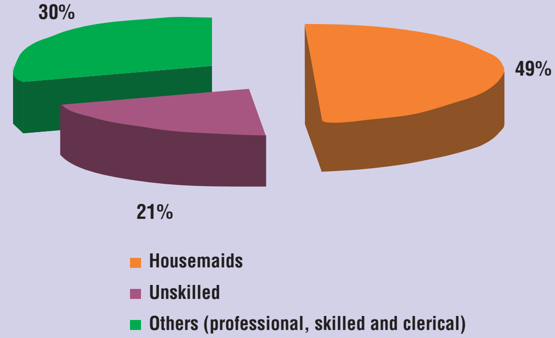


Source: World Bank (2005a).

Significantly, remittances comprise a larger[1] and more stable[2] financial inflow than foreign direct investment (FDI), and on a per capita basis, workers' remittances to Sri Lanka are the highest in South Asia (Figure 4.1). In recent years, remittances to Sri Lanka have exceeded FDI inflows by 2 to 3 times; more than doubled net receipts of foreign assistance; and reached close to 25 percent of export earnings, second only to the garment industry and ahead of tourism and tea; the country's traditional export industry. Migrant worker remittances account for 7 percent of GDP. At the microeconomic level, about 10 percent of households are recipient of overseas and domestic remittances. Overseas and domestic remittances constitute as much as 20.7 percent and 9.1 percent, respectively, of the total income of recipient households, according to the 2001/2002 household survey.[3]

FIGURE 4.2

Sri Lanka: Skill Level of Departing Migrant Workers (2003)



Source: SLBFE (2004).

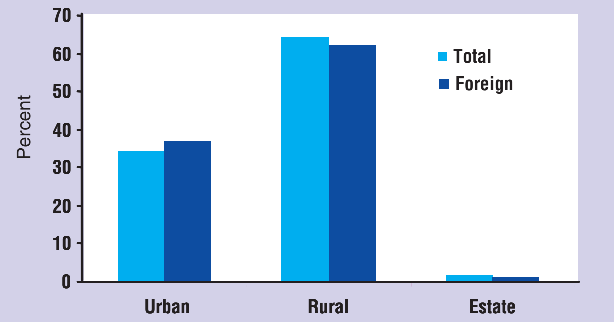
Remittance flows will continue to increase as unskilled workers continue to migrate to the Middle East (Annex 3). For the unskilled worker, temporary migration to the Middle East[4] brings in earnings that are 8 times greater than what could be expected at home.[5] The Sri Lanka Bureau of Foreign Employment (SLBFE) estimates that 49 percent and 21 percent of Sri Lankans working overseas in 2003 were housemaids or unskilled labor, respectively (Figure 4.2). Nearly 70 percent of Sri Lankan temporary migrants are female (Annex 3), and most work as housemaids. Just over 1 percent of all migrant workers are classified as skilled.

The Sri Lankan household survey of 2001/2002 indicates that about 28 percent of remittance recipient households stand within the top income quintile and around 27 percent stand within the lowest two income quintiles. These ratios, however, change considerably in the preremittance scenario. When remittances are deducted from total household expenditure, nearly 45 percent of recipient households stand within the lowest two income quintiles. Although information on how Sri Lankan recipient households use remittances is not yet conclusive, the above findings suggest that remittances can have an important impact on recipient households. A broader study by the International Monetary Fund (IMF) on remittances concluded that "remittances can help improve a country's development prospects, maintain macroeconomic stability, mitigate the impact of adverse shocks, and reduce poverty."[6] Remittances allow families to maintain or increase expenditure on basic consumption, housing, education, and small-business formation; they can also promote financial development in cash-based developing economies (IMF 2005). Speaking to the role of the financial sector in facilitating remittances, the IMF study also concluded that long-run output growth resulting from additional investments in physical and human capital financed by remittances might be especially likely "where a well-developed financial system and institutions allow remittances to be effectively intermediated and efficiently used" (IMF 2005).

The Sri Lankan government[7] like other developing country governments has recognized the importance of remittances and introduced incentives to facilitate foreign employment-including premigration facilities and services, identification of employment opportunities, training, and predeparture loan schemes (Annex 4). The government is also debating the capacity of formal financial institutions to facilitate migration policies and the challenge of enhancing the quality and outreach of the remittance infrastructure, especially in the face of an active informal remittance sector. To the extent remittances are transferred through formal financial institutions, the government's balance of payments benefits from the increased foreign-exchange reserves. In addition, the anonymity that is possible through informal remittance systems renders them highly vulnerable to abuse and illegal activities. Like other governments in remittance recipient countries, the Sri Lankan authorities are interested in having as much as possible of the remittance flows go through formal conduits.

This chapter reviews the key issues affecting the formal financial infrastructure for remittances in Sri Lanka. Section 4.2 details how the combined infrastructure of banking institutions, the postal system, and microfinance institutions provides a dense network for remittances flows. The section also shows, however, that the formal infrastructure's potential is not being maximized. The country remains largely cash dominated and rural areas, to which the greatest share of remittances flow, enjoy less access to formal remittance products (Figure 4.3).

FIGURE 4.3
Sri Lanka: Remittance Flows to Urban, Rural, and Estate Households (percent of total)



Source: SLBFE (2004).

Section 4.3 suggests ways to strengthen the formal remittance infrastructure[8] and make it competitive with informal service providers. Section 4.4 summarizes policy recommendations.

4.2 Formal and Informal Infrastructure for Remittances

Overall, Sri Lanka has an impressive density of institutions providing financial services (state and commercial banks, the postal network, and microfinance institutions), which offer a good basic infrastructure for remittances flows. Under the Exchange Control Act, foreign exchange transactions are permitted only through licensed commercial banks appointed as fully authorized dealers, unless any other person is appointed by the Central Bank of Sri Lanka (CBSL) as a restricted dealer. Accordingly, remittances from and to Sri Lanka are presently made through 22 licensed commercial banks (Table 4.2).

In addition to authorized dealers, the following organizations are permitted to engage in money transfers as restricted dealers: Sri Lanka Post (SLP); the National Savings Bank (NSB), which

TABLE 4.2
Commercial Banks Dominate the Formal Remittance Market (US$ million)

Institution	2002		2003		2004	
	Amount	%	Amount	%	Amount	%
Commercial banks	1,282.6	99.6	1,405.9	99.4	1,536.1	98.2
Specialized banks (only National Savings Bank)	-	-	-	-	11.6*	0.7
Sri Lanka Post	1.4	0.1	4.0	0.3	8.0	0.6
Nonbank remittance service providers	3.0	0.3	4.1	0.3	8.2	0.6
Total	1,287.0	100	1,414.0	100	1,563.9	100

- Not available.
*Authorization granted in 2004.
Source: Central Bank of Sri Lanka (2004).

is a licensed specialized bank; and one private company, MMBL Money Transfer Ltd. (MMBL), which is a subsidiary of a Merchant Bank in Sri Lanka. Of these, NSB and MMBL are permitted only to engage in inward money transfers. Although provisions under the Exchange Control Act prohibit any other entity to participate in the remittance business without permission from the central bank, some informal remitters are in operation. The identification of these informal dealers becomes difficult as their operators and localities are unknown and they hardly keep readily accessible records of their transactions (Hettiarachi 2005). Estimates based on a recent World Bank study (2005a) suggest that private remittances channeled through informal dealers were as much as 45 percent of total remittances in the mid-1990s.

The potential of the formal remittance infrastructure is not being maximized. The country remains largely cash dominated. Although the banks report a relative good ratio of 1 checking account per 6 inhabitants, the usage appears low, with only 4 cashless payments transactions per capita per year, or approximately 25 per account. On the other hand, many Sri Lankans keep large amounts of cash on hand. An average amount of SL Rs 5,000 per capita was in circulation with individuals in mid-2004 (Boon 2005). This suggests that access to basic payments services is in practice difficult. There is close to one bank branch per 14,000 inhabitants, but this ratio is inadequate to serve the nation given that the financial sector is predominantly cash-based and paper-based.[9] Lessons from other countries show that this ratio should at least be 1:6,000 and ideally 1:3,000 or better, as is the case in most industrialized economies (Boon 2005).

The remainder of this section examines the state of the formal and informal infrastructure for remittances in Sri Lanka. As is the case in other regions, the financial remittance market includes three principal actors: commercial banks, money transfer businesses, and informal money transfer agents. Slowly, other actors-such as the post office and microfinance institutions-have begun exploring opportunities in the remittance industry but their participation is still in its infancy.

Commercial Banks

State commercial banks, especially the Bank of Ceylon, have long dominated the official remittance business, in part because of their large branch networks. In 2004, their network comprised 618 branches compared to 1,734 for the entire banking system and together the Ceylon branches channeled close to 70 percent of private remittances.[10] Table 4.3 summarizes the contribution of the main commercial banks to private remittances during the last 3 years.[11]

TABLE 4.3

Remittances by Licensed Commercial Banks (million SL Rs)

Institution	2002	2003	2004	2004 (% of total)
Bank of Ceylon	741.8	772.0	881.4	56.4
People's Bank	183.3	208.9	232.7	14.9
Seylan Bank	102.5	129.0	147.5	9.4
Hatton National Bank	42.7	57.5	81.6	5.2
Comercial Bank	63.7	79.6	93.4	6.0
Sampath Bank	58.8	75.4	76.1	4.9
Others	94.2	91.6	51.2	3.3
Total	**1,287.0**	**1,414.0**	**1,563.9**	**100.0**

Source: Hettiarachi (2005).

The retail product range of the commercial banks is fairly broad and includes checking accounts, deposits, credit, insurance, and securities. For migrants and their relatives, banks offer checking products as well as electronic and Internet-based products. In a recent survey of financial institutions, Hettiarachi (2005) found the following were the most widely used instruments for transferring money: (i) telegraphic transfers based on SWIFT[12] messages; (ii) drafts/checks drawn on banks;[13] and (iii) international money orders issued by banks and post offices.

BOX 4.1

Financial Products and Services Offered to Migrants by Commercial Banks

- *Foreign currency accounts.* In order to induce inward remittances, CBSL has permitted nonresident workers to open and maintain foreign currency accounts with authorized dealers. These accounts are known as non-resident foreign currency accounts (NRFCs). If the account is to be maintained by a beneficiary in Sri Lanka who is a resident, the proceeds of remittance received by him or her are permitted to be retained in an account titled resident foreign currency account (RFCA). Funds in both a NRFCA and a RFCA can be freely used for any purpose in foreign exchange (in the case of resident other than for acquisition of any real and financial assets abroad) and are free from income tax. These accounts offer competitive interest rates ranging from 1-2 percent over the London Inter-Bank Offered Rate (LIBOR).
- *Insurance.* Commercial banks will offer life insurance to migrant workers when the balance of their foreign currency account rises above certain threshold.
- *Minors' accounts.* Migrant workers can plan for the future of minors by opening foreign currency accounts in their children's names in Sri Lanka.
- *Loan facilities.* Migrant workers with foreign currency or rupee accounts can raise low-interest loans from authorized dealers for housing and other purposes.
- *Information.* Printed and electronic advertisements and various pamphlets issued by authorized dealers publicize and explain the services offered to migrant workers.
- *Education.* SLFEB/Ministry of Education seminars and educational programs for migrant workers explain banking facilities available for remitting monies to Sri Lanka, as well as how workers can get the maximum benefits from their earnings and accounts.

Sensing a growing market for remittances in Sri Lanka, several private commercial banks have introduced remittance services and started aggressive marketing programs. Some banks offer a variety of products to migrants including insurance and predeparture loans at concessional rates to be repaid from remittance proceeds. The size of the loan is determined by the level of income offered by the prospective employer and the duration of employment. Some migrants use the loans to pay their employment agency fees, passage, and settling-in costs. Box 4.1 provides examples of the main products offered by commercials banks to migrants, including foreign currency accounts, insurance, accounts for minors, loan facilities, and educational programs.

Foreign banks in Sri Lanka are newcomers to the remittance business. They have tended to focus on skilled migrants such as doctors, accountants, lawyers, and other professionals. Foreign banks are not known to offer competitively priced services to walk-in clients. Their reluctance to participate in the sector is quite different from the experience in Latin America and Southeast Asia, where all banks are taking a serious interest in the remittances sector. The main reasons for foreign banks' limited participation in the sector are discussed below:

- *Transaction costs.* The high minimum account balances required by commercial foreign banks are a deterrent for lower-income migrants. People are reluctant to give up access to sizeable funds in order to maintain a bank account.
- *Profitability of remittance business model.* The remittances business has three direct sources of income: profit on the exchange rate, fees paid by the remitter and sometimes by the recipient, and the interest earned on remitted funds before they are paid out to the recipient. On all three accounts, the profits on remittances to the region have been falling. With the removal of exchange-rate controls in recent times, the margins have declined drastically. Competition between transfer agents has pushed down commissions and fees to US$1 or less, and pressure to make payments within 24 hours has minimized the potential for gains on cash float. Unless clients open bank accounts and banks are able to cross sell other more profitable products, remittances are not an attractive business proposition for foreign banks.
- *Limited branch networks.* Most foreign banks are concentrated in the capital cities. Their branch networks are designed for corporate clients and the more affluent individual clients. They do not have the rural outreach of the state banks and other local private banks.

- *Anti-money laundering and combating the financing of terrorism (AML/CFT) standards.* Heightened international concerns over money laundering and terrorist financing have increased pressure on international banks to adhere strictly to international AML/CFT standards. High volumes of individual money transfers, especially between nonaccount holders, make it difficult to comply with know-your-customer and suspicious activity reporting requirements. Reporting regulations could push the cost of doing business too high as remittance fees are dropping.

Most of the concerns listed above affect local private banks and nonbank financial institutions and advances in technology have been used to address them. Technology is having a positive impact on the remittance market. As account holders in some of the more technologically advanced banks discover the benefits of automated teller machines (ATMs), debit cards, and credit cards, the volume of account-to-account money transfers is increasing.

Money Transfer Businesses

Money transfer businesses play an important role in providing remittance services to Sri Lankan migrants. In the context of this chapter, money transfer businesses (MTBs) are financial service agents that accept cash, checks, other monetary instruments, or forms of "stored value" in one location and pay a corresponding sum in cash or another form to a beneficiary in another location by means of a communication, message, or transfer, or through a clearing network to which the MTB belongs.

In Sri Lanka, MTBs operate through banks, and there are initiatives to partner with other institutions. Only authorized foreign exchange dealers (that is, commercial banks, the post office, and the National Savings Bank) are permitted to deal in foreign currency transfers. Exchange bureaus, credit unions, and microfinance institutions are not.

The leading MTB in Sri Lanka is Western Union. With a 150-year history, Western Union is the global leader in money transfer services. It has more than 150,000 agent locations in 190 countries. Although estimates vary, it is commonly agreed that after banks, Western Union handles the largest share of remittances from the United States to South Asia. Western Union allows customers to send money using credit and debit cards through the company's Web sites, offices and agent locations, the telephone, or physical mail using a money order.

MTBs are increasingly taking advantage of the Internet to expand their outreach and quality of their service delivery mechanisms. e-Exchange allows the remitter to transfer funds instantly to any part of Sri Lanka. The company asserts that its branch and ATM networks throughout the country are electronically linked, thereby offering faster services. Senders can check to see whether funds have been received and can also review past transactions and print an account statement. For MTBs, the contribution of technology to the remittance business transfers is a welcome development. From a regulatory perspective, technology makes it easier to comply with know-your-customer requirements by automatically recording the identity of the remitter and the recipient. From the financial perspective, it facilitates the cross-selling of other financial products (such as credits cards and insurance products).

Post Office Network

Although the Sri Lanka Post has a long tradition in providing cross-border remittance instruments, its market share is minimal due to deficient and slow services. In 2004, the post office dealt with remittances amounting to US$8 million or less than 1 percent of the total market (Table 4.2). These remittances

TABLE 4.4

Variety of Payments Made through Money Orders and Postal Orders (SL Rs Million)

Type	2002	2003
Ordinary money orders	7,795.9	9,437.6
Telegraphic money orders	356.9	446.7
Fax money orders	652.2	1,147.2
International money orders	135.9	382.2

Source: Central Bank of Sri Lanka (2004).

primarily came from India and the United Kingdom. The remittance flows are settled through an account held at the Central Bank of Sri Lanka, which does the currency conversion. International postal money orders, which remain paper based, take up to four weeks to reach the beneficiary. Money orders can be cashed at any post office. The senders usually pay a value-based fee, in the range of 2-5 percent of total value. Complaints and queries as a percentage of the total number of transactions run higher than 5 percent. In comparison to remittances products offered by banks and money transfer agents, the paper-based postal money order compares poorly, except for its outreach. New initiatives are underway to improve the service as discussed in Chapter 5.

Sri Lanka Post has struck an agreement with the official postal service of the United Arab Emirates, Emirates Posts, to exchange postal money orders electronically. Emirates Post will help Sri Lanka Post with the installation of necessary software and training. This appears as a useful first step to improve the level of service with one of the key countries from which remittances originate. In 2004, Sri Lanka Post launched a tender for an agency for urgent money transfers and it was approached by representatives of firms such as MoneyGram and Western Union. A decision on the partnership is in process.

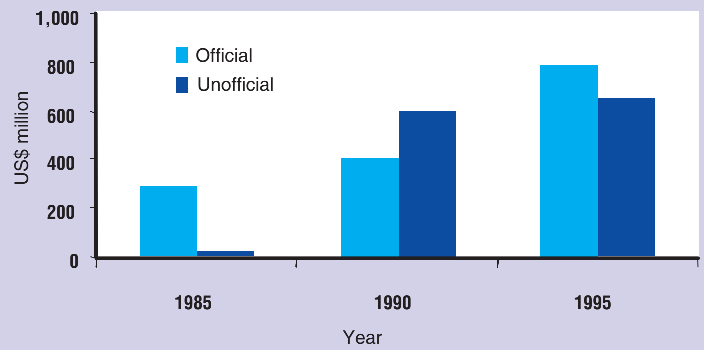
Informal Remittance Systems

As is the case in most South Asian countries, informal remittances are commonplace, having long been used to facilitate trade between distant regions where conventional banking instruments are either absent or weak. World Bank (2005a) estimates that unrecorded remittances are highly volatile and could have reached as much as 45 percent of total private remittances in Sri Lanka in the mid-1990s (Figure 4.4). Broadly speaking, the growth of informal funds transfer systems has traditionally been negatively correlated with the level of development and liberalization of the formal financial sector. Informal systems are more likely to be found in jurisdictions where the formal financial sector is either nearly absent or not functioning-as is sometimes the case in internal regions in conflict-or does not provide a reliable, cost effective, and convenient mechanism for the transfer of funds. The attraction of informal operators is heightened by financial policies that include foreign-exchange controls, as was the case in Sri Lanka. Over time, the operational features of speed, low cost, ethnic and cultural convenience, versatility, and anonymity led to the use of informal systems for various legal and illegitimate purposes.[14] Many Sri Lankan banks identify informal remittances as their most challenging competitor. Although some banks have tried to tap into the informal markets, there are no examples of success.

In addition to cost and speed, informal remittance systems also appeal to migrants dealing with the formalities required to transfer money and looking for reliability and convenience. The informality of Hawala is attractive to many Sri Lankan migrants who are uncomfortable dealing with banks and other financial institutions. The lack of bureaucracy renders informal services accessible to less educated customers, many of whom live in rural areas where alternatives are not available in any case. Informal systems are also reliable. Trust and the cultural importance of one's reputation and good name perform an effective self-regulatory function. Disputes and errors are settled among informal service providers, who assume the risk of a counterpart's default or law-enforcement actions.

FIGURE 4.4

Sri Lanka Official and Unofficial Remittances (US$ million)



Source: : World Bank (2005a).

The convenience of door-to-door service is appealing to all customers, especially in regions where transportation is poor, and particularly to female migrants in remote and traditional regions, where they may not be allowed to leave the house. In some instances, as field surveys indicate, informal service providers visit the workplaces of expatriates to collect money for remittances. Private banks have opened branches in migrant destination countries to help Sri Lankan nationals remit their earnings, and these branch offices have attracted a number of clients through personalized service. However, because of the constraints of work conditions, housemaids still prefer to use informal channels to remit their earnings. With the fluctuation of the dollar, many of these women are unaware that their informal contacts do not give them a fair exchange rate and that they are losing on the transaction. (See Malsiri and Jayasundere 1999.)

Areas of armed conflict are also more likely to be linked to informal methods of money transfers. The northern parts of Sri Lanka, for example, have limited formal financial services. Migrants from that region resort to the Hawala system and in-kind remittance services. Informal remittance services are also attractive to the undocumented immigrants, who may not be permitted to have bank accounts or do business with formal institutions. This is said to be particularly important to Sri Lankan migrants based in Italy.

Unfortunately, illegitimate use of the informal Hawala system may occur regardless of the level of development and convenience of the formal financial sector. While both the formal and informal sectors are vulnerable to abuse, the potential anonymity of the informal system makes it especially susceptible to smuggling activities; capital control circumvention; customs, excise, and income tax evasion; and money laundering and terrorist financing operations. These crimes are not new. For financial sector regulators, however, legislation against financial abuse of formal and informal remittance systems is a relatively recent phenomenon. In drafting new international standards-registration, licensing, reporting, and record-keeping requirements-financial authorities also need to consider the settlement process between Hawala operators and the economic and regulatory implications of Hawala-type systems.

In-Kind Remittances

In-kind remittances take place through the provision of goods or services in one country, while the payment is made in another country. The tourism business, for example, lends itself readily to this sort of practice. A travel agent may send groups to Sri Lanka and collect full payment from them in Europe. In Sri Lanka, an associate will cover all local expenses of the group and receive payment in an account maintained overseas.

Many expatriates plan to return and retire in their homeland. Paving the way for return often means building a house. A local company may provide the construction work for the expatriate and receive payment in an overseas account. In Sri Lanka, for example, the real estate market has provided opportunities for such transactions, as expatriates wish to buy or sell property at home without disclosing the true price to the authorities. Balances between the real and declared price are settled through middlemen and payments outside the home country.

In-kind remittances pose an important measurement challenge. Emigrants return to their home countries with large volumes of durable goods or valuable commodities such as gold and gemstones. Sometimes the value of these goods is counted as "official remittances," but sometimes it is not. Whether remittances are in the form of funds or value should not obscure the similar functions they perform or the effects they can have on regional economies. In Sri Lanka, initiatives are underway to mitigate the inefficiencies that arise from in-kind remittances. One of these initiatives is to allow the duty-free import quota to be used in special duty-free shops in Sri Lanka upon return from working abroad.

4.3 Public and Private Sector Options for Enhancing the Use of Formal Remittance Systems

There are different ways in which governments around the world have tried to encourage the use of formal remittance services, but most policies establishing legal remittance requirements have not been effective. India, for example, has enacted legislation banning the use of informal channels. In the Philippines, minimum remittance requirements (50-80 percent depending on the profession) were introduced in 1982, but the law soon became inactive because of implementation difficulties. Attempts in Pakistan, Thailand, and Bangladesh to introduce mandatory remittance limits met similar fates (Puri and Ritzema 1999).

The Republic of Korea has been more successful with mandatory remittance limits. The government mandated that at least 80 percent of the earnings of migrant workers be remitted through the Korean banking system. Available estimates indicate that the average formal remittance ratio of Korean workers (about 90 percent) usually exceeds the minimum legal limit. Puri and Ritzema (1999) observe that success in Korea is attributable to its unique migrant labor employment system, in which almost all Korean migrant workers are employed directly by Korean companies involved in construction projects in the Middle East.[15] The Korean corporations deposit their employees' salaries in foreign currency accounts in Korean banks. This approach ensures a higher remittance rate and promotes savings by workers in general.

By contrast, a large number of workers from Sri Lanka find employment overseas through independent recruitment agencies and other "unofficial" channels. A legal remittance requirement policy is therefore unlikely to be feasible. It might only succeed in the rare situation where the authorities have direct control over the entire process of labor migration.

Instead, it is recommended that reform efforts in Sri Lanka are invested in enhancing the quality of the outreach and quality of the formal financial sector. Lessons learned from other economies such as Mexico, which has a large migrant population, suggest that in order to compete with informal service providers the formal sector should consider the following: greater investment in remittance technology; sharing electronic payments systems platforms; creating payments systems linkages with nonbank financial institutions; negotiating bilateral financial initiatives with remittance source countries; and promoting more financial education of migrant workers (Hernandez-Coss 2005).

Greater Investment in Remittance Technology

A substantial amount of remittances is going through the informal sector to residents in Sri Lanka. Although the costs of formal remittances to Sri Lanka are falling, informal channels continue to maintain a competitive hold on the market. In part, this is because the final price of an informal transaction depends on the negotiating skills of both parties and their understanding of how the market operates. Such practices are common in every bazaar in South Asia. Some informal remitters quote a flat fee of 2 percent on international transactions, but this is usually only a starting point for discussion. Discounts and premiums are offered and charged depending on the transaction volume, the relationship between the client and the remitter, the currency of exchange, and the destination of the funds.

TABLE 4.5
Average Time to Remit Money to Sri Lanka (2005)

Country	Telegraphic transfer	Draft/ check	E-remittance
United Arab Emirates	1-2 days	3*-21 days	10-15 minutes
United States	1-2 days	3*-21 days	10-15 minutes
European Union	1-2 days	3*-21 days	10-15 minutes

*On local clearing.
Source: Central Bank of Sri Lanka (2005).

On the other hand, the formal financial sector still incurs higher transaction costs than the informal sector. The vast bank branch network is largely suboptimal with respect to handling US$100 in remittances for the average migrant. Formal remittance services in Sri Lanka largely rely on paper-based instruments (bank drafts) and telegraphic money transfers that have a relatively long processing time when handled through the bank-up to 21 business days for drafts and 48 hours for telegraphic transfers (Table 4.5). The charges levied for the use of each instrument depend upon staff and communication costs. Because of high SWIFT charges, the cost of a telegraphic transfer is higher than a draft or check (Table 4.6) and even more when compared to informal remittance channels such as Hawalla.

TABLE 4.6
Cost of Remitting Money To Sri Lanka (2005)

Country	Currency	Telegraphic transfer	Draft/ check	E-remittance
United Arab Emirates (exchange houses)	Diram	8-10	3-5	10-15
United States (banks)	USD	30-50	25	10-62 (for USD 100-500 remittance)
United Kingdom (banks)	GBP	27.50	22.50	7-11 (for GBP 100-500 remittance)
Other European Union (banks)	Euro	10-75	25	7-11(for Euro 100-500 remittance)

Source: Central Bank of Sri Lanka (2005).

The use of bank drafts for remittances is highly inefficient. Overseas remittance companies issue drafts on Sri Lankan banks, which the remitter mails to the recipient through the postal system. When the recipient receives the draft, he or she presents it to a bank branch. The branch presents the draft to the bank's main office for validation. When validated, the recipient's account is credited or cash paid over the counter. Remitting money using bank drafts presents several challenges. Drafts may be lost in the mail and may be forged. In Colombo, banks will deliver the cash for remittances to the home of beneficiaries without surcharge. This is not the case in the countryside where the beneficiary will have to visit the nearest branch once, in some cases twice, to obtain cash. The settlement time is long because of the large amount of manual work and transportation involved in processing the remittance. Although inexpensive to the remitter, the service level is inferior to what informal operators can provide and to what formal systems in developed remittance markets offer. The long transfer time may encourage recipients to relieve liquidity constraints through borrowing money at high interest rates from informal lenders.

There are also electronic fund transfers available to Sri Lankan migrants, but they are generally more expensive. International MTBs remit through commercial banks. Furthermore, commercial banks have entered into partnerships with exchange houses and overseas banks in setting up electronic infrastructures that allow remittance instructions from the overseas partner to initiate a credit to the recipient's account. Overseas workers are in some cases able to initiate transfers using the Internet. Such transfers, provided the branch where the recipient is banked is on-line with the main office, can take place within a day.

In order to compete with the informal providers, the formal operators must lower transaction costs and improve the speed and distribution reach of their services. Banks must expand their international electronic transfers to rural areas. Branches must be connected to electronic payments processing so that recipients in remote areas can receive timely transfers. The banks could also move their services closer to the recipient, through couriers or partnerships with other agents. To improve service, a few private banks have opened branches in migrant-destination countries, and these branches have been able to attract new clients interested in remitting their earnings. Domestically, banks in Sri Lanka are starting to invest heavily into payments system technology. The use of credit cards, debit cards, and the installation of ATMs is on the increase (Table 4.7). In 2004, there were about 40 ATMs per 1 million inhabitants. Although public banks dominate the banking system, most ATMs are owned by private commercial banks (68 percent at the end of 2003).

TABLE 4.7
ATMs in Sri Lanka

ATMs	2002	2003	2004
Machines	636	721	833
Transactions (SL Rs mn)	25	34	38
Value (SL Rs mn)	71,873	119,359	147,330

mn = millions.

Source: Central Bank of Sri Lanka (2004).

Hitherto, however, most banks have been investing in proprietary IT platforms for their payments systems with suboptimal gains for the remittance business. There is very limited outsourcing or sharing of domestic branch networks. Few banks have all branches on-line in a network. Paper-based processing of basic transactions has remained a predominant feature in branches and their head offices. Fortunately, this is changing. In 2004, close to 92 percent of ATMs in Sri Lanka were open-access, that is, they could be used by the holder of an ATM card issued by a bank other than the bank that owned the ATM. But more can be done.

Like many other Asian countries, electronic networks are unlikely to benefit poor and the rural areas in the short or medium term. This is not only based on the limited density of the ATM network and machine location (mainly in urban and commercial shopping areas). For the banks, ATMs require relatively high initial investments that will have to be recovered from the client operations. Hence, banks are likely to charge fees for cards and electronic transactions that will deter low-income users.

Sharing Electronic Payments Systems Platforms

To maximize the remittance potential of the financial sector network, there needs to be a harmonization of the payments infrastructure across banks in the country. As in many developed countries, institutions in Sri Lanka should share their infrastructure platforms and compete on service. For a long time, for example, only a limited number of ATM transactions that required cross-institution clearing could be conducted. Electronic instruments offer a superior service, but in order to provide the best value to the user, such remittance instruments require that payments be processed electronically to the disbursing branches and that interbranch and interbank networks be connected electronically. In Sri Lanka, the lack of electronic interconnectivity between banks and many bank branches means that the recipient may not be able to receive the remittance at a bank branch. Indeed, Sri Lanka's branch network is not fully maximized (Table 4.8).

TABLE 4.8

Total Branches of Commercial and Specialized Banks and Post Offices (2004)

Institution	Number of branches
Public commercial banks	618*
Private commercial banks	756*
Specialized banks	66
Rural development banks	196
National Savings Bank	112
Post offices	4,647**

*Excludes pawning centers (188) and student savings centers (328).

**Includes agency and sub-post offices but excludes estate sub-post offices.

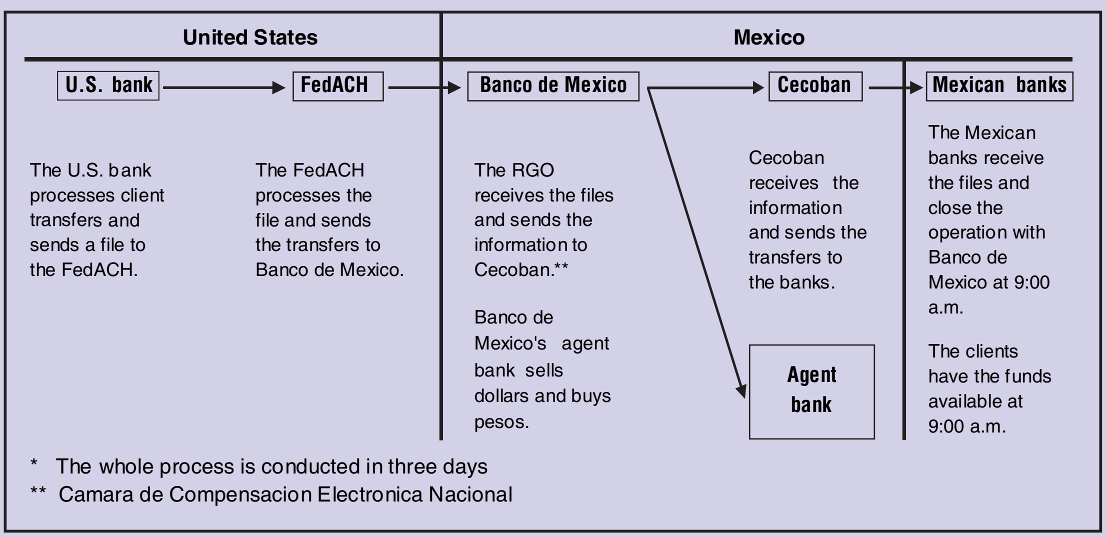
Source: CBSL (2004).

A notable example of the efficient sharing of an electronics platform (not only within one country but across an international border) is the Federal Reserve Automated Clearing House (FedACH) International (Box 4.2). The service is economical because it connects the existing payments infrastructure in both countries.

BOX 4.2

The United States and Mexico: Federal Reserve Clearing House (FedACH) International

A potentially significant addition to the remittances market between the United States and Mexico is the FedACH International Mexico Service. FedACH provides a "public highway" for bulk transactions between banks in the United States and Mexico. This clearinghouse is operated by the Federal Reserve System and the Central Bank of Mexico and reaches every bank in both countries, creating potential points of payment origination and receipt. Currently, this system works only from the United States to Mexico. Operators, however, plan to have transfers from Mexico to the United States working sometime in 2005. The cost to banks for using the FedACH system is estimated at around US$0.67 per transaction. One of FedACH's limitations is that it operates only from account to account, as opposed to "cash to cash."



Source: Hernadez-Coss (2005).

Hernandez-Coss (2005) rightly comments that it is too soon to know the impact that FedACH will have on the U.S.-Mexico remittances market. However, for smaller banks that do not have the capital to invest in their own systems networks, it presents an opportunity to become full participants in the market. In the case of the largest banks that have developed their own systems, the time required for a transaction through FedACH may be too slow compared to their own system. One notable aspect of the Mexican Service is that it publishes the foreign exchange rate and spread on its Website, including an archive of previous rates, thereby adding an important element of market transparency not present in most other services.

There are several advantages to shared payments systems platforms. They can reduce the cost of remittances. Currently, major transfer agents and banks use their own (costly) proprietary systems to send remittances. If funds were channeled through a single low-value payment system, the cost per transaction could drop. Furthermore, the network effects of shared systems could provide easier access to disbursement points for the remittance recipients. One option for consideration is to allow post office branches to engage in payments. Post offices could be connected to an open network through which payments can be made and received. The ability to receive remittances from any bank through the post office could attract remittance recipients. In addition, directing remittance payments through a broader electronic infrastructure is likely to reduce the cash dependency of local payments. It would help pave the way for increased penetration of electronic payment instruments, such as credit and debit cards, which again would prepare the recipients of remittances for future cost-reducing innovations, such as card-to-card remittances.

The national IT platform that will soon be completed by Lanka Clear will also open new opportunities for expanding interconnectivity among banks. Lanka Clear's Check Imaging and Truncation System will involve connections with 11 regional IT clearing centers.[16] Once tested and operational, this electronic platform could be made available to commercial banks for a fee, thereby avoiding unnecessary and costly duplication of proprietary systems.

Creating Payments Systems Linkages with Nonbank Financial Institutions

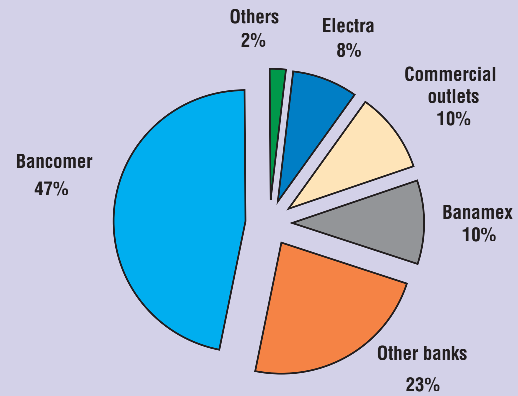
In order to increase the speed with which remittances are channeled through the formal sector, banks need to explore greater linkages with nonbank financial institutions. Speed is a critical consideration. With self-carried courier and Hawala deliveries, funds are available immediately, whereas some formal alternatives may take many days. Discussions in Sri Lanka suggest that on average 7-8 days is required to clear a draft made on a bank, although this varies widely among the banks, depending on their risk-taking policies and the level of technology. The timing also depends on the location of the branches; the clearing period becomes significantly longer for remote areas. With informal transfers, confirmation and payment can be instantaneous, and the entire transaction can be concluded in minutes. Commonly 24 hours are required for transfers. Slightly more time is usually required for payments in the more remote regions or villages where the money exchange dealer has no local office or representative.

Sri Lanka can further reduce the cost of remittances by increasing rural access to banking services through partnerships with nongovernmental organizations and microfinance institutions. Such institutions may in particular be able to leverage remittance receipts to increase financial literacy and, if connected to payment networks, promote the use of technology in financial retail services. Such efforts would be hindered by the lack of network effectiveness that results from an excess of proprietary systems. Results can only be achieved with financially sound microfinance institutions.

As a whole, Sri Lanka's 6,000 microfinance (MF) points of contact, around 4,650 post offices, 1,374 commercial bank branches, around 800 ATMs, and 112 NSB branches constitute a dense structure with a potential for very high electronic financial services penetration with providers

FIGURE 4.5

Estimated Shares of Remittances Market in Mexico (June 2004)



Source: Hernandez-Coss (2005).

focusing on services rather than infrastructure (Table 4.8). Looked upon as separate networks, however, Sri Lanka's remittance institutions will not be able to realize such benefits. In countries like Mexico, for example, remittances are delivered to recipients through a variety of outlets: banks, microfinance institutions, department stores, small neighborhood stores, telegraph offices, exchange houses, and post offices (Figure 4.5). In Sri Lanka, some of the better managed and financially stable microfinance institutions could be links for channeling remittances to rural communities. This will likely require substantial investments in information technology and improvements in financial management systems.

An even larger network with tremendous potential for supporting the remittance industry is the Sri Lanka Post network of nearly 4,650 branch offices. Sri Lanka Post has a long tradition in providing financial services, mainly payments and savings, and these services constitute a substantial share of the workflow of the post offices (see Chapter 5). *At least two private commercial banks have expressed an interest in expanding the flow of payments through the postal network, a strategy that could enhance their outreach in a cost-effective manner.* Sri Lanka Post is not connected to the Automated Clearing House (Lanka Clear), but efforts to increase its remittance capacity are under consideration. As part of the e-Sri Lanka program, Sri Lanka Post has recently launched e-money orders. Initially, the e-money order has been developed as an on-line payments instrument to support e-commerce transactions for those who do not have a credit card. The application of the e-money order, however, could be expanded to an on-line payments instrument for individuals.

Connecting the postal network to other postal and international payments networks (for example, Eurogiro) would help to improve coverage and service. Eurogiro remittance products are delivered within two working days at a relatively low, fixed sender fee (US$5-8). Through a Eurogiro connection, Sri Lankan migrants in, for example, Italy, Greece, Canada, Germany, and Switzerland can use the local postal network and several local banks abroad to send money home. Several major Sri Lankan banks also envisage the postal network as supporting the "last mile" of delivery of cash for their remittance products by linking the postal network with the banks' processing center. *Although the role of the postal network in domestic money transfers and migrant remittances is limited, there are untapped opportunities to expand these services by connecting the postal network with the local payments systems and international remittances networks.*

Negotiating Bilateral Financial Initiatives

Bilateral initiatives between remitting and recipient countries can enhance the usage of formal remittance channels. The U.S.-Mexico Partnership for Prosperity, a private-public alliance launched in September 2001, is perhaps the best example for Sri Lanka to emulate. Recognizing the need for cooperative measures to manage the flow of remittances, the United States and Mexico have worked together to streamline the remittance process and to enhance the productive use of remitted funds.

The alliance has set out an action plan to promote economic development in the poorer regions of Mexico. Although the partnership is dealing with several important bilateral development issues, remittances have received the most attention. *The goal of the alliance is twofold: first, to reduce the cost of transactions; and second, to help transform remittances into productive activities that generate access to more integrated financial services.* Partly because of the alliance described above and other initiatives referred to in this section, transfer costs between the two countries have declined dramatically over the past eight years.

Supporting connectivity between domestic institutions and cross-border payments systems has the potential of providing low-cost, safe, and efficient remittance transfers. Such initiatives will need to be taken in cooperation with the remittance-sending countries, as the price to the sender depends on policies and connectivity in the sending country. Initial measures are being taken to connect Sri Lanka Post with foreign postal networks.

Financial Education and Consumer Protection

There is evidence that Sri Lankan migrants do not have the necessary knowledge to make informed choices among remittance alternatives. Despite an unusually high literacy rate for a developing country, these workers are often oblivious to the realm of financial products and services available to them The banking industry as a whole offers many services that enable migrants to better manage their savings, but the country lacks a cohesive strategy for financial education of this vital sector of workers (Abeywickrema 2004).

Financial education is important for several reasons. First, it can help migrants overcome some of the misperceptions and social conditioning regarding formal financing institutions. Second, if the various providers of remittance services disclose all costs and benefits associated with their services prior to the migrants' departure, migrants will be encouraged to direct remittances to the most efficient providers and thereby create incentives for all remittance providers to enhance their services. Unskilled migrants are unfamiliar with the range of financial products and services available to them. The banking industry as a whole offers a wide spectrum of services that enable migrants to better manage their assets, but the country still lacks a cohesive strategy in educating this vital sector. Availability of information about providers and their services will encourage users to channel remittances to the most efficient providers and motivate competition in remittance market products. In the past, the SLBFE has controlled the amount of information available about services offered by state commercial banks. Third, educating workers about the benefits of opening accounts and using financial products such as loans, deposits, and cashless bill payments is a key step in moving from a cash-based society to a society based on electronic transactions, safe storage of value, and equal access to financial products. Such financial education should not be limited to migrants.

Stronger consumer protection will also encourage higher usage of formal networks. Remittance services should be covered by a well-founded consumer protection system that resolves disputes and handles complaints. In particular, there should be disclosure to recipients of the total price paid for remittance services compared to the original amount paid by the remitter to the sending agent. Furthermore, domestic organizations that enter into partnerships with overseas agents should ensure full disclosure of the price to the sender; or in cases where price components such as the exchange rate are not determined until after the transaction has been entered into, make the uncertainty of the pricing known to the sender beforehand.

4.4 Conclusions

Migrant labor remittances to Sri Lanka have been growing steadily over the last few decades. The economic benefits of that growth are widely accepted-remittance income enables families to supplement their local income. To the extent remittances are transferred through formal networks, the government's balance of payments benefits from the increased foreign-exchange reserves and the risks posed by informal networks are minimized. Equally important, the usage of formal financial institutions exposes migrants to a wide range of financial services (such as credit, savings, and insurance) that can help them manage their savings and economic risks better.

In Sri Lanka, as in most other countries in the region, the majority of international remittances are channeled to rural areas. To maximize the development potential of remittances, however, it is important to enhance the service quality and rural outreach of the formal remittance infrastructure. This paper has discussed a number of options that the government may wish to consider to enhance the capacity of the public and private infrastructure to facilitate remittance flows.

In undertaking some or all of the steps discussed in this paper, Sri Lanka is not alone. The importance of remittances and efforts to reduce the transaction costs for migrants is increasingly being recognized on an international level. In recognition of the increased worldwide focus on remittances, the World Bank and the Bank for International Settlements have convened a Task Force on General Principles for International Remittance Systems. These principles will support greater access to financial services in both remittance-sending and recipient economies. Because of its experience with migrant worker remittances, the Central Bank of Sri Lanka was invited to join the Task Force, together with eight other central banks representing important sending and receiving countries. Through its participation, Sri Lanka is helping to create a global understanding of the dynamics of the remittance sector.

Notes

1. Remittance trends in Sri Lanka are similar to worldwide trends. Globally, remittances remained the second-largest financial flow to developing countries in 2003 after foreign direct investment, more than double the size of net official development assistance. Remittance volumes continue to increase, despite expectations to the contrary based on weak labor markets and the tightening of border controls in the industrial countries after the terrorist attacks of September 11, 2001.
2. The relatively stable nature of remittances suggests that countries with access to significant remittance inflows may be less prone to damaging fluctuations, whether in output, consumption, or investment. In extreme cases, remittances might reduce the probability of financial crises. Such considerations are strengthened by the fact that remittances, unlike capital inflows, are unrequited transfers, which do not create future debt servicing or other obligations (IMF 2005).
3. Based on the 2001/2002 household survey, total remittances constituted nearly 3 percent of income of the average household.
4. The Middle East region has been the primary destination, having received almost 90 percent of total Sri Lankan contract workers.
5. As early as 1982, Sri Lanka was among the top 10 countries with the largest portion of nationals living outside the country. Of a population of 17 million at the time, 1.5 million had left the country (The Economist, 1993, p. 40).
6. Research by Richard Adams (1998) suggests that if remittances are used mainly to finance basic consumption, they may have an effect on poverty even though their growth impact may be minimal. On average, a 2.5 percentage point increase in the remittances/GDP ratio is associated with less than a 0.5 percentage point decrease in the share of people living in poverty (IMF 2005).

7. The Ministry of Employment and Labor and its implementing arm, the Sri Lanka Bureau of Foreign Employment (SLBFE), are directly active in the migration and remittances business. The ministry is responsible for formulating policies and monitoring the overall administration of foreign employment, as well as coordinating with relevant state agencies. SLBFE implements a wide range of workers' welfare programs, both locally and in host countries that protect migrant workers during the entire migration process. SLBFE is responsible for monitoring the migration of individuals, the activities of employment agencies, and the promotion of foreign employment opportunities, especially to the Arabian Gulf states to which the majority of unskilled workers emigrate.

8. Although this chapter focuses on the financial benefits of remittances, it does so recognizing that labor migration is not without its negative social consequences. Before they leave Sri Lanka migrants may become involved in an illegal process of paying bribes to employment agencies, borrowing money from loan sharks, and falsifying passports and travel documents. On arrival in the host country, tales of slavery, forced prostitution, and inhumane treatment of female migrants abound. Often, there is nothing the worker can do except run away without her travel documents; after which, she may be picked up by the numerous prostitution rings, or by law enforcement agencies and detained for long periods without legal recourse before being unceremoniously deported. Finally, on her return to Sri Lanka, the migrant may further face stigmatization as communities assume she led a promiscuous life abroad. Others find that their husbands have taken on mistresses, become alcoholics, and have not tended to the family's education, housing, or medical needs (Abu-Habib 1998, pp. 53-55; The Economist 1993, p. 40).

9. While access to financial services in Sri Lanka has improved, households in rural areas still have less access to formal financial services in general and remittance products in particular. Many banks claim to be present in every corner of the country, but large regional disparities exist in the distribution of financial services (Figures 1.6-1.7). These differences exist both in terms of transactions and in branch density, with clients in economically weaker regions having a disproportionately lower level of financial services.

10. These figures exclude pawning centers (188) and student savings centers (328).

11. State banks have taken the initiative to encourage savings with enhanced interest rates for foreign currency accounts and other loan benefits (Malsiri and Jayasundere 1999). The People's Bank offers two low-interest loan schemes. One, called Siyatha, offers credit at an interest rate of 16 percent to sudden returnees from war-torn Gulf countries of up to SL Rs 250,000; the loan can be used for purchasing land, building a house, or for investing in self-employment activities. The second scheme, called Videshika, provides credit to all migrant workers to meet costs of employment or to purchase assets. This scheme also offers a credit ceiling of SL Rs 250,000 at an interest rate of 16 percent. Both credit schemes are subsidized by the SLBFE, which pays 9 percent of the interest on Siyatha loans and 7 percent on Videshika loans. The Bank of Ceylon offers two credit programs to migrant workers. The first is called Ransaviya I, and is used to set up self-employment projects at an interest rate of 16 percent (of which the SLBFE pays 8 percent). The second program is Ransaviya II, which enables Non-resident foreign currency account holders to obtain credit to improve their standard of living at an interest rate of 16 percent (of which the SLBFE pays 7 percent).

12. Society for Worldwide Interbank Financial Telecommunication (SWIFT).

13. This includes drafts/checks drawn on banks of which the settlement of foreign currency is funded by Nonbank money transfer service providers (NBMTSPs) in blocked accounts; and drafts/checks drawn on nonresident rupee accounts and nonresident foreign currency accounts funded and maintained by NBMTSPs with authorized and registered dealers in Sri Lanka of which payments are made to beneficiaries by debiting such accounts.

14. Informal transfers to the region are said to be significant, particularly from countries with large groups of illegal migrants, and countries where the formal banking sector is weak or lacks relations with a particular country. Some observers note that many South Asians shifted their savings and investments from the West back to South Asia-through formal and informal channels-because of uncertainties and anxieties generated by asset seizures and other counterterrorist finance measures introduced after September 11, 2001.

15. The government plays an active role in the process by directly assisting companies to win contracts, as part of its export promotion strategy.

16. Lanka Clear is an organization jointly owned by the Central Bank (20 percent of capital), state banks (28 percent), and local private and foreign commercial banks (52 percent). It operates the check clearing system, the SLIPs, and the U.S. dollar check-clearing systems.

CHAPTER FIVE

Leveraging the Postal Network to Deliver Rural Financial Services

5.1 Introduction

Like the postal systems of many countries around the world, Sri Lanka Post has a dense national network. There are nearly 4,650 branch offices-about 2.8 times the infrastructure of commercial banks (Table 4.8). The rural presence is particularly dense, and in the Northern Province there are nearly 6 times as many post office branches as commercial bank branches (Figures 1.7-1.8). However, this dense infrastructure appears underutilized, judging from the relatively low volume of letters per post office (about 125,000 per year) and very low productivity (125 items of correspondence per year per staff).

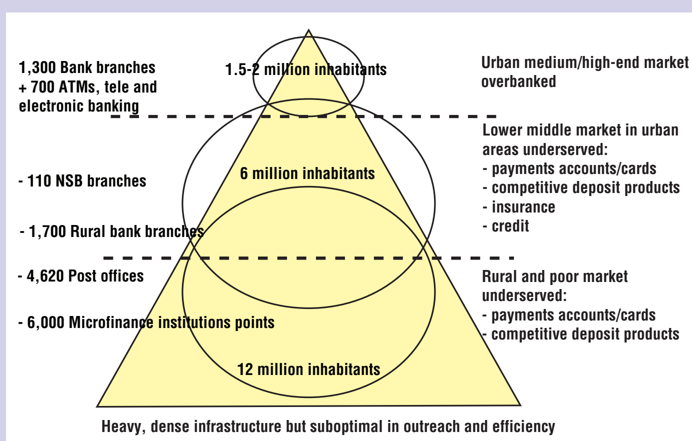
Sri Lanka Post has a long history of delivering financial services, mainly payments and savings accounts. These services constitute a significant part of the workflow of the post offices (and an estimated 30 percent of the retail network revenues), but the processes supporting financial services are outdated and there has not been sufficient maintenance of fixed assets and capital expenditure. Postal financial services remain underdeveloped and the introduction of new financial products has not even been tested.

Although the Sri Lankan financial sector has diversified over the last decade, many market segments remain inadequately served (Figure 5.1). Only a small percentage of the Sri Lankan population, primarily in urban areas, enjoys access to a broad range of sophisticated financial services and makes use of them. The economy remains largely cash based, which suggests that access to basic payment services is difficult. The high amount of cash in circulation and the storing of valuables suggest that the financial sector is not serving the needs of savers. A significant share of private remittances is presumed to flow through informal channels (Chapter 4).

The relatively high penetration of microfinance institutions has extended finance to low-income households, helping them manage their social and economic risks. However, microfinance services mostly are limited to short-term credit. Microinsurance products, for

FIGURE 5.1

Sri Lanka: Suboptimal Outreach of Financial Infrastructure



Source: Boon (2005)

example, cover only the creditor's insurance in case of death. Insurance products have not been popularized and there appears to be a large unmet demand. And very few Sri Lankans have access to a full financial service package from the formal financial sector. Against this backdrop, the government is considering using the postal network as a conduit to expand the reach of basic financial services.

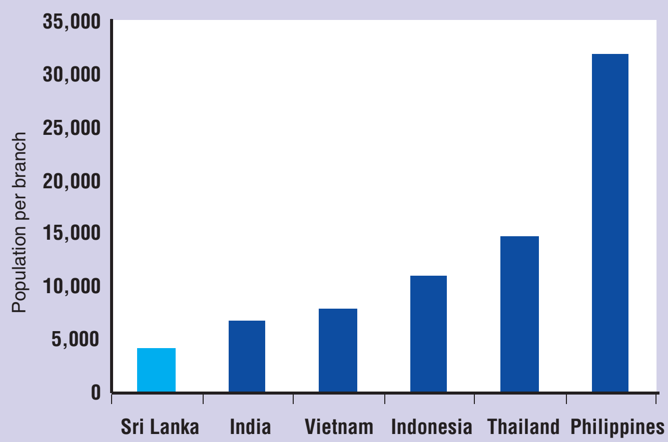
This chapter assesses the performance of Sri Lanka Post and its potential to bridge some of the most critical gaps in financial services provision by using its vast network of offices. Section 5.2 reviews the current status of Sri Lanka Post and Section 5.3 discusses its historical role in the provision of financial services. Section 5.4 examines opportunities for expanding the delivery of financial services through Sri Lanka Post. Section 5.5 presents conclusions and recommendations.

5.2 Current Role and Status of the Postal Network

Compared to other countries in South Asia, Sri Lanka has the densest network of post offices per capita (Figure 5.2), with especially concentration in rural areas. The post office currently delivers to 99 percent of addresses across the country, six days a week, at a uniform tariff. At the national level, it has the densest network of all financial operators (Figure 5.3). Density is attractive to business mailers, for example, who want to communicate with a wide range of people in the most economic manner. Sri Lanka has a relatively high mail demand of about 27 items per capita pre year.

FIGURE 5.2

Post Office Branch Density: Sri Lanka and Other South Asian Countries (population per branch)



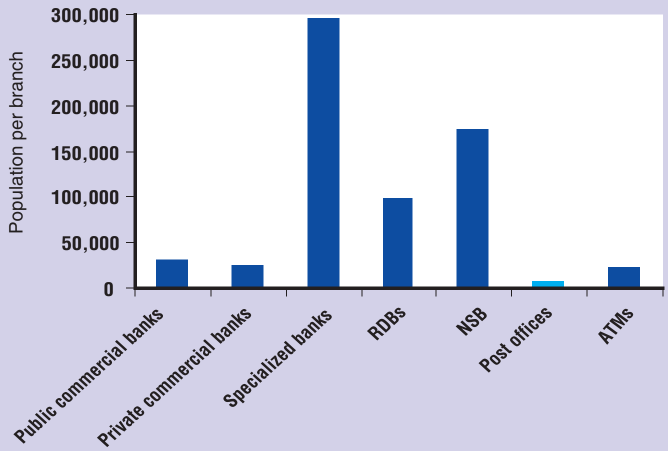
Source: Sri Lanka Post, World Bank, and author estimates

However, the postal service also has significant long-standing problems. Its major weaknesses include the following:

- low perceived quality of service;
- lack of commercial orientation;
- limited capacity for strategic planning;
- poor financial performance history;
- inadequate investment in infrastructure; and
- low staff morale.

Sri Lanka Post has incurred substantial losses for the last twenty years, including a loss of SL Rs 715 million in 2003 (Annex 5). Losses as percent of revenues have fluctuated widely from year to year and reached as high 30 percent of revenues in 1995. These financial problems primarily stem from lack of innovation and marketing of new services and heavy regulation of rates for existing services. Government departments also benefit from some free services, although these have been reduced in recent years.[1]

FIGURE 5.3
Sri Lanka: Density of Financial Operators (population per branch in 2004)



Source: Sri Lanka Central Bank (2004); Sri Lanka Post (2004).

The poor financial performance of Sri Lanka Post has been a significant burden to the Sri Lankan government and has crowded out investments in sector development and network rehabilitation (Table 5.1). Also, investment budgets traditionally have been directed towards expansion of the postal network, while funds for improving its quality, security, and technology remained low. Fortunately, this policy was changed in the early 2000s. About 160 offices have been equipped and connected with personal computers, data communications, and other information technology. New services have been offered to the local communities, such as access to the Internet. Nevertheless, substantial new investments are necessary for further upgrades to the postal network, along with a profound redesign of business processes for collecting, processing, and sorting out mail.

TABLE 5.1
Financial Performance of Sri Lanka Post 1992-2003 (SL Rs millions)

Category	1993	1994	1995	2002	2003
Operating income*	1,130	856	1,321	2,145	2,311
Profit/loss	(42)	(665)	(405.8)	(622)	(715)
Loss per post office (SL Rs thousands)	(10)	(164)	(98)	(140)	(154)

*Excludes value of free services, which in 2003 was 7.7 percent of actual revenues.

Source: Sri Lanka Department of Posts. Various. Financial Statements.

Strategic planning, marketing, and market research for improved postal services remain at an early stage. As a consequence, there are no major initiatives to identify opportunities for expanding business and prioritizing investments. Some technology-driven innovations have occurred, including Internet cafes, telemail messages, facsimiles, and e-money orders. However, Sri Lanka Post is becoming less competitive with the private sector in several areas. It has about 1 percent market share in express mail (a fast-growing business line) and low presence in the parcel delivery market segment. In the absence of strategic planning, the post office has foregone opportunities for expanding revenues from financial services.

To become a competitive, customer-oriented organization, Sri Lanka Post needs, among other things, management information systems (MIS), better staff morale, and increased efficiency. Symptoms of low staff morale were evident in late 2004 when several postal workers were caught misappropriating overseas parcels. The post office had a total of 19,578 employees in 2004, a considerable number relative to total mail and number of postal offices. Most employees fill low-level positions and there is a corresponding lack of staff with specialized skills, including specialists in information technology. Due to hiring freezes implemented over the last decade, the average age of the staff is in the mid-40s, which implies that during the coming decade a considerable number of staff will be retiring. This creates opportunities for introducing new human resource policies and attracting a skill mix that will be more supportive of a modern post office organization.

The growth of the telecommunications sector has not been mirrored in the postal sector. While the telecommunications sector has grown exponentially during the last decade, in part because of the transfer of management to the private sector and the award of licenses to new operators, the institutional structure of Sri Lanka Post has not changed since posts and telecommunications were split into two departments in 1980. The government of Sri Lanka fills the combined roles of owner, operator, and regulator, and in fact Sri Lanka Post formally remains the Department of Posts of the Ministry. The rigidities of the civil service regime hinder the post's commercial responsiveness.

5.3 The Role of the Postal Network in Providing Financial Services

Sri Lanka Post has a long and rich history in providing financial services, primarily savings accounts and payment services, through its large national network of post offices (Annex 6). Indeed, the density of post offices in the rural areas surpasses considerably the density of commercial bank branches (Figures 1.7-1.8). Services related to financial transactions represent more than 30 percent of the total volume of over-the-counter transactions at post offices. Most of the financial services offered by Sri Lanka Post, however, have seen little or no change since their introduction, which was in some cases more than 100 years ago. This means in practice that these financial services are provided on a fully manual and paper-based system, which results in delays, labor intensity, and a relatively high degree of inaccuracy. Some new (small-scale) initiatives applying information technology are promising though.

Postal Savings

Currently more than 4.8 million people (close to a third of the adult population) have a passbook savings account in a post office branch. About 80 percent of these accounts are presumed to be dormant.[2] This would suggest about 950,000 active savers, with two or three deposits or withdrawals per year and an average balance of US$75-100. The group of active clients appears to include small rural savers and poor, urban senior citizens who do not have easy access to other financial outlets and continue to use the post offices as a matter of tradition.

Originally, the post office operated its own savings bank, but this was amalgamated with other state institutions into the National Savings Bank (NSB) in 1972. The NSB has continued to maintain a statutory agency relationship with Sri Lanka Post, but the share of postal savings as percent of NSB savings has fallen dramatically from more than 25 percent in the early 1970s to 5.3 percent in 2002 (Table 5.2). NSB, however, also has a considerable number of dormant accounts.

TABLE 5.2
Postal Savings

	1995	2000	2003	2004
Postal savings accounts (SL Rs mln)	4.3	4.7	4.9	5.1
Total NSB savings accounts (SL Rs mln)	11.6	12.9	13.7	14.2
Post Office as percent of NSB accounts	**37.2%**	**36.4%**	**35.8%**	**35.9%**
Postal savings balances (SL Rs bln)	7.2	7.4	8.2	8.5
Total NSB balances (SL Rs bln)	60	105	161	180
Post Office as percent of NSB balances	**12.0%**	**7.1%**	**5.1%**	**4.7%**

mln = millions; bln = billions.

Source: Sri Lanka National Savings Bank (NSB). Various. Annual Report.

The continuous decline in the market share of postal savings can be largely attributed to the little emphasis placed by NSB on mobilizing savings through the post offices. There are no products geared to the needs of the postal network clients. NSB focuses on promoting services through its own branches (approximately 112), which are mainly located in urban areas. In the late 1990s, NSB established 7 postal banking centers (as bank branches in post offices), but these are based in some of the larger post offices. In late 2004, NSB and Sri Lanka Post agreed upon a savings campaign through the post offices that drew as many as 500,000 new deposit transactions.

The remuneration for the exclusivity and all operations performed by the postal offices is based on an outdated price-indexed formula, which is unlikely to recover the fixed and variable costs of providing services for NSB. This formula results in a fixed fee of around US$100 per post office per year and provides no incentives for more operations, better customer service, or product development. The remuneration inadequately expresses the strategic value of the postal network and is not cost oriented. This would suggest that Sri Lanka Post is providing an agency service on behalf of NSB at a loss.

Despite its historical tradition, the agency agreement between NSB and the post office is currently insufficiently productive. The remuneration formula limits the scope of Sri Lanka Post for expanding revenues and improving financial performance. At the same time, NSB is facing the challenge of modernization and is not ideally positioned to improve the operations at post offices, provide staff training, or create incentives. NSB has identified the need to upgrade its own technology since it continues to lag significantly behind commercial banks in the provision of retail financial services. Its branches are not interconnected and are not linked to a central database and transaction platform. Transactions are mostly processed manually and eventually entered in a back-up computer system. The origination of deposits through the postal network is relatively insignificant for NSB, and it regards the quality of service at post offices as inadequate compared to its own levels of service. As a state savings bank with a narrow range of services,[3] NSB would not appear to be the most suitable partner for a modernizing Sri Lanka Post that wants to introduce a wide range of innovative financial services through its dense network.

Payments Services

The post office fulfills a valuable function in the payments system of Sri Lanka. The total value of money orders processed in 2004 was SL Rs 10.8 billion, of which less than 1 percent was international money orders. In addition, the post office processed about 15 million other transactions such as pensions, social benefits, collection of utility bills, collection of spot fines, and fees for radio and television licenses. Although these transactions are a small part of total operations conducted by the post office, they represent at least 30 percent of over-the-counter transactions.

Sri Lanka Post is not connected to the automated clearing house (Lanka Clear) and does not qualify to become a member since it is not a licensed bank. However, postal payment services are seen as a valuable service, and at least two private banks have expressed an interest in expanding the flow of payments through the postal network. From the banks' perspective, this would help to improve cost efficiency and outreach. As part of the e-Lanka program, Sri Lanka Post has recently launched e-money orders (e-MO) as an on-line payments instrument to support e-commerce transactions for those who do not have a credit card. The e-money order could be expanded to an on-line payments instrument for individuals (Box 5.1).

BOX 5.1

The e-Money Order: Sri Lanka's Alternative Credit Card

The electronic money order (e-MO) system, launched in March 2004, is an important addition to the financial services of Sri Lanka Post. e-MO is Sri Lanka's first virtual cash system: it allows postal customers who cannot afford or do not have access to credit cards a fast, reliable, and convenient way to transfer funds. This project is still at a pilot stage, but the government hopes to scale it up nationwide in the near future.

Source: Information and Communication Technology Agency of Sri Lanka.

Remittances

The postal service also provides traditional cross-border remittance instruments through paper-based international postal money orders. In comparison to remittance products offered by banks and money transfer agents, the paper-based postal money order fares poorly, except for its outreach through the branch network. Despite this outreach, the market share of Sri Lanka Post is estimated at only 0.6 percent (Table 4.2).International postal money orders take up to 4 weeks to reach the recipient, and senders' fee range between 2 and 5 percent of total value. New initiatives are underway to improve the service including possible connections with international payment networks. Several of the major Sri Lankan banks also envisage a role for the postal network to support the "last mile" delivery of cash for their remittance products by linking the postal network with the bank's processing center.

Insurance, Unit Trusts, and other Financial Products

Sri Lanka Post has not yet tested the introduction of nontraditional savings products, even though there is a large untapped market. Sri Lanka's insurance penetration is very modest. Total insurance premiums and life insurance premiums were 1.3 percent and 0.6 percent of GDP, respectively, which compares unfavorably with other countries in South Asia (Chapter 1). The total number of life insurance policies was estimated at 161,000 at the end of 2003. These figures suggest that access is very limited given general household interest in insurance products. Although specific data for Sri Lanka is not available, a survey of rural households conducted in India in 2003 revealed a high demand for insurance products. Of surveyed households, 73 percent indicated life insurance was their preferred product (World Bank 2004a). "Bancassurance" as a means of distribution has barely been tested in Sri Lanka. Sri Lanka Post has concluded agency agreements with several of the smaller insurance companies to collect premiums. The postal network, however, could be more actively used for selling insurance products and contribute to the industry's development and provision of new risk management tools for households. One approach could be to launch innovative, yet very simple "sure savings" plans that jointly promote savings and life insurance.

The securities market has not been popularized. Access to securities, including unit trusts, is very limited in Sri Lanka. In the longer term, the development of these products and greater access to them would be desirable to strengthen the function of capital markets as an alternative to traditional savings. The postal network could function as a distribution channel and thus as a way to popularize unit trusts and other nontraditional savings products.

The strengths, weaknesses, opportunities, and risks (SWOT) of Sri Lanka Post in the delivery of financial services are summarized in Box 5.2 below.

5.4 Unlocking the Potential of the Postal Network

Most banks in Sri Lanka view the provision of formal banking services in sparsely populated rural areas as a low priority. Expansion of physical infrastructure to improve outreach is a low priority because sizable initial investment costs and modest business volumes prevent fast recovery of investment costs. The postal network's extensive branch network could help fill this gap. There are substantial opportunities, extensive interest from banks, and several initiatives from Sri Lanka Post to expand its role in the provision of financial services. Presently, however, the post office is trapped in a "vicious circle" of low investments that result in antiquated services and declining market share and prevent it from unlocking its potential.

BOX 5.2

SWOT Analysis of the Postal Financial Services System in Sri Lanka

Strengths

Has offered postal financial services for more than 125 years.

Dense branch network with nearly 4,650 post offices nationwide.

Higher density of post offices in rural areas than commercial banking system.

Mobilizes deposits as small as SL Rs 5; deposits totaled SL Rs 8.5 billion at the end of 2003.

Fulfils a valuable function in the payment system by processing money orders, pensions, social benefits, electricity bills, and other transactions.

Rural communities trust the post offices.

Post has never defaulted in payments to depositors.

Weaknesses

Stagnant growth in number of accounts and deposits mobilization. Since 1971, continuous decline in market share (from more than 25 percent of NSB savings to 5.3 percent in 2002). 80 percent of accounts are presumed to be dormant.

Transfer services remain stable in a growing market.

Agency arrangements with NSB are underdeveloped. Potential of savings mobilization and retail banking underutilized.

Lack of marketing, banking, and technology skills at management levels. Risk control and management accounting virtually nonexistent.

Inefficient, paper-based, manually processed operations. Level of computerization at a nascent stage.

Heavy reliance on low-skilled staff, limited training opportunities, and no performance incentives for staff.

Operates as a government department, with bureaucratic management and procedures.

Opportunities

Postal banking offers the potential to increase savings propensity and provide new banking and other financial services to the rural communities.

With proper marketing and improved efficiency postal banking can capture 15 percent-25 percent of the incremental growth of domestic household deposits.

In the medium term, there is potential to offer products such as life insurance and unit trusts through the post offices (linked to existing savings/payments accounts).

Potential for rapid increases in transfer operations, including direct credit transfers (salaries) into personal accounts and application of chip card technology for small-value payments.

Threats

Complexity of overall postal reform distracts management attention and dilutes priority from implementation of a Postal Financial Services System.

Poor labor conditions.

Insufficient capture of new market share and inadequate profits make Sri Lanka Post growth unviable because of high up-front cost to improve post office interior, technology, and staff capability.

When defining a comprehensive modernization strategy for Sri Lanka Post, there is a good rationale for the government of Sri Lanka to promote the postal network more actively as a distribution channel for financial services, especially in rural communities. More specifically, linking the postal network more closely to the financial sector could help achieve the following policy objectives: (i) expand the formal financial infrastructure for remittances; (ii) offer those living in remote and rural areas and low-income groups with convenient access to a wide range of financial products complementing the existing formal financial sector, which is likely to maintain its focus in urban areas; (iii) help popularize nontraditional savings products (including life insurance); (iv) facilitate the transformation from a cash society to a cashless payment system and thus support financial stability and efficiency; and (v) provide new sources of revenue to the postal network, which will help improve its financial performance. In addition, an improved postal infrastructure for Information and Communication Technology (ICT)-based financial services will offer a platform for the provision of other ICT-based services, such as e-government, e-learning, and e-commerce, all of which could help close the "digital divide."

Indeed, post offices around the world, including Asia, are rapidly transforming and diversifying their businesses by offering new services that capitalize on their large branch networks and good reputation as a public entity. These services include more sophisticated financial products-such as electronic money transfers, banking activities, sale of insurance, pensions, and mutual funds-as well as e-government services and e-commerce.

International experience has demonstrated that there is no single business model to enhance the postal network potential as a distribution outlet for financial services. However, there are some important prerequisites to a successful modernization agenda:

- Coordination of cross-sectoral policies: Consistency among postal, banking, and ICT sector policies, including on universal and rural access, will facilitate the optimal use of the postal network as a portal for delivery of various services. The postal network's mandate on universal access will impact its cost structure. If fixed costs are high and fiscal support is to be minimized, it would be consistent for the government to encourage the use of post offices as a platform for the provision of financial, communication, and government services.
- Commercialization and private-public partnerships: Commercial and marketing orientation will be critical to the successful introduction of new services. The postal incumbent and the financial services institution will negotiate, for example, a service agreement allowing the bank to access the postal network at a "fair" cost. Agency agreements are difficult to negotiate because the postal incumbent is rarely in a position to charge access to its network on a cost-oriented basis. This access system usually calls for rapid capacity building in cost-accounting expertise for the postal operator.
- Corporate strategy, business plan, and profitability: To develop an economically viable postal retail network as a portal for delivery of various services, the preparation of a detailed market analysis, business plan, and investment return analysis will be necessary. While these vital decision-making tools are commonly used by the private sector, they are rarely applied by postal public operators.
- Capacity building for postal staff: Private sector interest in the postal network is more likely if staff are qualified and experienced. This often involves changes in the skill mix of post offices and the provision of extensive staff training.

BOX 5.3

Lessons from Successful Postal Financial Systems: Case Studies from Brazil and China

Brazil. With no historical legacy in postal financial services, Correios (Brazil's Post Office) benefited from a strong government policy agenda that sought to improve access to finance and that used direct and indirect incentives to attract new operators. The government modified the regulatory framework to allow Correios to become a "correspondent" of a bank. Correios selected, through a transparent bidding process, a strategic partner (Bradesco, the most important retail bank in Brazil) and launched Banco Postal in 2002. Its range of services spans from traditional giro and savings accounts to payments and remittances and has also included microfinance since 2003. Building effective and strong partnerships between state-owned postal operators and private financial institutions has proven to be a complex and cumbersome process. In the case of Brazil, seven years passed between the first feasibility study and the actual launch of postal financial services. Today, Banco Postal is a leading player in retail banking in Brazil. Its success arises from a clear strategic vision, a new regulatory framework to reflect government policy, a balanced contract with the strategic partner, and substantial investments in the network (in particular in information systems) in order to offer quality services.

China Post. China Post has operated a Postal Savings Bureau (PSB) since April 1984 and it has become a key source of revenue for the postal service. Postal savings are provided at nearly 40,000 post offices, which gives the PSB approximately the same number of locations as China's entire bank branch network (37,000 branches). Postal savings have grown rapidly since their operational launch in 1986 and accounted in 2002 for 189 million accounts and more than US$65 billion in deposits, representing a market share of 8 percent and making the PSB the fifth largest deposit taker in China. The Postal Savings Bureau operates an ATM network and accounts linked to debit cards ("green cards"). It also provides 90 percent of private remittances in China (through postal money orders). The volume of transfer operations has grown quickly and amounted to 210 million transactions in 2002, that is, approximately 15 percent of the total volume of cashless payments transactions in China. China's postal network also plays a role in international remittances. It provides traditional international postal money orders, Eurogiro, and Western Union services.

China Post has embarked on the development of innovative services such as life insurance, payroll services, mutual funds, and credit. Because China Post does not have the required license to manage such products, it has sought partnerships with various financial institutions. The competitive edge of China Post rests on its large number of postal outlets, low charges, convenience, reliability, and long service hours.

Source: Authors

Among other countries, Brazil and China present some interesting experiences in the development of postal financial services from which Sri Lanka could draw valuable lessons. (See Box 5.3.)

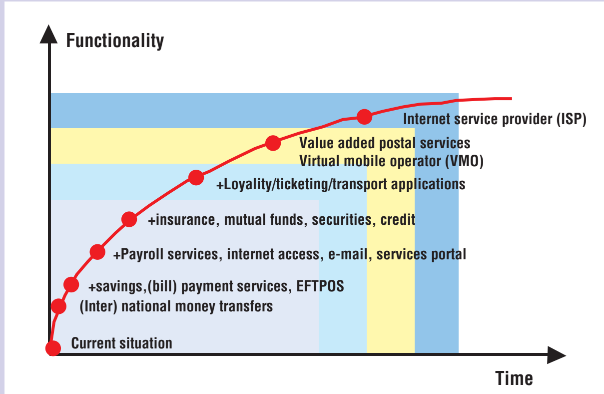
Based on other international experiences and regional trends, the following guidelines should be considered when defining the modernization strategy of Sri Lanka Post and exploring its potential role as a distribution channel for financial services:

- The policy agenda for Sri Lanka Post should be consistent with other sectoral policies for expanding access to financial services and ICT.
- Competent, licensed, formal financial institutions should develop the postal financial products and assume the risks, whereas the post office network should play an intermediary or front-office role (taking charge of sales promotion, cashier operations and distribution of information, cards and other instruments). To this end, Sri Lanka Post would have to develop partnerships with financial institutions and connect itself institutionally, commercially, and technically.
- To achieve cost efficiency and economies of scope and scale, financial services would be provided by postal staff, preferably at universal counters, rather than deploying bank officers at post offices.
- Postal financial services would be predominantly liability-based and the nature of these products (mainly savings and payments cards/accounts) should exclude the involvement of post office staff in individual credit risk. Other products could be subsequently introduced including insurance and unit trusts.
- The institutional concept would require application of advanced technology. Terminals at post offices would be interconnected through telecommunications networks allowing voice, data, and image communication. The technology, eventually including cards, terminals, and communications, can be seen as a basic modern information infrastructure that could be utilised for multiple applications for front-, mid- and back-office, including management information systems for the postal services, track-and-tracing systems for mail items, e-mail and internet services, and e-commerce.
- The postal network would not be linked on an exclusive basis to one financial institution since this would not support an optimal utilisation of the public network. There is a need to phase out the exclusive arrangement with NSB.
- The network and applications should be rolled out on a gradual basis, thus allowing the organization and its staff to move along a "learning curve" (Figure 5.4). The network development should start by upgrading and expansion of existing business flows, in which Sri Lanka Post has a certain amount of competence and turnover. Entering new markets at the outset would possibly meet much higher hurdles and requirements.

The guidelines above suggest that the first phase of reform (about 2 years) could be initiated with several small-scale demonstration projects. These pilots could be instrumental in providing real-life lessons and preparing the institution for a nationwide rollout. These pilots would also help measure the demand of financial services by rural communities. They would facilitate the dialogue with stakeholders by illustrating that Sri Lanka Post is capable of innovating and delivering modern financial services. The pilot would need to focus on the expansion of basic financial services where the post office already enjoys some experience. Within a relatively short period of time, Sri Lanka Post could register a positive cashflow for these business areas.

FIGURE 5.4

Sri Lanka: A Learning Curve for the Post Office, its Partners, and Clients



Source: Boon (2005)

Based on existing demand, the pilot phase could focus on the expansion or introduction of the following financial services:

- Upgrading the international money order and transfer systems, introducing a faster and broader range of migrant remittances instruments, and linking them to postal networks and systems elsewhere in the world (through the Universal Postal Union and Eurogiro Networks) and also connecting them to banks that are involved in remittances.
- Introducing deposits (sight and time deposits accounts). Sri Lanka Post should under the current agreement with NSB consider the development of one or two new postal savings accounts that provide an "anytime, any office" banking facility. This would require an agreement with NSB on product specifications and conditions for providing such services.
- Issuing payment cards backed by customer deposits. Initially, these should be debit cards that facilitate electronic funds transfer at point of sale. These cards should also be used at post offices for bill payment.
- Expanding the collection services to various institutions (such as public utilities) could help increase Sri Lanka Post revenue in the short term. The dense post office network can be used as a low-cost channel for collection of bills from citizens who do not have an account or established relationship with a bank or financial institution.

The pilot could also be used to test the market and prepare the post office for a broader scale of services. The postal system already has access points and could build the communications infrastructure to interconnect government applications that are currently being developed (such as a tax collection system). In fact, Sri Lanka Post would be able to deliver access to e-based government services, such as account-based payments of pensions, benefits, wages, and salaries; issuance of various certificates and business and personal documents by the local and central government; and collection of tax payments, fees, and other dues for central and local government.

The pilot program could also be used to test access points and integrated support services for e-commerce, especially for servicing the requirements of micro and small enterprises and small-scale dealers, which comprise a large part of the economic activity in Sri Lanka. Such services could include e-mail accounts and access to the Internet in areas where there are no commercial providers. Internet access could help expand access to information and electronic markets. This would require coordination with the ICT Agency of Sri Lanka which is managing the e-Sri Lanka program.

The second phase of reform could focus on the rollout of the piloted services nationwide and the introduction of new financial services (3-6 years). The ICT infrastructure and applications could be further expanded, thus enabling the post office to become an access point for a broad range of financial services and other ICT-based services. The exclusive partnership with NSB on provision of deposit and savings accounts would need to be phased out so that new partnerships could be developed with a more diverse group of financial institutions offering a wider range of products.

Sri Lanka Post could become over time an attractive channel for insurance companies to sell policies and collect premiums. Insurance companies have shown interest in affordable, easy-to understand life-insurance products which can be sold over the post office counter. Moreover, insurance companies could ally with banks to offer a full range of financial services. The concept of direct writing or "bancassurance" has not been tested in Sri Lanka, but if Sri Lanka Post joins with one or more banks and an insurer, it could provide ground-breaking access to small-value basic financial services. As a retailer of services, the postal network could popularize access to mutual funds and unit trusts, which could become important alternatives to traditional savings instruments that are poorly remunerated. India Post, for example, has already partnered with financial institutions to sell unit trusts through its network. The potential division of tasks and responsibilities between Sri Lanka Post and other financial partners is summarized in Box 5.4.

BOX 5.4

Division of Roles, Responsibilities and Tasks between Sri Lanka Post and Partner Financial Institution

SRI LANKA POST

Marketing and sales

- Promotions in post offices (posters, displays, brochures)
- Opening of accounts (intake of application forms)
- Advice and information on product features
- Cross-selling between postal and financial lines

Operations

- Front office operations, cashier/teller
- Acceptance and handling of forms and cash, and reporting to bank on transactions

Staff

- Recruits and employs staff at post office counters
- Manages and controls staff
- Counterpart staff for cooperation with bank

Finance

- Charges for work performed on a full-cost basis
- Charges for sales performance
- Charges for promotions in post offices
- Charges for investments specifically made to provide financial services
- Charges for network availability

PARTNER FINANCIAL INSTITUTION

Strengths

- Marketing and sales
- Marketing strategy and planning
- Product development, product definition
- Communications campaigns in public media and direct mail
- Pricing for clients/end-users

Operations

- Back office operations
- Application of information technology
- Determination of procedures/processes

Staff

- Determines staffing requirements for post office clerks
- Develops and provides training
- Develops performance-measurement instruments
- Provides incentive schemes

Finance

- Remains fully responsible for asset and risk management of funds mobilized or extended through the post office network
- Determines accounting processes and systems
- Compensates Sri Lanka Post for costs made for promotions, administration, sales, processing
- (Co)finances investments in the post offices related to the execution of financial services.

Source: Authors

Preparing Sri Lanka Post for New Financial Partnerships

Currently, the gap in operations and management culture between Sri Lanka Post and private financial institutions is substantial. Entering into new partnerships will involve considerable organizational changes within Sri Lanka Post.

During the pilot or first phase of reform, institutional changes could focus on the most critical managerial, financial, and technological issues, creating the basis for successful small-scale demonstration projects and laying the foundations for more profound changes and more ambitious partnerships (Box 5.5). As a first step, Sri Lanka Post will have to strengthen management functions that are needed for providing financial and other services. This will require the formation of a management team responsible for all financial service business units and that will have the authority to introduce new products. The current structure is not geared to commercial business and has no identifiable officers with clearly delineated responsibilities for products, services, and their performance.

The second stage of reform-national rollout and introduction of new financial services-will require deeper institutional and human resource changes (Box 5.5). The current structure of Sri Lanka Post as a Department of the Ministry of Posts, Telecommunications, and Upcountry Development constraints its operational autonomy. The Ministry of Posts appoints the Postmaster-General and other key staff. The general management of the Posts is focused on day-to-day operations and reports to the ministry for policy and investment issues. This bureaucracy is a potential obstacle to the development of efficient and sustainable commercial operations. Sri Lanka Post should be given greater autonomy to manage its business and be held accountable for achieved performance. One option would be the transformation of Sri Lanka Post into a state-owned corporation with greater flexibility to manage staff and investments. A number of post offices around the world have already moved in this direction. These reforms will need to be accompanied by extensive staff training and hiring of specialists in critical areas. The high average age of staff presents a unique opportunity to change the skill mix according to the needs of a modern post office.

Furthermore, there must be improvement of financial accounting and management information systems that will gather vital information and promote greater focus on cost recovery and commercially sustainable operations. As a government department, Sri Lanka Post has recorded operational losses for the past 20 years. Its profit and loss accounts are prepared according to government accounting standards, and recent financial statements are not available due to the amount of paper-based processing of information. There is no balance sheet nor a valuation of assets allocated. In addition, the current management practice, in which all operations are manually processed through segmented counters and with a large variety of forms, is not only inefficient but also includes a high risk of inaccuracy and fraud. During the first phase of reforms, Sri Lanka Post could arrange for an external financial audit and focus on the preparation of detailed and transparent financial accounts that would show the impact of revenues and expenditures by new services. In subsequent stages and supported by additional IT investments, Sri Lanka Post should seek to fully automate its accounting systems and develop a detailed cost allocation model that would permit the implementation of product profitability analysis.

Lastly, it will be necessary to formulate a comprehensive IT strategy for Sri Lanka Post. Good IT will enable rapid growth in the quality and volume of business and will lay the foundations for the expansion of postal, financial, and other communication services. Data processing services and technology utilized by Sri Lanka Post are still very limited.[4] This process should start with the formation of a small IT unit responsible for managing the existing IT infrastructure and formulating a medium-term IT development and maintenance strategy. Some IT investments will be required in the short term to support the implementation of several small-scale demonstration projects.

BOX 5.5

Expanding Financial and Communication Services of Sri Lanka Post: Short- and Medium-Term Program

Strategy	Activity
Development of comprehensive strategy for Sri Lanka Post and implementation of pilots (1-2 years)	◆ Development of comprehensive strategy ◆ Establishment of financial services business unit ◆ Establishment of financial accounts ◆ Business process redesign in selected postal counters ◆ Establishment of IT unit ◆ Development of medium-term IT strategy and implementation of initial IT investments ◆ Establishment of small-scale demonstration projects ◆ Preparation for wider partnerships agreements
Implementation of comprehensive strategy (3-6 years)	◆ Establishment of new public-private partnerships ◆ Implementation of new marketing and business processes based on ICT and training of staff ◆ National rollout and further expansion of financial services ◆ Introduction of new e-government, e-learning, and e-commerce services

Source: Authors

5.5 Conclusions

With nearly 4,650 outlets, the postal network is the most extensive service infrastructure in Sri Lanka. No other national network can better provide standardized services, ranging from postal (mail) to financial services, in particular payment and savings accounts. Although the Sri Lanka Post network presents many attractive features, it is beset with problems. Sri Lanka Post has recorded operational losses for more than 15 years and has accumulated a serious backlog in maintenance of fixed assets and capital expenditures. It appears to be trapped in a vicious circle of deteriorating level of service, weakening income, lack of funding to modernize, and dissatisfied customers. While Sri Lanka Post is underutilized and its financial performance imposes a burden on the government, the postal network can be put to new use as infrastructure for financial services. There are considerable gaps in the financial market, which can be explained by a lack of low-threshold access to a convenient and efficient package of basic financial services. The dense and uniform postal network, especially in rural communities, can play an important role in narrowing the access gap.

There is a need to develop a comprehensive modernization strategy for Sri Lanka Post that will be consistent with postal, banking, and ICT sector policies in order to promote optimal use of the postal network. Sri Lanka Post can be turned around into a portal for delivery of various services, including more active promotion of financial services and correspondent banking. This process could start with improvements to existing and priority business lines (payments, remittances, and deposits) and move up a learning curve to a wider range of financial products (such as insurance and eventually longer-term savings products) that have not been popularized with consumers. The optimal use of the postal infrastructure calls for a competitive process and a gradual phasing out of the exclusive arrangement with NSB. At least two private banks are exploring the possibility of expanding their services through the postal network. An advanced ICT infrastructure to deliver financial services would also enable the post office to become an access point to a broad range of e-government, e-learning, and e-commerce services, thus helping close the digital divide. The development of new financial and communication services should also be seen as a major opportunity for Sri Lanka Post to improve its financial performance.

Partnerships with private financial institutions will need to be carefully engineered if they are to be successful and meet commercial, economic, and public interests. Success will entail important organizational changes, given the current culture and structure of Sri Lanka Post. The modernization program can be launched with some pilot projects to expand priority financial services to the rural areas (such as payments and remittances), and can be supported by small but fundamental managerial, technical, and financial changes. A national rollout of these services and introduction of new products and business lines will require deeper organizational and human resource changes, and sizable IT investments.

Notes

1. Until 1997, all government departments and certain agencies had access to unlimited free postage. Foregone revenues resulting from this policy amounted to about 15-20 percent total revenues. This privilege, however, has been partially eliminated in recent years. The value of free services was estimated at 7.7 percent of total revenues in 2003.
2. With 2 million transactions per year only, and an average account balance of US$11.29 (down from US$30 in 1995), it seems that a large number more than 80 percent) of accounts should be presumed to be dormant.
3. NSB offers limited products to its retail clients. It is largely a savings bank that does not widely offer payment products, although it is involved in bill collection, transfers, and issues cards. It does not offer consumer credit, insurance, or mutual funds, and plans to broaden the product base are at an early stage. About 83 percent of its deposits is used to finance the government. Another 7 percent is used for wholesale lending and another 4 percent for housing loans.
4. Existing IT largely comprises personal computer terminals in some 120 larger post offices that are connected through dialup lines. The terminals are used by clients for "community locale" (Internet access). The application and implementation for e-money orders were developed by the University of Colombo.

CHAPTER SIX

Conclusions and Policy Recommendations

Improving access to financial services for households, small businesses, and farmers presents numerous challenges but also plenty of opportunities. In Sri Lanka, small businesses remain highly dependent on state financial institutions and semiformal institutions; such dependence makes the businesses vulnerable to shifts in government policy and donor support and restricts their growth potential. Inadequate access to finance has restricted opportunities for enhancing agricultural productivity and improving the livelihoods of small farmers. Most households have only limited access to the wide range of financial services available.

For the most part, government policies for addressing uneven access have focused on state ownership of financial institutions, subsidizing or controlling interest rates (especially in agriculture), and, at times, debt forgiveness programs. Despite the good intentions of government, these policies have not built the conditions for the market to expand services to underserved groups and have often exacerbated market misconceptions that some groups (such as small farmers) are not creditworthy. Responding to these challenges by establishing a new SME bank will duplicate the extensive infrastructure of public financial institutions. In addition, such a bank would likely face the same governance constraints that have undermined the performance of other public banks. While this report does not attempt to cover all challenges in access to finance and the full range of potential market and institutional solutions (in particular microfinance), it highlights numerous opportunities for promoting higher financial inclusion and points to the need for a multipronged approach to address current gaps and serve the diverse needs of households and businesses. As noted earlier, analytical work undertaken by other development partners in the microfinance area complements the findings of this report.

Encouraging the formal financial sector to move down market entails a concerted effort by the government, the banking system, and the business community. There are several areas where public interventions could encourage private banks to market their services to smaller customers. First, public policy should concentrate on developing a friendly environment for lending through a stable economy and a supporting legislative and regulatory framework, in particular strengthening creditors' rights. Recognizing that much of the commercial banking system remains comfortable with its corporate and consumer finance business and that entering new market segments is risky, the government could motivate banks' participation into higher-risk markets by defraying their cost of entry (for example, through partial credit guarantees). In parallel, the government and financial institutions could jointly develop new financial products better suited for small enterprises such as credit scoring, reverse factoring, and other export-oriented products. Furthermore, government and financial institutions could continue their joint efforts to modernize the Credit Information Bureau in order to mitigate market information asymmetries and collaborate with the business community in the training and education of small entrepreneurs.

The proposed initiatives would reorient government efforts from direct market participant to market facilitator. In this vein, the government should reevaluate whether there is a need for a new first-tier SME bank. Rather, it could consider the establishment of a small and lean second-tier (apex) institution that would focus on promoting financial market development for underserved customers, a function that CBSL has traditionally played. The rationale for this approach becomes stronger if it forms part of a longer-term strategy to gradually disengage from first-tier banking. Following a long and unsuccessful tradition of state participation in the banking system, some countries in Latin America have withdrawn from first-tier development and commercial banking and refocused on a market facilitator role, often through a second-tier development institution. Mexico, for example, is closing some of its first-tier development banks and converting others into second-tier institutions. Peru also closed its first-tier development banks in the early 1990s, following a hyperinflation period, but established a second-tier development financial institution (COFIDE) that has helped to develop new financial products, more recently export-financing instruments.

Improved incentives and a friendlier lending environment need to be accompanied by a stronger commitment from private commercial banks to allocate more human and financial resources to lending for small enterprises. As part of this commitment, commercial banks could partner with the government in disclosing more detailed information to the market on lending patterns in underserved markets. If deemed necessary, current banking legislation already provides the legal basis for CBSL to require disclosure of lending patterns.

Besides downscaling formal financial institutions, other complementary instruments need to be developed, especially in agriculture. The agricultural sector is exposed to higher risks and price volatility and its small producers are scattered, which raises borrowing transactions costs. Linking credit to agricultural supply chains can help mitigate market information asymmetries and transaction costs, but supply-chain finance in agriculture has not been used to its full potential. With the exception of tea, multiple layers within supply chains weaken the links between small producers and markets. A robust supply chain is necessary to make its participants creditworthy and link financing through it.

Although a few initiatives are underway, there is a formidable potential for the government and other stakeholders to help improve coordination of agricultural supply chains and link new finance mechanisms through them, especially within sectors offering high value addition and strong growth potential. Among the new financing tools, warehouse financing schemes for major nonperishable commodities (such as tea, pepper, and paddy) could play the dual role of helping to stabilize post-harvest prices and supply additional lending to small producers. The establishment of value added centers could integrate primary producers to product markets and financial institutions. In addition, agriculture service centers could open new opportunities for linking small producers to a wide range of supporting services, including financial services. In the fruits and vegetables sector, the government could further promote financing structures for contract farming by educating farmers on the medium-term benefits of honoring their contracts, facilitating coordination, and encouraging stakeholders to develop contracts with better incentives for all parties (for example, through price sharing mechanisms). There are also opportunities for developing new weather insurance instruments linked to credit products, examples of which are already being piloted in India.

Previous failed attempts to introduce these instruments in Sri Lanka indicate that the government by itself cannot develop such market tools. However, the government can support market development by establishing the enabling regulatory environment, fostering coordination among stakeholders, and engaging in various kinds of public-private partnerships. In this vein, it should also allow rural cooperatives to embrace new commercial concepts and permit a much needed rationalization and restructuring of the agricultural sector.

While the majority of Sri Lankan households have access to some form of savings account, other basic financial services are not available to the population at large. Reportedly, a significant share of the growing remittance market flows through informal conduits. Basic insurance products and other savings instruments remain at a nascent stage in Sri Lanka. Most international experiences indicate that legal remittance policy requirements are not effective and that there is a need to invest in the quality and outreach of the infrastructure to facilitate remittance flows. This will entail greater financial education of migrant workers; investment in remittance technology; more effective sharing of electronic payments systems platforms; and negotiating bilateral financial initiatives with key remittance source countries. To deliver the "last mile," of service provision, banks can also explore greater linkages with nonbank financial institutions, including microfinance institutions and Sri Lanka Post, which presents a vast rural infrastructure.

Sri Lanka Post offers a unique network by which to expand rural financial services, but it is highly underutilized. Unlocking the post office's potential will require the development of a comprehensive strategy consistent with postal and financial sector policies and other efforts to promote higher access to ICT. The challenge is formidable because the institution has been trapped in a vicious circle of deteriorating levels of service and lack of funding to modernize. The modernization process could begin with existing and priority business lines (such as remittances), which would allow Sri Lanka Post to move up a learning curve and gradually engage in a broader set of financial products and other e-services.

The delivery of new products will entail the development of new partnerships with private financial institutions, auctioned off on a competitive basis, and winding down the unproductive exclusive agency agreement between the NSB and the post office. Reportedly, two private financial institutions have already expressed interest in partnerships. New partnerships will need to be carefully engineered and will involve profound organizational and cultural changes within Sri Lanka Post. Other international experiences, most recently in Brazil, suggest that it could take Sri Lanka Post several years to prepare itself for such challenges. A summary of priority reforms identified in this report follows in Box 6.1.

BOX 6.1

Summary of Priority Recommendations

Downscaling private commercial banks

The government

- Promoting a stable macroeconomic environment
- Strengthening the enabling environment for lending and the legal framework for creditors' rights, asset securitization, leasing, and movable collateral
- Collaborating with financial sector in expansion of credit information on small businesses and consumers
- Mitigating costs of commercial banks entering new high-risk underserved markets
- Monitoring and disseminating information on lending patterns to underserved markets

Commercial banks and the business community

- Modernization of Credit Information Bureau
- Development of a unified charges registry
- Greater commitment of financial and human resources to support small business lending
- Training of small entrepreneurs
- Disseminating more detailed information on lending patterns to underserved markets

Enhancing financing in agriculture through supply chains

The government

- Facilitating coordination among various stakeholders to strengthen supply chains
- Collaborating with private sector in development of international brands, most importantly "Ceylon Cinnamon"
- Developing a modern and commercially oriented legal framework for rural cooperatives and providing technical assistance to support their restructuring
- Developing the regulatory framework to support warehouse finance receipts
- Possible involvement in public-private partnerships (i) to improve logistics of supply chains and (ii) to develop new financial instruments (such as an indemnity fund for warehouse financing schemes)

Producers, private sector entities, and other financial institutions

- Establishment and operation of logistical support for supply chains (such as auction centers and storage facilities)
- Rationalization and restructuring of cooperative centers
- Development of Agricultural Support Centers
- Development of Value Added Centers
- Establishment and operation of warehouses and management of certification system
- Testing new weather insurance instruments, possibly linked to credit

Expanding the quality and outreach of rural remittance infrastructure

The government

- Sponsoring greater financial education of migrant workers
- Possible negotiation of bilateral initiatives with key remittance source countries

Commercial banks

- Investment in remittance technology
- More effective sharing of electronic payments systems platforms
- Partnering with nonbank financial institutions (such as microfinance institutions and the post office)

Leveraging the Postal Network to expand rural financial services

The government

- Developing a comprehensive strategy for Sri Lanka Post that will be consistent with postal and financial sector policies and policies to expand ICT services, and that will improve the post office's financial performance
- Facilitating technical assistance to modernize the post office
- Allowing the post office to partner with new and private financial institutions, and winding down the exclusive agency agreement with the NSB

Sri Lanka Post

- Collaborating with the government in the development of a comprehensive strategy for the post office
- Implementing organizational changes and strengthening its IT and human resources
- Developing agreements to partner with new institutions

Commercial banks

- Partnering with the postal network to deliver the "last mile" of service

ANNEX ONE

Semiformal Financial Institutions and their Role in the Microfinance Sector

A wide range of semiformal institutions are involved in microfinance, as well as a number of formal financial institutions (mainly publicly owned), and informal lenders. The semiformal category mainly comprises the National Development Trust Fund; 311 cooperative rural banks (CRBs) with about 1,196 outlets; nearly 8,500 thrift and credit cooperative societies (TCCSs);[1] Sarvodaya Economic Enterprises Development Services (SEEDs);[2] about 1,000 Samurdhi Banking Societies; and 200 microfinance nongovernment organizations.

TABLE A 1.1

Formal and Semiformal Providers of Microcredit (December 2000)

	Average balance (SL Rs)	Percent of number	Percent of amounts
Total formal	19,263	20.2	40.4
Bank of Ceylon	18,266	5.1	9.7
People's Bank	10,000	9.9	10.3
Hatton National Bank	41,031	0.5	2.0
Seylan Bank	22,000	0.2	0.5
SANASA Development Bank	20,415	0.3	0.7
RDBs	40,000	4.1	17.1
Total Semiformal	7,216	79.8	59.6
SBSs	6,345	16.7	11.0
CRBs	7,713	36.9	29.5
TCCSs	11,258	12.9	15.1
SEEDs	2,827	12.3	3.6
Janashakthi Bank Hambantota	4,854	0.9	0.5
Total	**9,652**	**79.8**	**59.6**

RDBs = regional development banks.

Source: Charitonenko et. al (2002).

The Samurdhi Banking Society program, which was started in 1997 by the Ministry of Samurdhi and Poverty Alleviation, is one of the fastest growing microfinance programs. It enjoys the widest geographical coverage of all the microfinance institutions and caters to the very poor. Its growth is partly explained by its captive market. Recipients of the Samurdhi welfare benefit program are required to participate in the Samurdhi Banking Society Program, which in turn gives them access to their credit programs. Seemingly, repayment rates have been high. Because welfare transfers are paid through the Samurdhi Banking Society Program, loan officers are in a good position to ensure repayment. Despite its wide outreach, the system lacks transparency. There is insufficient information on administrative costs, and audits are not publicly available. With more than 20,000 Samurdhi animators (development officers), the system appears overstaffed and is highly vulnerable to political capture.

Multipurpose cooperative rural banks have a long tradition in rural areas and agricultural finance, but their market share has been on the decline due to poor commercial orientation. Out of 311 CRBs, only 174 made profits in 2001. Indeed, CRBs operate under the Ministry of Cooperatives and are quasigovernment institutions. The ministry determines the lending interest rate, which is not a cost-covering rate. The multipurpose structure of CRBs makes their consolidation more difficult, while the absence of an effective apex structure limits their access to product development and financial markets.[3]

SANASA, a large network of cooperatives, is a three-tier system with societies at the village and district levels and a national federation. Societies are autonomous at each level. At the village level, there are about 8,500 TCCSs registered with an estimated membership of around 850,000, although not all of these societies appear to be active. At a district level, district unions mobilize surplus savings from the village societies and on-lend them to other societies in need of funding. The national federation used to fund district unions in a similar manner, but the importance of the federation decreased following the establishment of the SANASA Development Bank in 1997, which lends directly to qualified district and village societies. The financial operations of the national federation are likely to be passed to the SANASA Development Bank.

SEEDS, formed in 1986 to promote financial and other services through village-based organizations, has become one of the largest NGO-managed entities in the microfinance sector. It presently manages close to 820 village banks with a membership of about 600,000 members. There are many other smaller NGOs in the microfinance area, but most of these appear to be weaker and are not operating on a sound basis.

In the formal sector, the main financial institutions participating in microfinance are the two state banks and the six regional development banks. State-owned banks primarily implement government programs for poverty alleviation and agriculture through subsidized loans. The recovery rate of these programs was relatively lower (65-70 percent) than credit programs funded from their own resources (80-85 percent).[4]

Participation of private commercial banks in the sector is minimal with a few exceptions (in particular Hatton National Bank and Seylan Bank). Starting in 1989, the Hatton National Bank was the first private commercial bank in Sri Lanka to offer microfinance services. It started microfinance activities with its own funds through a program called Gami Pubudu and subsequently participated in a number of government-sponsored microfinance programs. Over time, the bank has moved from the very poor to rural entrepreneurs, partly due to the increasing number of entities participating in the microfinance sector (often through subsidized programs) and the need to turn the program into a profitable activity following about 12 years of modest losses. The Seylan Bank, which launched its first microfinance products around 1997, appears to focus on special projects in remote rural areas. In addition, the SANASA Development Bank, which acts as an apex institution for the TCCS network, also lends to microfinance NGOs, community-based organizations, and individuals who are not TCCS members. Lastly, there is a third category of informal lenders comprising savings and credit associations, input suppliers, traders, moneylenders, landlords, friends, and relatives.

Because of this diverse group of providers, nearly 80 percent of Sri Lankan households appear to have access to some form of savings service, including more than 70 percent of low-income households (Table A.1.2). According to the Sri Lanka Integrated Survey (SLIS 1999-2000), around 27.5 percent of households borrow with no sharp differences in borrowing rates among different income groups. There are variations, however, in the financing providers and the purposes of the loans. Nearly 44 percent of loans drawn by the highest income quintile are used for a business or farm compared to only 26 percent for the lowest income group.[5] The highest income quintile seems to rely less on informal sources.

The relative role played by formal and semiformal institutions in microfinance seems to differ according to the source. Charitonenko et al. (2002) estimate that the market share of semiformal microfinance providers (measured in terms of loan numbers) is significantly larger than the share of formal institutions (Table A1.1); these differences narrow when measured against lending amounts since

TABLE A 1.2
Patterns in Households (HH) Saving and Borrowing (percent)

Income quintile	1 (lowest)	2	3	4	5 (highest)	Average
HH who save with formal and semiformal institutions	71.1	73.8	76.9	80.7	88.1	79.2
HH with loans outstanding	25.4	23.2	28.1	29.7	30.0	27.5
HH who borrow from semiformal institutions	24.1	26.3	26.1	20.9	16.7	23.2
HH who borrow from formal institutions	40.8	40.5	39.4	44.8	56.6	45.4
HH who borrow from informal sources	35.1	33.8	34.4	34.2	26.7	32.4

Source: Sri Lanka Integrated Survey (SLIS, 1999-2000).

formal providers tend to cater to the upper end of the microfinance market. By contrast, the SLIS (1999-2000) suggests that 40 percent of poor households borrow from formal institutions compared to about 25 percent who borrow from semiformal institutions.

Microfinance institutions have made an important economic and social contribution by filling critical needs of poor households. In the aftermath of the tsunami that struck Southeast Asia on December 26, 2004, and which had a terrible impact on the population living on the coast of Sri Lanka, microfinance institutions played a supportive role by providing short-term emergency help. Many institutions rescheduled the loans of those affected, giving them time to rebuild their income. Some institutions also helped their clients by settling insurance claims and letting them withdraw their savings.

Notwithstanding their contribution, the sector presents a number of weaknesses. *First, the range of financial products offered is extremely limited.* Microfinance is largely short-term oriented; a modest share of the portfolio is allocated to loans with terms longer than a year. Semiformal institutions, for example, may provide one- to three-year loans for dwelling improvements. Reportedly, there is a demand for microinsurance products, but these have barely been developed.

Second, the performance of microfinance providers varies significantly and many of them have become even weaker in the aftermath of the 2004 tsunami. Some microfinance providers use modern practices including market rates of interest, group contracts, and progressive lending; these providers enjoy high rates of loan recovery. Many other providers, however, suffer from poor accounting systems, weak financial discipline, and subsidized interest rates, which impairs their financial sustainability. Post-tsunami donor support has exacerbated bad practices. Some institutions have mixed microfinance with grants in some of their programs, creating confusion as to what needs to be repaid. Interest rate ceilings have become more prevalent, thus threatening the sustainability of microfinance institutions and generating wrong expectations for clients. Also, subsidized microfinance programs create a nonlevel playing field, which undermines the growth of microfinance providers that are trying to operate on sounder financial principles.

Many donors are offering more funding than microfinance institutions are able to absorb and intermediate in a healthy manner, whereas the provision of technical assistance to build more efficient and viable institutions is not receiving as much attention.[6] Government interventions in the sector have not promoted sound financial practices either. The Samurdhi Banking Societies present the most troubling case because they are linked to the government's safety net program and rely on a captive source of funding.

Third, semiformal institutions are not properly regulated or supervised, which raises serious concerns due to the large amount of deposits that these institutions mobilize from the public. This is to be addressed under a new law to be introduced soon - the Microfinance Institutions Law. *Fourth, coordination among donors remains very weak to the detriment of the sector's development.* In sum, the current microfinance landscape is plagued with a wide array of donor projects and government interventions that prevent the long-term viability of the sector.

With the proposed increase in donor funding, there is an immediate need for improving donor coordination and agreeing on a common strategy for supporting the sector. The strategy should pay special attention to the development of sustainable microfinance providers, which will involve reaching agreement on good practices for the sector, phasing out subsidized programs, and assisting the government in the formulation of a sound regulatory framework. Inadequate transparency has hurt the sector's performance. It will be critical to enhance transparency, starting with the publication of financial performance data for microfinance institutions and microfinance programs. Donors should also support the government in evaluating various options for expanding availability of credit information to the microfinance sector. While government-funded programs have achieved a wide outreach, they have benefited from subsidies that undermine other microfinance providers. The weak governance and lack of transparency of the Samurdhi banking system, also tied to a captive market, is of particular concerning. The Samurdhi banking societies should be transformed into separate and self-sustaining microfinance institutions that can serve the rural poor. For further information on the sector's strengths and weaknesses, see ADB (2003) and the forthcoming study by the Consultative Group to Assist the Poorest (CGAP).[7]

ANNEX TWO

FRUITS AND VEGETABLES

The fruits and vegetables sector in Sri Lanka has good potential for further development due to the country's warm climate and fertile soils. However, this potential is largely untapped as most produce is grown for local consumption. Compared to tea and spices, the fruits and vegetables sector is the least organized and probably needs the most attention to improve its standing. Post-harvest losses are estimated at around 30-40 percent. The product range is more diverse than in other agricultural sectors.

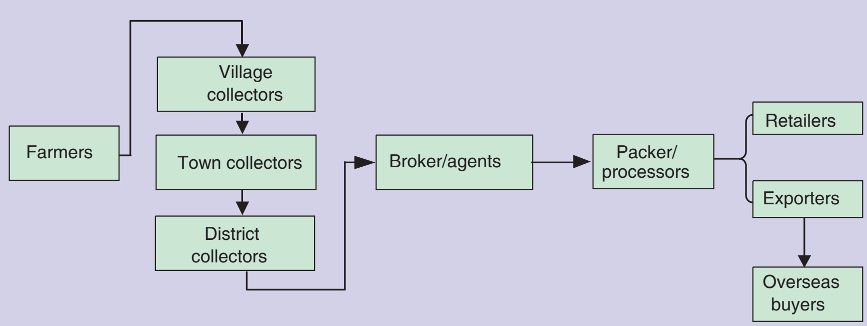
Overview: Similar to most other agricultural sectors, the fruits and vegetables sector consists of a large number of small growers. The sector has seen rapid growth in recent years, albeit from a small base, due to rising domestic per capita income and a growing tourism industry. In the fruits segment, pineapples and tamarind are the most important products. Pineapple exports have increased by an average of 10 percent per annum in recent years. Although the quality of exported fruits is acceptable, it does not command a premium in export markets.

Currently, vegetable production is undertaken in three agronomic zones. Low-country vegetables are generally cultivated under rain-fed conditions in small plots or home gardens, with limited inputs. By contrast, up-country (temperate) vegetables are grown under more intense irrigated conditions in Nuwara Eliya, Bandarawela, and Welimada with staggered year-around harvesting. More recently, commercial-scale greenhouse cultivation of vegetables has become popular, in some cases under contract growing arrangements, and similar production of a few fruits, such as pineapples and bananas, has also recently appeared. Vegetable exports have fluctuated widely. The main export destinations are the Middle East and the Maldives. The sector is unable to penetrate more sophisticated markets such as Australia, Europe, Japan, and the United States due to high quality requirements and freight disadvantages.

Supply chain structure: The fruits and vegetables supply chain is very fragmented (Figure A.2.1). The sector is composed of a large number of small growers who, as individual suppliers, cannot influence the market price. Growers are mainly price takers, and margins are predominantly determined by middlemen and collectors. Linkages between growers and processors and exporters are tepid. Contract farming still accounts for only a small fragment of the production of fruits and vegetables due to

FIGURE A 2.1

Fruits and Vegetables: Unnecessary Layers in the Chain



the lack of commercial discipline. Contracts are not honored either by farmers or the offtakers and corporates. In those cases where there are no alternative markets for the produce, the contract farming system appears to work well, as with gherkins, for example (offtaker Sunfrost). There is a pressing need to form producer groups and co-operatives or integrators, professional associations of traders, processors, and exporters, and to establish a secondary interprofessional platform that all stakeholders collaborate in to strengthen the industry.

When looking at the availability of farm credit, the sector lacks tailor-made financial products and medium- and long-term credits. Some initiatives have started to introduce contract farming combined with so-called forward sales as an advance, but these have been targeted to only a few farmers in pilot situations. Under these contracts the farmer (or farmer group) is obliged to grow a certain volume and quality for a specified offtaker (trade house or supermarket chain). Once the relationship between farmer and offtaker has proven to be sustainable, contract financing could be introduced. Financial institutions could finance the farmer using the offtake contract as collateral. There is no long-term credit available for farmers to invest in agro-technology (like, for example, plastic tunnels and green houses) or acquire new higher-yield fruit trees.

Key issues and prospects: There are many problems faced by growers, processors, and exporters that impact the entire supply chain (Table A.2.1). In particular, the following issues and problems need to be addressed:

- *There is limited knowledge of export markets* and in what specific products and time of the year Sri Lankan produce is competitive in mature markets.
- *There are no high-yield seed and fruit tree varieties.* The poor quality of material for cultivation hinders the market expansion of Sri Lankan fruits and vegetables. Although the government has somewhat relaxed import criteria, further reforms are necessary.
- *Handling standards are poor.* Frequent rough handling of fruits and vegetables lead to the present high wastage of product. There is a need to agree on the introduction of uniform and easy-handling returnable crates. A recent project to introduce plastic crates for transport to wholesale markets has made a successful start.
- *Infrastructure and logistics are poor.* Growers and collectors do not have easy access to cooling and storage facilities and seed-cleaning services, which combined with the poor infrastructure is one of the main reasons for the high post-harvest losses. In the absence of these services, farmers overflow markets after harvesting and prices plummet due to the price inelasticity of demand. The private sector, possibly with government support, should be aware of the significant investments needed to improve infrastructure and logistics.
- *A government instrument for improving supply-chain logistics* is the development of "master plans" for the most critical logistics bottlenecks (such as cooling and storage facilities and marketing) in consultation with the agriprocessing industry and other stakeholder organizations.
- *There is a lack of awareness at the farmer level of export potential.* Fruits and vegetables are purchased on the basis of the "fair average quality" (FAQ) price with no price premiums offered for quality produce. This discourages growers from producing premium-quality products. Strict application of proportional-quality payment systems is necessary, with adequately organized calibration, control, and sanctioning by the government. Only after these measures are in place can further expansion overseas be expected.

- *There is a lack of local product certification.* The industry has not agreed on minimum quality criteria for pineapple and other fruits and vegetables. The government, for example, could help implement a quality certification system that could be promoted in overseas markets.
- *There are export hurdles.* Other bottlenecks, especially for exporters, are the high freight charges and high cost of certification for exports (through customs and quarantine). Export packing facilities are in a very poor state in terms of physical condition, equipment, and management and require immediate improvement.
- *Government policies* should mainly focus on the following: (i) increasing the number of products (both fruits and vegetables) that are recognized as potential export earners; (ii) increasing farmers' awareness that their products have export potential when certain qualities and quantities are produced; (iii) facilitating the development of a better-organized supply chain; and (iv) developing quality standards.

TABLE A 2.1

Fruits and Vegetables Sector: Key Problems and Potential Solutions

Factor	Problem rating	Remarks on problems	Potential solutions*
Yield	High	Yields need to be improved.	Support needs to be given to improve harvesting methods.
Varieties	High	Low-yield varieties are used and some varieties are not grown.	Government should support the high-yield varieties. Diversify product range with varieties that Sri Lanka can grow competitively.
Procurement & logistics	High	Extremely high post-harvest losses.	Establish commercial cooperative structures. Develop storage and processing facilities.
Middlemen	High	Too many middlemen erodes profits.	Integrators are required to manage the supply chain.
Processing technology	Medium	There are hardly any value-added activities. Processing is done abroad.	Processing is needed to make value-added production and overcome gluts of fresh produce.
Distribution & marketing	Medium	There is no brand development.	Interprofessional organizations can help develop marketing and brands.

* See Tabor, Abeyratne, and Epaarachchi (2000) and World Bank (2003) for further discussion of potential solutions.

Stakeholders are aware of the issues affecting their industry, and a few initiatives have been started to enhance the development of the sector. The Sri Lanka Fruit & Vegetable Producers, Processors & Exports Association, for example, is trying to issue standards in quality and pricing methods and is encouraging a marketing system between growers and exporters. The government of Sri Lanka has identified bananas as one of the priority crops for development and promotion by way of major irrigation settlement schemes. As a result, a group of agencies have implemented programs to increase the productivity of select banana varieties in irrigated lands. The Department of Agriculture has recently released several new varieties of high yield fruits and vegetables and has carried out several training programs on protected agriculture and post-harvest processing. The Institute of Post Harvest Technology (IPHT) has also developed new plastic crates for transportation and is researching further improvements in post-harvest handling. IPHT also carries out training programs for producers, processors, traders, and extension officers.

ANNEX THREE

Estimated Numbers of Sri Lankan Contract Workers Overseas, 2003

Country	Male	Female	Total
Kingdom of Saudi Arabia	128,500	198,500	327,000
United Arab Emirates	43,000	98,000	141,000
Kuwait	25,000	142,600	167,600
Jordan	5,000	35,000	40,000
Lebanon	5,000	75,000	80,000
Oman	7,600	28,400	36,000
Bahrain	6,000	21,000	27,000
Qatar	50,000	16,000	66,000
Singapore	2,000	12,000	14,000
Greece	350	300	650
Italy	15,000	45,000	60,000
Cyprus	3,500	11,500	15,000
Malaysia	1,700	750	2,450
Maldives	10,500	4,000	14,500
Republic of Korea	4,500	1,000	5,500
Hong Kong, China	250	2,250	2,500
Seychelles	350	50	400
Mauritius	300	400	700
Egypt	75	350	425
Libya	300	50	350
South Africa	150	50	200
Pakistan	100	75	175
Israel	50	125	175
Syria	50	100	150
United States	100	25	125
China	100	25	125
Ireland	100	25	125
South Yeman	100	25	125
United Kingdom	50	75	125
Kenya	50	50	100
Others	825	275	1,100
Total	**310,600**	**693,000**	**1,003,600**

Source: Sri Lanka Bureau of Foreign Employment (2004).

ANNEX FOUR

Public Services and Incentives for Migrants

Overall, successive Sri Lankan governments have noticed their workers abroad and have undertaken various initiatives-with varying degrees of success-to facilitate migration of their nationals, the welfare of their citizens abroad, and the remittance of earnings to their home country. Government legislation, dedicated departments, labor training centers, labor attachés in embassies abroad, and a plethora of targeted incentives are part of a far-reaching public framework for remittances in Sri Lanka. Consistently improving the frameworks' effectiveness will substantially aid the development impact of migrant remittances in the years to come. The main public services and incentives for migrants are summarized below.

- *Premigration.* Sri Lanka has a comprehensive range of premigration facilities and services that include identifying foreign employment opportunities, predeparture training, and predeparture loan schemes.
- *Identification of foreign employment opportunities.* SLBFE seeks out employment opportunities for its nationals abroad. The majority of opportunities, however, are identified and filled by numerous foreign employment agencies registered and supervised by the SLBFE. Traditionally, the largest markets have been for unskilled laborers, particularly housemaids in the Middle East. However, new markets are opening up in Europe and Southeast Asia. Recent efforts have been made to increase the number of male migrants, increase opportunities for skilled workers, and diversify the geographical destination of Sri Lankan migrants.
- *Training.* In coordination with the Ministry of Vocational Training and other government bodies, SLBFE provides training to prospective migrants at 22 training centers and works with a further eight private institutions. Provided free of charge to all who desire foreign employment (as long as they are registered with the SLBFE or a private employment agency), the training includes immigration procedures, customs and etiquette in the host country, and basic financial management skills. The training for housemaids destined for the Middle East, who constitute as much as 80 percent of the migrant labor force, is particularly important given the number of complaints received from that region and the high social costs associated with female migrants.
- *Predeparture loan schemes.* Through the state banks, the SLBFE also provides predeparture loans to cover departure expenses, including travel costs. The loans are available at a flat interest rate of 8 percent. The difference between that rate and the market interest rate is subsidized by the government. The loans can be used for the purchase of the air ticket, for Sri Lankan Foreign Bureau registration fees, and for medical expenses and other necessities. To obtain the loan, applicants must open an account with a state bank and must be 18-50 years of age, hold a valid visa, a letter of employment from an employment agency in Sri Lanka or employer abroad, and a certificate from the SLBFE.

- *Predeparture insurance schemes.* The SLBFE also provides free life insurance to eligible migrants and their families.[8] A migrant becomes eligible on producing the following documents: passport, return ticket and purchase receipt, receipt of registration payment with the SLBFE, medical records if the migrant has been sick, documents from the employer or employment agency, a letter from the agency (if the migrant returns within three months), and a bank pass book.
- *Migrants.* Once abroad, migrants are permitted to maintain nonresident foreign-currency (NRFC) accounts through which they may send their remittances. While all banks provide NRFC accounts, there is a clear market segmentation between the foreign banks and the state-run banks. The former concentrate on middle- and higher-income skilled professionals, while the latter hold the accounts of the majority of lower-income unskilled laborers. The following categories of migrants are eligible to open NRFC accounts: (1) Sri Lankans employed abroad or within 90 days of return to Sri Lanka; (2) non-nationals of Sri Lankan origin living abroad; and (3) Sri Lankan nationals who go oversees to study or participate in conferences, subject to production of documentary evidence that they have brought into the country any funds received from overseas institutions.[9]

In its recently published National Employment Policy, the government made it clear that it will seek to "adopt a proactive approach to identifying global employment opportunities and uplift the image and skills of migrant human capital by providing them with appropriate training to enhance their competitiveness" (Ministry of Employment and Labor 2004). To achieve this, the government plans to reorganize the SLBFE to make it more market oriented and effective in its promotional and training activities, particularly with respect to domestic female workers.

ANNEX FIVE

Current Role and Status of the Postal Network

The Sri Lanka Post-is the historic and public postal operator and has an extensive network of branch offices (4,647). Compared to other countries in South Asia, Sri Lanka enjoys the densest network of post offices per capita (Figure A.5.1). At the national level, it has the densest network of all financial operators (Figure A.5.2).

FIGURE A 5.1

Post Office Branch Density: Sri Lanka and Other South Asian Countries (population per branch)

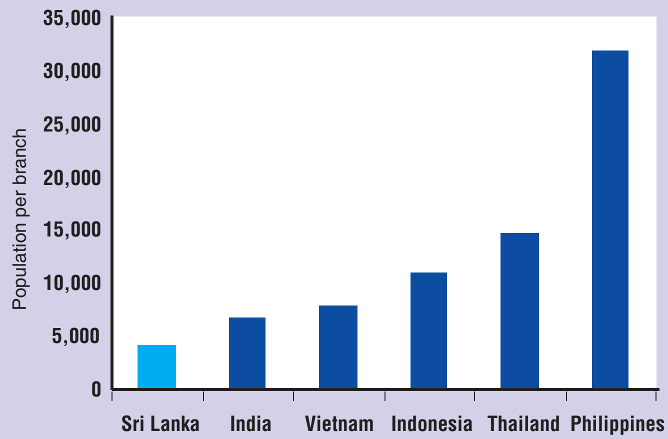
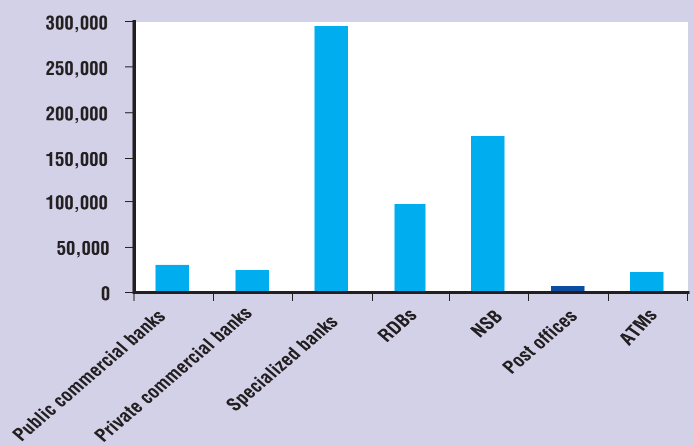


FIGURE A.5.2

Sri Lanka: Density of Financial Operators (population per branch)



Source: Sri Lanka Post (2004).

Remarkably, the legal and regulatory framework for the postal sector is vague and contains no definition of universal service obligation and of reserved area. Competition, however, has de facto developed. Several attempts by the government to reenergize the sector in the 1990s did not succeed.

Sri Lanka Post presents many attractive features which could contribute to its successful repositioning in the market:

- *Sri Lanka Post constitutes an essential element of the community service provision.* It currently delivers to 99 percent of the addresses across the country, six days a week at a uniform tariff. Typically for a public postal operator, there are de jure or de facto public service obligations to maintain a high level of accessibility, and these obligations are not compatible with profitability. In order to partially compensate for these imbalances, uniform tariffs approved by the government often allow some cross-subsidy between urban and rural users.[10]

- *The postal service is attractive to business mailers who want to communicate with a wide range of people in the most economic manner.* Sri Lanka has a relatively high mail demand of about 27 items per capita per year.
- *The postal service has an extensive network of post offices, especially in rural areas.*

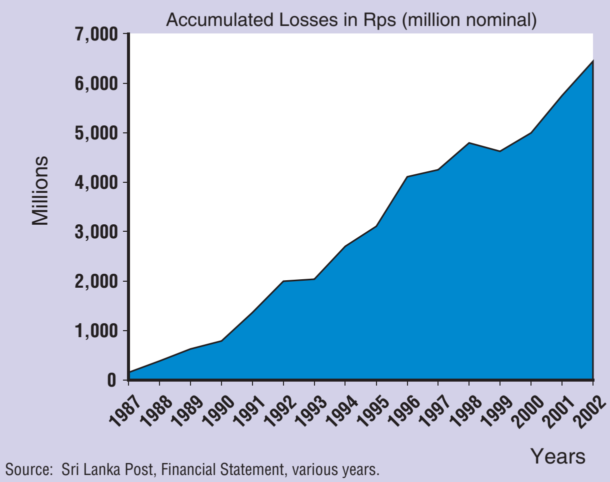
Sri Lanka's postal service, however, is also plagued with significant problems which appear to have resided in the system for a long time. Some of its major weaknesses are as follows:

- low perceived quality of service;
- lack of commercial orientation;
- limited capacity for strategic planning;
- poor financial performance history;
- inadequate investment in infrastructure; and
- low staff morale.

Although there is no systematic measurement of customer service or standards, there is a widely held view that service performance is low.[11] This is supported by the reportedly large number of private courier operators (currently more than 50) that are delivering mail in Colombo. The Website of the former "sister" entity Sri Lanka Telecommunications has referred to the postal service as slow and unreliable. Besides the lack of information on service standards, there is no statistical data on the causes of service failure (such as rail transport failures) and no market research to identify the reasons underlying public perception.

FIGURE A 5.3

Sri Lanka Post: Rising Fiscal Losses (1987–2002)



Source: Sri Lanka Post, Financial Statement, various years.

The Sri Lanka Post has been incurring substantial losses for the last 20 years (Figure A.5.3). In 2003, losses amounted to SL Rs 715 million. Losses as percent of revenues have fluctuated widely from year to year and were as high as 30 percent of revenues in 1995. Losses primarily stem from lack of innovation and marketing of new services and heavy regulation of postage rates for existing services. Government departments also benefit from some free services, although the extent of these has been reduced in recent years.[12] The current postal rates for an ordinary letter are SL Rs 4.5 or roughly US$0.04, which is about 10 times lower than in developed countries. Estimated cost for service provision in 1996 was a little under SL Rs 4.00 per letter. Therefore, with the escalation in the cost of operation undergone during the last decade, it is doubtful that the current tariff could adequately meet costs. In principle, the price of all postal products should be set at a level which covers costs and generates sufficient revenues to help finance requisite investments. Current information and accounting systems, however, can not provide accurate cost accounting data.

TABLE A 5.1

Financial Performance of Sri Lanka Post 1992-2003 (SL Rs millions)

Category	1993	1994	1995	2002	2003
Operating income*	1,130	856	1,321	2,145	2,311
Profit/loss	(42)	(665)	(405.8)	(622)	(715)
Loss per post office (SL Rs thousands)	(10)	(164)	(98)	(140)	(154)

*Excludes value of free services, which in 2003 was 7.7 percent of actual revenues.

Source: Financial Statements of the Department of Posts (various).

The poor financial performance of Sri Lanka Post has been a significant burden to the government (Table A.5.1). The taxpayers have been underwriting the postal system's operational losses and providing funds for capital expenditures. The net financial impact of all this is depicted in Figure 5.3. The cumulative net cash drain for the government of Sri Lanka from 1997 through 2002 exceeds SL Rs 10 billion. After accounting for the cost of financing the losses at an average interest rate of 10 percent per annum, accumulated losses amount to nearly SL Rs 20 billion (or close to US$200 million).

Operational losses have crowded out investments in sector development and network rehabilitation. Also, investment budgets were traditionally directed towards expansion of the postal network, while funding to improve the quality, security, and technology of the postal network remained low. Fortunately, this policy has been reversed since the early 2000s. The network has been expanded through arrangements with private sector entrepreneurs (postal agencies). In 2004, about 441 post offices were operated on an agency basis compared to 67 in 1989. Scarce investment funds have been channeled to enhance quality of the postal network. About 160 offices have been equipped and connected with personal computers, data communications, and other office computerization. These improvements have resulted in "community locale" services (such as Internet access). Nevertheless, very sizeable investments are necessary to upgrade the postal network along with a profound redesign of business processes for collecting, processing, and sorting mail. The tender process for capital investments is also very laborious, which slows down the response to capital investment needs.

Strategic planning, marketing, and market research remain at an early stage. As a consequence, there are no major initiatives to identify opportunities for expanding business and prioritizing investments. Revenue and costs are not identified by individual product lines. A few innovations have occurred that are mainly technology driven, such as Internet cafes, telemail messages, facsimiles, and e-money orders. However, Sri Lanka Post is becoming less competitive with the private sector in several areas. It has about 1 percent market share in express mail (a fast-growing business line) and low presence in the parcel delivery market segment. In the absence of strategic planning, the post office has foregone opportunities for expanding revenues from financial services.

Sri Lanka Post suffers from low staff morale and the absence of management information systems (MIS) and human resource instruments to enhance performance and efficiency. Symptoms of low staff morale were made evident in late 2004 when several postal workers were caught misappropriating overseas parcels. Mail with presumed valuable content was opened. In the wake of these events, the Sri Lanka Post has taken disciplinary action. However, the lack of MIS, management accountability, and modern human resource policies limit the scope for enhancing operational quality of Sri Lanka Post and transforming it from a traditional task-orientated organization into a competitive, customer-oriented one. The post office had a total of 19,578 employees in 2004, a considerable number relative to total mail and number of postal offices.[13] Most employees fill low-level positions and there is a corresponding lack of staff with specialized skills, including specialists in information technology. Due to hiring freezes implemented over the last decade, the average age of the staff is in the mid-40s, which implies that during the coming decade a considerable number of staff will be retiring. This creates opportunities for introducing new human resource policies and attracting a skill mix that will be more supportive of a modern post office organization.

The growth of the telecommunications sector has not been mirrored in the postal sector. While the telecommunications sector has grown exponentially during the last decade, in part because of the transfer of management to the private sector and the award of licenses to new operators, the institutional structure of Sri Lanka Post has not changed since posts and telecommunications were split into two departments in 1980. The government of Sri Lanka fills the combined roles of owner, operator, and regulator, and in fact Sri Lanka Post formally remains the Department of Posts of the Ministry. The rigidities of the civil service regime hinder the Post's commercial responsiveness.

ANNEX SIX

Sri Lanka: Historical Overview of Postal Financial Services System

Sri Lanka Post: A long and rich history of providing financial services

The first (five) post offices date from 1798. Postal money orders were introduced at an early stage but became a nationwide system in 1877 when the Inland Postal Money Order System was inaugurated, and this service functions-basically unchanged-to this day.

In 1885 the Post Office Savings Bank was established, which allowed easy access to deposits and withdrawals through the network of national post offices. For the first time in the nation's history, a bank was available to every citizen. In 1909, The Telegraph Money Order Service between Colombo and India was launched, which marked the beginning of cross-border payment services that have been continued to this day.

In 1938, the Post Office Savings Bank started to issue Savings Certificates to further promote the savings function and it soon gained a leading position in mobilizing small deposits throughout the country. Its market share (value) in deposits exceeded 30 percent in 1970 through more than 4 million savers. But the Post Office Savings Bank was not the only (state-owned) saving institution.

In 1972, the National Savings Bank was established using as a basis the Post Office Savings Bank and other state institutions functioning in the country at the time for the purpose of mobilizing savings. Links between the NSB and Sri Lanka Post were maintained through an agency agreement and the Postmaster General being ex officio a member of the Board of the NSB. The focus of the NSB, however, was shifted from the then more than 3,500 post offices to the 80 "own" branches over which it had full control.

With the advent of social security, Sri Lanka Post was charged in 1947 with the payment of monthly public assistance benefits. In 1949 the disbursement of government pensions became a task of Sri Lanka Post. Gradually other payment functions were added to the range of services of the post offices. In the 1960s and 1970s payments services were added for the Electricity Board, later for the Water Supply Board, and subsequently for TV and Radio Licenses and (Police) Spot Fines.

In the 1980s and 1990s the range of financial services was expanded with payments for rural pensions and the collection of other bills. The year 1997 gave birth to a new product, the Fax Money Order, in fact a sequel to the Telegraph Money Order, and in 2004 the e-Money Order was launched.

Notes

1. TCCSs have reached the smallest farmers through their three-tier cooperative banking system with societies at the village and district level and a national federation that serves as an apex institution supporting the previous tiers. In 1997, the SANASA Development Bank was formed, and it may now absorb many of the operations of the district unions and the apex institution. SANASA makes special efforts in promoting solid financial policies and avoiding political interference. Credit charges are largely determined on a cost-recovery basis.
2. Savordaya Economic Enterprises Development Services (SEEDs) was established in 1986 to promote financial and other services through village-based organizations
3. SIDA, KFW, and GTZ (2004), "Draft Report on the Promotion of the Microfinance Sector in Sri Lanka."
4. Charitonenko et al. (2002).
5. According to SLIS (1999-2000) estimates, low-income households allocate loans for the following purposes: 26 percent for business or farm use, 26.6 percent for purchase or improvement of dwelling, 30.5 percent for household consumption, and the remaining for other personal needs.
6. Recent estimates indicate that donor funding for microfinance and rural finance in Sri Lanka for the next few years could amount to US$250 million.
7. The ADB's Rural Finance Development Program, approved in 2003, comprises a loan of US$60 million to support policy and institutional reforms in the rural finance sector, including extensive technical assistance (see http://www.adb.org).
8. In addition to this scheme, migrants have access to a welfare fund financed through a fee of US$25 levied on employers abroad.
9. The accounts may be held individually or jointly. Spouses may open a joint account in their names provided at least one is working abroad and the other is living with him or her.
10. The costs of universal provision could also be compensated by granting exclusive rights for specific market segments (for example, a monopoly on letters below a certain threshold) or direct fiscal subsidy.
11. A survey undertaken in 1994 indicated that next-day delivery of mail was at the level of approximately 50 percent of posted mail with slightly higher rates for Colombo. A brief examination by a World Bank team in 1997 indicated an even lower level of performance (close to 34 percent).
12. Until 1997, all government departments and certain agencies had access to unlimited free postage. Foregone revenues resulting from this policy amounted to about 15-20 percent of the attainable total. This privilege, however, has been partially eliminated in recent years. The value of free services was estimated at 7.7 percent of total revenues in 2003.
13. The total approved cadre was 22,470.

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