ASSOCIATION OF PROFESSIONAL BANKERS - SRI LANKA

19th Anniversary Convention

21st & 22nd September - 2007

"Financial Inclusion - An Imperative Need for Sustained Economic Growth"

Our Vision

The Power of Professionalism in
Banking in Sri Lanka

Our Mission

To Sustain The Highest Standards of Professionalism and Integrity, among bankers

To Advance The Public Interest

To Influence The Achievement of The Highest Ethical Standards and Governance in The Banking

Cover Story

What is Financial Inclusion? Financial inclusion is delivery of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups. Unrestrained access to public goods and services is the sine qua non of an open and efficient society. As banking services are in the nature of public good, it is essential that availability of banking and payment services to the entire population without discrimination is the prime objective of the public policy.

Many people, particularly those living on low incomes, cannot access mainstream financial products such as bank accounts and low cost loans. This financial exclusion imposes real costs on individuals and their families – often the most vulnerable people in our society. Families can be locked in a cycle of poverty and exclusion, or turn to high cost credit or even illegal lenders, resulting in greater financial strain and un-manageable debt. They may also suffer from a lack of quality advice on how to improve their finances. Tackling financial exclusion is the responsibility of financial service providers, working in partnership with the government and the voluntary and community sector.

The artwork of the cover page depicts the following.

The plant *– the sustained economic growth.*
Watering the plants *- financial service providers promoting financial inclusion.*
The bearing fruits *– nourishing of various industry segments which operates at the bottom of the Pyramid.*
The colour shading *– breaking the barriers within an economy through financial inclusion.*

" Financial Inclusion - An Imperative Need For Sustained Economic Growth "

Publication to Commemorate

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Association of Professional Bankers - Sri Lanka

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Contents

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PREFACE

The inexorable engine of economic prosperity was made possible due to the invention of a medium of exchange. Thus, the financial landscape has evolved naturally, to meet the needs of the financial community, from the primitive times of Shylock to the golden age of Greenspan. During its evolution, the unyielding principle of natural selection prevailed, where the fittest survived and others were completely excluded from its modern marvels. Those who have so far been excluded are the poorest of the poor and the rural community.

Thus financial exclusion can be thought of in two ways. One is exclusion from the payment system, which is, simply speaking, having no access to a bank account. The second is that requiring those excluded from the financial activities, by the formal markets, to approach more informal but exploitative markets. This financial exclusion imposes real costs on individuals and their families - often the most vulnerable people in our society and therefore taking a toll on the larger social fabric. It is estimated that half of the world's population lives below the poverty line and in Sri Lanka, it is around 23%.

The global community desires a Mother Teresa to look beyond Corporate profiteering and put in place a system where everyone has equal opportunity to improve and fulfill his or her own life style and aspirations. Perhaps, the answer lies elsewhere; a new way of doing banking, that meets the needs of the poor with the banking sphere expanding to include the rural community, is unfolding. Sri Lanka has so far lagged in this sector as compared to some of our regional counterparts such as Bangladesh and India but efforts are now being made to study the causes of financial exclusion and design strategies to ensure financial inclusion of the poor and the disadvantaged. Some of the major local banks, including leading foreign banks, have already ventured into this sector and it is possible that new developments would take place in this untapped sector before long. It nonetheless requires much work to accomplish the full import of its final destination.

As customary, Association of Professional Bankers has made a laudable effort to bring out a volume of articles by eminent writers in their respective fields. This year, while the presentations at the convention are on topics related to the main theme itself, this publication has broadened the scope to cover even wider banking related themes. This volume therefore should be of much interest to those in the financial services industry, academics and the general public so that they may become aware of the intricacies involved in financial inclusion and learn about other current banking related issues.

On behalf of APB, I would like to record my gratitude to Managing Director and staff of Graphic Systems (Pvt) Ltd., our printers, the editorial panel and the eminent writers who contributed their valuable time to produce this volume of high standard.

Resonating, Churchill - "to improve is to change; to be perfect is to change often".

Dimantha N Seneviratne
Chairman – Editorial Panel
20 th September 2007

FINANCIAL VIABILITY AND SUSTAINABILITY OF MICROFINANCE: THE FINANCIAL SYSTEMS APPROACH

Dr. Nimal Sanderatne

Former Chairman, Bank of Ceylon and National Development Bank

A striking feature of financial markets in the last two decades has been the rapid expansion of microfinance services. The Asian Development Bank has defined microfinance as "the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to the poor and low-income households and their micro enterprises."(ADB 2000)

Microfinance - credit and savings - enable people to begin or expand micro enterprises or other income generating opportunities and provides poor people an opportunity to accumulate their small savings safely. It is a means of providing finance in small quantities, at reasonable cost and on conditions that are both convenient and suitable for the enterprises they undertake. The objective of microfinance institutions (MFI) is to combine the functional features and strengths of informal lending with the strengths and sustainability of institutional finance. Microfinance is a means of strengthening incomes of the poor, enhancing their self-reliance, improving employment opportunities, reducing gender inequality and eliminating the feeling of social exclusion. Micro financial services have succeeded in empowering poor communities around the world though its impact on the poorest of the poor appears limited still.

A large proportion of population in developing countries ekes out an existence by undertaking very small informal enterprises. This is so in both urban and rural communities. These micro enterprises could be small manufactures, trading activities or service enterprises. These enterprises are very small, often risky and undertaken by persons whose main asset is their labour. Consequently, financial institutions like banks are reluctant to lend to them. They have been considered "unbankable" by banks. The survival of this vast number of enterprises depends on finance from outside the formal banking system. Most such finance is for their working capital. A wide range of informal lenders - from professional money lenders, itinerant traders, boutique keepers to the more prosperous neighbours, relatives, friends and landlords, *inter alia* provided finance to them. Microfinance provides a means of meeting this need more effectively and at lesser cost to the poor.

There have been broadly two approaches to microfinance. One views microfinance as basically a charitable exercise to assist the poor by providing financial services, mainly credit at low or no interest cost. One can appreciate the 'goodness' characterising this approach. The second approach is that of providing financial services at costs that would ensure that the costs of operations of the microfinance operations would be covered. A vital ingredient of this approach is the setting of interest rates such that the income of the enterprise would be covered. This approach has come to be termed the financial systems approach.

If microfinance institutions are to play a significant role in poverty reduction then they must reach large numbers of clients. Expansion in outreach is vital in order to provide large numbers of very poor people financial services. For MFIs to reach large numbers they must expand their services. The most successful examples of large-scale outreach have been accomplished through specialized financial institutions that have operated on the basis of commercialization of microfinance.

For financial viability an organization must cover its operational costs as well as the cost of its funds, including the cost of borrowing from banks and payment for of interest to depositors. Once a microfinance organization is financially self-sufficient, it can also fund its activities with capital from financial institutions such as commercial banks, making it independent of donor or government subsidies. Being financially self-sufficient is the only way for financial institutions to grow.

The financial systems approach is imperative in as far as most microfinance organisations are concerned as the outreach of the charitable approach is not likely to be adequately widespread to reach an adequate number of the poor and therefore to make a dent on the alleviation of poverty of the multitude. It is now widely recognised that this approach is the only means by which microfinance could be broad based and effective. This paper discusses the principles and practice of the financial systems approach.

Financial viability is a key issue in microfinance. The conventional wisdom was that lending for micro enterprises and the poor was not profitable. The higher administration costs of such lending, the presumption of high rates of default and the policy of low interest rates for such borrowing, it was contended, would not enable MFIs to run on commercial profit making lines or break even. The implication of this is that a continuous flow of donor funds would be required to sustain micro enterprise credit. A further implication is that the prospect of expanding the coverage and credit for micro enterprises would be severely limited, as it was dependent on a continued availability of charitable funds.

This paper discusses why the financial systems approach to microfinance is needed in order to develop a viable and sustainable system whose outreach and depth would ensure that microfinance plays a vital role in employment generation and poverty reduction, two of its avowed objectives.

Financial Systems Approach

What do we mean by financial viability and sustainability? Financial viability means that year-on-year out a microfinance institution (MFI) should generate an adequate income to cover its financial and all other costs, including provision for bad debts. A MFI whose income is continuously inadequate to cover the costs of operations, costs of finance, and the provision for bad debts, would be eroding its capital base, unless there is a continuous flow of funds from outside to offset the erosion in capital. This means that MFIs incomes must be equal to or greater than its total costs.

Since a MFI's income is primarily interest income, the interest income derived from its lending must be adequate to meet all its costs. We can express these ideas more precisely in the following equations:

For financial viability:

$Y > C$

$C = f + a + t + L$

Where Y = Income, C = Total cost, a = Administration costs, f = Financial costs, t= transactions costs and L = Loan loss provisioning.

What are the factors that determine financial viability? The above formulation answers that question. Each of the constituents requires to be discussed to understand their significance.

On the income side, interest income is the main source. There may be other sources such as investment incomes, rents or returns from other services. Yet these are generally of lesser significance than interest income for MFIs. Therefore the most important factor is the rates of interest for on lending. If the rate of interest does not reflect the cost of funds, administration and transaction costs of lending and the loan loss provisioning, then the costs of the MFI is likely to be higher than its income. In most cases financial viability can be achieved only when interest rates reflect costs. This issue is therefore discussed in detail in the next section.

However, interest rates are not the only determinants of viability. The factors on the expenditure side are also of consequence. In fact the costs determine the realistic rate of interest that should be charged. Operational efficiency and low administration costs have an important bearing. These factors affect the non-financial costs of MFIs and can be a sizeable part of a MFI's expenditure. It is vital that MFIs do not incur heavy overhead costs like high rentals or costs of building or pay high salaries to their staff. The financial viability of MFIs can be compromised by high overhead expenditures, which have little relationship to the scale of operations of the MFI or its interest income. The Association for Social Advancement (ASA) a leading microfinance organisation in Bangladesh is an excellent example of low cost microfinance administration (Fernando and Meyer 2002). Every effort is made to be thrifty and prudent in reducing administrative expenditure by conservation of electricity, recycling of paper and the very simplistic style of operations.

As indicated in the equation above, there are three kinds of costs that the MFI has to cover in providing financial services. The first two, the cost of the money (f) that it lends and the cost of loan defaults or loan loss provisioning (L), are more or less proportional to the amount lent and there are no economies of scale. They do not vary with size of loan. The financial costs of the funds borrowed are the same percentage of the loan whether the amount is Rs.500 or Rs.5000. It would be a percentage of the loan amount.

In contrast, the third category of cost, transaction costs, varies with the size of loan. It is not proportional to the amount lent. The transaction cost of a loan is not directly proportional to the loan amount. Very often the transaction costs of a small loan is not very much different from the transaction costs of a larger loan as they both require about the same amount of time for meeting with the borrower to process the loan and ensure repayment. In fact at times it may even cost more if the follow-up and supervision of loan use monitoring is regular. The transactions cost of small loans is larger in terms of the loan amount and therefore the interest rate would require to reflect the higher transaction costs. That is why the interest rates of viable MFIs are not necessarily low.

Successful microfinance operations have been characterized by committed and dedicated staff. This is especially so with the pioneer, Grameen Bank. It is vital that workers in MFIs have a dedication and commitment to the objectives of microfinance. Their salaries may be lower but their rewards must include a satisfaction derived by doing socially useful work. Operational efficiency implies that staff is deployed effectively and the functions expected of them are performed efficiently. If the operational efficiency is low it would result in poor quality lending, larger defaults and ultimately higher costs and lower incomes for the MFI.

Operational efficiency is of paramount significance as it has a direct bearing on the quality of lending and the rate of default. In turn the rate of default is the single most important factor in costs, as an increase in the default rate would require a more than commensurate increase in interest rate to ensure an adequate income. The interest rate has to be enhanced considerably to offset the amount of default, other costs remaining the same. (Hulme and Mosley 1996, CGAP 1996). Financial viability is therefore significantly determined by administrative efficiency influencing the rate of defaults. Administration expenditure should be not merely contained but be cost-effective. A curtailment of expenditure by paying low salaries and recruiting poor quality staff or unsatisfactory working conditions may reduce costs but increase inefficiency. Cost effectiveness rather than reduction of costs is the important principle.

Financial viability could be adversely affected by other objectives, such as greater outreach, as well. Though the usual caution is that an increased outreach to the poorest would increase financial risks, there are even greater threats to financial viability when MFIs extend to new areas, where their local knowledge of the borrowers are much less and the staff are either less skilled or less motivated to administer microfinances. Poorer infrastructure and marketability of goods and services could also have an important bearing on the rate of defaults (Sanderatne 2002).

It may be difficult for a MFI to reach financial viability quickly. It has therefore been suggested that a MFI could achieve financial viability in three stages or levels. At the first stage, the fixed costs of the MFI and the costs of administering credit would have to be met by a 'subsidy' or grant. At the second stage, the MFI would cover its administration costs but not the full financial costs and loss provisioning. It is only in the third stage that it would achieve full self sufficiency. This implies that MFI's be subsidized to an extent till the scale of operations, skills, information base and its monitoring systems are put in place and are effective. The start-off period would be subsidized, but in the long run the MFI would be able to generate at least a small surplus.

Interest Rates

The all important and most controversial issue is that of interest rates. The relationship between interest rates and financial viability was discussed in the previous section. Interest rates are discussed here mainly from the point of view of the principles which should guide the on lending interest rates of MFIs.

The "poverty alleviation" approach to lending for small farmers and rural needs was based on the premise that these borrowers were too poor to obtain credit at market rates. Therefore, the provision of cheap credit, which meant subsidized finance, was the objective of most lending schemes. While it was mostly government's which could provide finances for such subsidized lending, some well meaning NGOs too began limited credit operations in villages and among poor communities at low interest rates.

There were many deficiencies in such lending. Repayment rates were low, unintended beneficiaries were large, the funds were often not used for the purposes for which they were given. The total outreach of such credit was not significant. Analysts, especially of the Ohio School of thought, contended that the subsidized interest rates were largely responsible for these deficiencies. (Adams, Graham and Von Pischke 1984).

When interest rates are subsidized, microfinance organizations remain dependent for outside funds. A policy of lending at less than the total cost of funds means that these MFIs would never become sustainable financial intermediaries. Although this aspect is connected with the issue of viability discussed in the previous section, the issue highlighted here is that even if the MFI continues in operation by a continuous flow of outside funds, it will not be financially sustainable institution, unless the interest rate covers costs in the medium or long run.

There is evidence to suggest that when a credit scheme or a credit organization disburses cheap credit, the borrowers perceive the credit to be a grant or gift rather than a repayable loan (Sanderatne 2002 chapters 9 and 10). This attitudinal approach undermines the credit culture of the organization leading to higher loan delinquency. This in turn affects the financial viability and sustainability of the lending organization. (Sanderatne 1978).

Those arguing for cheap and subsidized credit for micro enterprises base their case on two pivotal issues. First, that small enterprises cannot afford market interest rates and second, that the poorest of the poor and the really small micro enterprises would not be reached when the cost of finance is high.

In fact, small enterprises, as well as the poorest, borrow at high interest rates from informal lenders and do repay their loans. Therefore, the ground situation is that micro enterprises can and do borrow at much higher rates than those offered by commercial banks to their clientele. It has also been demonstrated that the interest cost is a small proportion of total costs of borrowing from formal sources, as micro enterprises have to incur additional transaction costs to borrow funds from institutions. These additional costs increase the total costs of borrowing from institutional sources. Therefore the actual costs of borrowing is much higher than the nominal interest rate. Further, the total costs of borrowing by micro enterprises is often a small proportion of their total costs of production. (Adams, Graham and Von Pischke 1984).

What micro enterprises require are easy access, repayability on conditions suited to their enterprise, flexibility on repayment conditions when necessary and finance for a multiplicity of purposes, including consumption needs. The issue of interest rates pales into insignificance in comparison to the provision of these facilities. MFIs have tended not to reach the poorest of the poor as the interest rates charged are inadequate to cover the administration costs and risks of lending to the poorest. (Hulme and Mosley 1996).

There is evidence that when credit is given at low rates, the better off members of the community and even the officers of the MFI and their kith and kin would siphon off credit for other investments. Cheap credit provides an incentive for borrowing by unintended beneficiaries and the objectives of microcredit are undermined (Adams *et al.*, 1984). However others have pointed out that MFIs could design their programmes to ensure that credit is not utilised by unintended beneficiaries. (Johnson and Rogaly 1997, Gulli 1998, Hulme and Mosley 1996).

Low interest rates have an added disadvantage for the mobilisation of savings. Since the savings deposit rate has to be lower than the on-lending rate, a MFI which gives credit at a low rate would be offering a low savings deposit rate too. This would reduce its capacity for the mobilisation of savings from its community, especially if the deposit rate is below the inflation rate; in which case the saver gets a negative real interest rate. Yet a MFI may be able to mobilize savings even at a negative rate as many savers may be interest insensitive and more concerned about the safety of their deposits rather than the yield. (Rutherford, 1999). Nevertheless a higher savings deposit rate should strengthen the savings mobilisation potential of MFIs.. And this is possible only if on-lending rates too are high. There are three considerations which should temper this discussion.

First, the arguments against subsidized lending rates should not be interpreted to mean that MFI's are justified in charging very high interest rates. The reasons for higher interest margins above the financial costs are the higher administration and transaction costs owing to small loans being more costly to administer, higher costs of accessibility of borrowers and closer monitoring of loans. The higher risk and possibility of high defaults could also add to costs. Yet all these costs could be reduced over time by improved practices, higher accountability of borrowers, improved information and reduced moral hazards and improved operational efficiency. Therefore, especially in the long run, MFIs should attempt to cut their margins and reduce their rates of interest. On-lending interest rates could also be reduced if MFIs are able to source funds more cheaply. With a greater reliance on savings mobilized by the MFI itself, lending rates could be reduced; both due to reduced costs of mobilisation of funds and risk reduced asset based lending. The objective of MFIs should be to lend as cheaply as its financial viability permits by reducing its costs of operations.

Second, the case against subsidized interest rates should not be interpreted to mean that if MFIs do not lend at subsidized rates, the financial viability and sustainability of the MFI is assured and its objectives achieved. This is similar to the macro-economic argument that is often made that if you get prices right, other things would fall into place. Just as much as there is no automatic resolution of all economic problems by getting prices right, MFI objectives will not be necessarily achieved by merely getting the interest rate correct. The other issues discussed in this paper are as significant for the success and sustainability of MFIs, as interest rates.

The third aspect in the author's view is that there is a case for subsidized interest rates as a temporary phase. This is where the initial costs of administration are so high that if these have to be incorporated in the on- lending rate, it would be too high. In such situations the MFI may have to suffer a loss for a time and even erode its capital base, but view this as a temporary phenomenon. Ultimately the administration costs would have to be brought down and the interest rate charged could be such that there is a profit which could offset the initial losses. Such a strategy is not the adoption of a policy of subsidized credit, but a policy of coping with the costs of setting up a new organization and overcoming the financial difficulties of the gestation period. Initial losses are a normal feature of business enterprises which ultimately turn out to be very profitable. Similarly, an initial phase of losses or subsidisation of MFIs should be expected. It is in the long run that interest rates would require to be covered all costs. Some researchers, who have advocated unsubsidised interest rates, admit to the need for a subsidy of other costs for an initial period of operation.

It is necessary to clarify that financial viability does not mean that a MFI depends on its own funds. A MFI could be financially viable although it borrows funds, provided it obtains a profit from on-lending their funds. This is the essence of financial intermediation.

Conversely the fact that a MFI does not obtain funds from outside does not necessarily mean that it is financially viable as it could be incurring continuous deficits and eroding its capital. Such a financially non-viable MFI is not sustainable, unless a fresh contribution of capital is made.

Financial viability is also significant to a financial intermediary as its capacity for sourcing funds from outside is enhanced. Its capacity for financial leverage increases as its profitability increases. A financially viable MFI could leverage funds which would be a multiple of the increase in its own funds. This would in turn increase its capacity to expand the scale of its operations. A US AID study argues that:

Once an institution demonstrates that it is secure and profitable, whatever its type, it can gain wider access to commercial funding sources. Such institutions can fund their loan portfolio fully in commercial financial markets, either by capturing individual savings deposits or by attracting investors through the assurance of debt securities. (Christen, Rhyne, Vogel and McKean 1995, 17)

Conclusion

The case for realistic interest rates is not readily recognized. In fact many still argue that the poor are too poor to pay market interest rates and should be provided with credit at low interest rates as they would be unable to repay loans obtained at high interest rates. This argument goes against the experience of MFIs. Besides, the poor do in fact borrow at very high interest rates from professional money lenders and repay loans. This is due to their needs, on the one hand, and the fact that small sums of money used in small enterprises give high returns.

The argument for realistic interest rates outlined above should not be interpreted to mean high interest rates of the professional money lenders. Money lenders often charge interest rates of between 10 and 20 percent per month that are, when annualized, between 120 to 240 percent per year. In contrast, the Grameen Bank charges 2 percent per week that is 104 percent per year.

The preceding argument was that for MFIs to maintain and increase its services over time, they should charge interest rates that are adequate enough to cover the cost of their lending. If they do not charge interest rates that cover their costs they would lose money and their activities will contract rather than expand, unless there are fresh infusions of money from foreign or domestic donors or governments. The problem is that donor and government money is not enough to expand microfinance to meet the large and expansive demand for such services. On the other hand, commercial borrowing can meet the expanding demand for credit. However MFIs can resort to commercial borrowing only when they are profitable and sustainable. It is only when they are profitable that they are deemed creditworthy to attract large volume of funds from commercial sources.

The preceding argument has been appropriately summarised in these words by CGAP as follows:

> Lending programs that continually subsidize their borrowers will de-capitalize themselves unless they continue to receive new subsidies from donors or governments. By contrast, MFIs who charge their clients enough to cover all the loan costs can attract funding from commercial sources and are capable of exponential growth without relying on scarce and uncertain subsidies as funding sources. MFIs have to charge rates that are higher than normal banking rates to keep the service available, but even these rates are far below what poor people routinely pay to village money-lenders and other informal sources, whose

percentage interest rates routinely rise into the hundreds and even the thousands. (CGAP, "Why MFI's Charge High Interest Rates", in Building Financial Systems for the Poor).

There has been a significant expansion of microfinance in Sri Lanka in the last three decades. Yet the outreach and penetration is still inadequate to meet a substantial amount of the financial needs of the poor and the self-employable. One of the foremost reasons for this is that there is inadequate appreciation of the need to adopt a financial systems approach and expand microfinance services through its commercialisation.

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CENTRAL BANKING NEARLY SIX DECADES AFTER JOHN EXTER

By W.A. Wijewardena

Deputy Governor - Central Bank of Sri Lanka

Nearly six decades have elapsed since John Exter, founding Governor of the Central Bank of Sri Lanka (then, Ceylon), enunciated his wisdom on and philosophy of Central Banking. He did so in a report titled ***'Report on the Establishment of a Central Bank for Ceylon'*** which he completed in 1949 as one-man commission on the request of the Government of Ceylon. His ideas on central banking could also be found in his speeches and press conferences during the formative years of the Central Bank. The Report, also known as the Exter Report was published by the Government as a Sessional Paper in November, 1949. The case for a Central Bank for Sri Lanka has been presented succinctly and cogently in this report. As a mark of appreciation of his work and in recognition of the need for placing a competent skipper on the newly formed organization, Exter was invited by the Government to form the new Central Bank as its first Governor. Exter is reported to have accepted this offer only for a limited period. True to his word, he resigned from the post of Governor in 1953 and returned to the States.

The Exter Report consists of two parts. Part I presents a lucid summary of the significance of a central banking system for Ceylon. It is in this part that he argued the case for a Central Bank for the country in preference to a currency board. Part II is a draft bill for the establishment of the Central Bank of Ceylon with explanatory comments. These comments have helped to guide generations of central bankers, in the past, what was exactly meant by each section or clause of the bill. It will continue to do so in the future as well. The commentaries presented were succinct, precise and to the point. They testify to the vast knowledge which Exter had about the functioning of an economy, his reading of the status and the direction of the country's economy, the functioning of a monetary system both in domestic and global economies and how a central bank should be organized and operated. Hence, to understand Exter Philosophy of Central Banking, there is no better document than the Exter Report.

Nearly six decades after John Exter completed the Exter Report, it would be useful to re-visit the report and assess his philosophy of central banking in the context of the body of knowledge of Central Banking today and identify its relevance to central bankers as guidance. This paper is an attempt at this exercise.

The Choice Between a Central Bank and a Currency Board

Prior to the establishment of a central bank, Sri Lanka was operating under a currency board system in which the country's currency had been backed by 100 percent in foreign reserves maintained with the Reserve Bank of India. Hence, the first choice which Exter had to make was whether to retain the currency board system or go for a central banking system. In a way, he did not have much choice in this regard, because his mandate was ***'to report on the organization and the functions of a Reserve Bank for Ceylon....'*** If he preferred a currency board, he should not have accepted the assignment.

However, like a true professional, he compared and contrasted the two systems before he made his recommendation in favor of a Central Bank. The report demonstrates that his recommendation was out of conviction rather than the performance of a mere duty.

His choice of a Central Bank for Ceylon in preference to the continuation of even a reformed currency board system was made on the basis of strong economic arguments.

1. **The higher credit needs of a growing economy**: Currency Boards which are restrained by the need for maintaining a 100 % foreign reserve backing for the currency cannot supply enough liquidity to meet trade and other requirements unless the country continues to experience a huge balance of payments surplus year after year. Exter argued that it was not only impossible, but also undesirable to have such a surplus. Impossible because a country cannot continue to maintain a competitive edge over its competitors. Undesirable because freezing foreign reserves does not help the country to attain higher growth or welfare.

2. **Inappropriate reserve maintenance**: A currency board has to maintain its reserves in Sterling or in Indian Rupee because of the long economic relationship with those countries or economic dependence on them. But, both currencies at that time were not convertible, due to exchange controls imposed in the UK and India in the post-war period.

3. **Adjustment for the future**: Ceylon had at that time applied for the membership of the IMF and one of the requirements to be met once the country gained the membership was to express the value of currency in gold or in a gold-convertible currency. Both sterling and Indian rupee were not gold-convertible.

4. **Limited activities of a currency board:** Currency boards do only the issue of currency. Hence, they cannot supervise banks or take action for the development or the stability of the financial system.

5. **Inability to cope with a wider definition of money:** Demand deposits have become an important part of money supply. Currency boards do not have any instrument to control demand deposits, while a Central Bank could do so through statutory reserve systems.

6. **Meeting the needs of financial institutions:** Financial institutions need liquidity, reserves and clearing and settlement facilities. Currency boards cannot meet them.

7. **Inability to tackle crisis situations:** Currency boards are 'fair-weather' systems and not geared to tackle serious domestic or international crises. For instance, if a crisis demands an expansion of liquidity as its solution, currency boards cannot act in such situations.

8. **Lack of instruments to control an inflationary situation:** If there is a continuous surplus in the balance of payments, a currency board has to necessarily monetize the surplus at the cost of building inflationary pressures. But it does not have instruments to contain it and is reduced to the status of a passive spectator.

In view of the above shortcomings of a currency board system, Exter recommended that Ceylon should establish a Central Bank with wide powers.

Exter could not be faulted for making this recommendation, since this was the accepted wisdom at that time. The frustration of the newly independent nations regarding their colonial past, the desire to attain economic independence soon to match the political independence and the obvious inflexibility of currency board systems to supply liquidity in a growing trade and payment era would have contributed to the popular belief at that time that the Currency Board should be replaced by a Central Bank.

However, about two and a half decades later when Singapore had to make the same choice, 'Dr Goh and the Cabinet chose the path of prudence for Singapore and sought to preserve the Currency Board System for its in-built financial discipline' (***Prudence at the Helm,*** 1992, p 15). Many nations since then, after devastating experiences with undisciplined monetary management, chose for currency board systems to institutionalize monetary discipline by legal means. Ironically, this virtue of a currency board system had not been dealt with in the Exter Report, possibly it would not have been foreseen at that time. However, to the credit of Exter, many safeguards, checks and balances were added to the law establishing the Central Bank to prevent such undisciplined monetary management by the new Central Bank. The absence of even a single episode of hyper-inflation or crises of monetary nature during the past 57 years of existence of the Central Bank is testimony to the efficacy of these measures added to the law.

The Role of the New Central Bank

The mandate given to Exter was, inter alia, to 'report on the organization and functions of a Reserve Bank with a view to ensuring, within the limits of monetary action, full employment of the economic resources of the country, and, if need be, on the promotion of supplemental credit institutions in furtherance of this policy...'. The mandate itself had recognized that the Central Bank should facilitate economic development '***within the limits of monetary action***'.

This meant that, though short-term economic stimuli could be provided by raising money and credit, the bank should not do that, since it leads to the abandonment of price stability. Any stimulus to be provided by the Central Bank should, therefore, be practised cautiously and with due regard to its impact on price stability. While emphasizing on the importance of money and credit on an economy, Exter referred to this as **'stable money** which is essential to performance under contracts and to the equitable liquidation of debt'.

Within that limitation, the Exter Report has highlighted that ***'the greatest significance of the introduction of a Central Bank lies in the power of the bank consciously to influence the supply, availability and cost of money in Ceylon'***. While this conscious action constitutes monetary policy, it differs from what a currency board does and even from a Central Bank's creation of money through similar action by foreign exchange operations. Foreign exchange operations are compulsory and a central bank has no choice in that. When commercial banks offer foreign exchange to the Central Bank, it has to buy that exchange and issue local currency. But, a Central Bank's credit creation through domestic operations is **discretionary and voluntary.** So, a Central Bank is in a position to regulate such money creation depending on the situation and the credit requirements of the economy. Hence, Exter did not expect the new Central Bank to have an open policy of creating money to finance the domestic operations. He wanted such operations to be conducted at the sole discretion of the bank.

Exter also empowered the Central Bank to examine and supervise commercial banks in order to strengthen the banking system. Such powers would prevent banks from engaging in unsound practices, protect the depositors against bank failures and, with 'lender of last resort' facility, provide liquidity in times of crises. Up to the establishment of the Central Bank, there was no any attempt at regulating commercial banks in Sri Lanka. Hence, Exter was successful in realizing two objectives in a single operation: price stability and banking system stability. While the broad objective of price stability remained unchanged over the years, the banking system stability was expanded to cover the entire financial system and, therefore, today, the Central Bank has been charged with the responsibility for maintaining financial system stability.

Exter's wish was that the new Central Bank would consolidate, under one umbrella, all financial operations which had been widely scattered at that time. Thus, the Central Bank was expected to encourage the public to make greater use of banks to keep their deposits and channel funds to the government securities market by building confidence in same.

While submitting the draft bill on the Central Bank, Exter remarked that 'good central banking is less good law than good practice'. What he meant by this is that a Central Bank should not rely solely on the legal powers given to it. The strict application of such legal powers sometimes leads to the destruction of sound market relationships. To make Central Bank policy more effective, it has to make its presence felt by others. Exter advised that it should be done ***'through the development of day-to- day relations of confidence and understanding between itself and various banking institutions than through the exercise of all of the powers given it'*** under the law. In other words, he suggested that practicing 'moral suasion' would pay more dividends to a Central Bank than seeking cover under the law.

Caution against the Excessive Creation of Money

Exter belonged to the old guard of economists who believed that economic prosperity cannot be attained by printing money. This was indeed going against the popular tides of the late 1930s and 1940s. At that time, Keynesianism had been accepted by the mainstream economists on both sides of the Atlantic as a new religion. It explicitly advocated the desirability of deficit financing as a strategy for attaining full employment. Exter doubted the validity of this claim both in his public speeches and writings. In this respect, Exter was a loner and belonged to the minority of economists of the day. The fact that there were no supporters for his views did not prevent him from making public what he believed to be true. On the very first day of the establishment of the Central Bank of Ceylon, in a press interview he gave as its first Governor, Exter warned against the use of the Bank for things it cannot fulfill.

'Today, we can only be filled with high hopes for the future. It would be a mistake to expect startling results immediately from the establishment of the Central Bank. There is no financial wizardry by which the Bank can suddenly pull out of a hat a higher standard of living for everybody. The Bank's contribution must necessarily be a long-run contribution. The Bank does not itself produce goods and services, but it should, by creating the right monetary conditions enable the country to do so....'

What Exter repeatedly maintained was the Central Bank was only a necessary condition for future prosperity. That necessary condition was to be created by maintaining price stability so that the economic agents could make economic decisions based on long-run economic prospects. Since the Central Bank does not produce goods and services, it cannot directly get involved in economic activities. It is, therefore, the task of the government and the private sector to take appropriate measures to create wealth in the society. The only weapon of the Central Bank is to print money and such money, by changing the price levels, acts only as an illusion. Hence, Exter thought it necessary to warn those who had been advocating the Keynesian type of ideology to raise government expenditure through printed money.

In the Exter Report, he argued that higher income created through money creation would simply stimulate consumption of imported goods and precipitate serious balance of payments difficulties. A similar view has been expressed by Dr Goh Keng Swee, economic architect of Singapore, when he clarified why Singapore chose a currency board system in preference to a Central Bank. He says that none of his Cabinet colleagues ***'believed that Keynesian economic policies could serve as Singapore's guide to economic well –being'***. Since Singapore's economy was small and open, ***'financing budget deficits through Central Bank credit creation appeared to us as an invitation to disaster'*** (***Prudence at the Helm,*** p 33). About 25 years before Singapore used this wisdom, Exter argued that, given the underlying domestic production capacity, deficit financing would be an efficacious policy in developed countries that were largely dependent on foreign trade. But, it would not be the case with a developing economy. Hence, the Exter Report highlighted that, ***'this should serve as a warning to those who might hope that some of the policies growing out of Keynesian economics can be uncritically adapted to Ceylon'.*** As a safeguard, a provision was included in the Monetary Law Act prohibiting the

Central Bank to engage in trade or otherwise have a direct investment in any commercial, industrial or other undertaking. In Exter's opinion, such interests would lead to money creation, generate conflicts of interest and prevent making investment decisions based on hard-core economic principles. As such, the Central Bank's involvement in economic activities was considered sub-optimal.

It would be useful to examine whether Exter indeed proposed the necessary legal provisions in the draft bill to facilitate the new Central Bank to carry on business as per the advice given above. In this respect, it is also pertinent to understand that Exter made his recommendations at a time when the whole world had embraced Keynesian type of deficit financing as the sole remedy for unemployment problem and Central Banking with power to lend to the government or the economy was the rule of the day. Hence, as he had explained in the Exter Report, he had to adopt a pragmatic approach for the issue. He, nevertheless, proposed checks, balances and limitations for the Central Bank's Credit operations with the government or with the economy.

The following are the provisions and limitations he proposed.

1. Provisions have been made in the Monetary Law Act for the Central Bank to grant provisional advances to the government to facilitate the latter to meet any liquidity shortages in its cash flow. Exter has been criticized for making this provision in the Act, because it amounts to printing new money and making it available to the government to finance its operations. Such provisional advances create reserve money and work opposite to the price stability objective of the Bank. Any neutralization of the adverse effect of such advances has to be done by the Bank through its open market operations. But Exter did not propose to offer an open cheque to the government and limited such advances to 10 percent of the estimated government revenue at any time and made them repayable within a period of six months. He justified his limitation arguing that ***'many central banks and national economies have come to grief because governments have had too easy access to central bank credit'***. Hence, he argued that it would be wise to limit such credit just to meet only the very short term cash requirements of the government arising from seasonal requirements of funds. This wisdom of Exter was not followed and, as a result, provisional advances which were meant to be short term credit facilities for six months became permanent credit. As a result, the level continued to increase to a new high level in each successive year with increased estimates of government revenue. It has, therefore, provided permanent free funding to the government, almost similar to the annual profit transfer which the Central Bank makes to the government.

2. The Central Bank has been authorized to acquire Treasury bills from the primary issues and it, therefore, constitutes another form of lending to the government. The Bank has been prohibited to subscribe to primary issues of or, underwrite, the other types of government securities, viz., Rupee securities or Treasury bonds. Exter justified this prohibition on the ground of the obvious possibilities of abuse by governments. Even the

purpose of investing in Treasury bills was not to finance the government but to acquire the necessary liquidity for conducting smooth open market operations. This was explained by Exter as an injunction familiar to Central Bankers and Commercial Bankers alike that a bank should look to the liquidity of its portfolio.

An important principle established by Exter has been that the principal use of Open Market Operations (OMO) was to offset the effects of surpluses and deficits in the Balance of Payments (BOP). Since the surpluses of BOP raises money supply and deficits would do the opposite, it is necessary to counter their effects by an equivalent change in the domestic assets of the Bank. Hence, any OMO to siphon off the additional liquidity created by the Bank by increasing its domestic assets first, i.e., by investing in primary market Treasury bills, is contrary to the wisdom expressed by Exter in his report.

Can Exter be faulted for permitting the Central Bank to lend to the government? Though it is completely contrary to the principles of responsible central banking advocated by him elsewhere in the Report, he should be viewed as a pragmatic person. He argued that ***'if the Government were determined, even in the face of opposition by the Monetary Board to make excessive use of Central Bank credit, legal limitations could be relaxed'*** by the government. In such a situation, ***'the Board being a Government agency would have no alternative but to comply'***. Thus, legal provisions are not of any use if governments do not function responsibly and the civil society is weak in resisting such dangerous moves by the governments. He made this point clear in his Report as follows:

'The danger that a government will make use of the power of a Central Bank to over-expand credit is a real one and might appear a strong argument against having a Central Bank at all. But, as already indicated, if a government wishes to engage in the irresponsible creation of money, it can do so without a Central Bank. Paper money has come to stay. The only real safeguard against its abuse is responsible government'.

So the blame should not go to Exter. It is the absence of responsible governments that would erode the value of money through excessive creation of central bank credit. An example for such irresponsibility could be found in a reported statement by Robert Mugabe, President of Zimbabwe that, if money is not found for projects, he would print the same, at a time when inflation was rising at more than 4500 % in his country. (***Time,*** 13 Aug 2007)

Elimination of the Seigniorage from the Books of Accounts

The issue of paper based fiat money at a fractional cost of the face value has enabled sovereigns to earn a substantial profit known as the seigniorage. Since there is no requirement for the issuer to back such money with an equivalent reserve, there is no limit to the issue of money by a sovereign. As a result, Central Banks which have been mandated by sovereigns to issue currency grow like an inverted pyramid: with a very low base as capital and reserves at the bottom and substantially high level of acquired assets through money creation at the top. This pushes a Central Bank to a very high risk level, when it is viewed from the point of solvency, since an overgrown Central Bank may not have sufficient assets to discharge its liabilities in a crisis situation.

Exter, having known this fundamental risk faced by a Central Bank, made provisions in the Monetary Law Act to automatically hide the seigniorage. In terms of these provisions, the printed currency stock in the vaults of the Central Bank does not become a part of its assets. When currency is issued, it becomes a part of its liabilities with a corresponding asset created in its books. However, when that asset is liquidated, currency issued earlier comes back to the Central Bank and such currency is taken out of its books by deducting it from the currency issue. Thus, the accounting system prescribed in the Monetary Law Act does not take into account the profits made by the bank in its currency issue. The cost is simply charged to the income account of the bank and eliminated from the books.

On the currency issued, the Central Bank makes a seigniorage. However, that seigniorage is dispersed among all the assets of the Central Bank and cannot be identified for the purpose of paying out to the government. Instead, what is explicitly recorded in the books of accounts is the interest income which the Bank earns on the assets it has created. All costs of the Bank are charged to this interest income and the net surplus is ascertained. That surplus is not automatically paid to the government, since Exter has made specific provisions regarding the appropriation of the profits of the Bank.

In terms of these provisions, there is an order of priority for the appropriation of profits of the Bank.

First, profits should be applied to pay any outstanding amount carried to a Monetary Adjustment Account on account of (a) extraordinary currency issue (b) expenses and interest payments on the issue of Bank's own securities and (c) any interest paid on commercial bank reserves in that unlikely event of the Bank's raising the statutory reserve ratio to 100 percent to fight a very high inflationary situation.

Second, anything remaining after the first appropriation, a reserve should be created to a value of at least 15 percent of the domestic assets of the Bank.

Third, if any profits are left out after the above two appropriations, the remaining profits can be paid to the government.

In terms of the above provisions, the payment of profits to the government is the third and last priority on the scale. Exter argued that, that should be the case because of the inflationary or deflationary effects which the payment or the non-payment of profits can have on an economy. For instance, when the profits are transferred to the government, the reserve money will increase, raising both money supply and creating inflationary pressures. Exter argued that such an expansion that would have arisen from the Central Bank's own contribution to inflation by raising its domestic assets should be prevented. Domestic assets of the Bank could go up due to the

Bank's lending to the Government or the commercial banks. If these assets have increased too rapidly, the result would be inflation through a similarly rapid increase in money supply. Exter's prioritization of the appropriation of profits intended to prevent the Bank from paying to the government such profits earned by inflating the economy. But, he did not have any objection to the transfer of profits to the government, if such profits have been earned on the Bank's investment of its foreign assets. Since the foreign assets are maintained by the Bank on behalf of the government, the latter have a right to receive its due rate of return. So, Exter concluded that if the domestic assets have not expanded (in other words, if the Central Bank has not inflated the economy), '***there should be no ill-effects from paying out the Central Bank's profits to the Government, especially since in this case the Government could not have been obtaining excessive accommodation from the Central Bank'.***

The most important provision relating to the appropriation of profits of the Central Bank is the requirement that the Bank should build reserves out of profits to back its demand liabilities, viz., currency issue and demand deposits maintained by the Bank. Exter's recommendation was that such reserves should be equal at least to 15 percent of the Bank's domestic assets. Such reserves need not be built up against foreign assets, since those claims on the rest of the world would in anyway back the currency and demand liabilities. But, the domestic assets which are created by the Bank at its own discretion have no value in the domestic economy in a severe crisis. Since the build up of the reserves would prevent the transfer of profits to the government, Exter concluded that it would '***prevent them from adding to the expansion of central bank credit'.***

Given the ever rising provisional advances granted by the Central Bank to the government and its permanent nature making such advances another form of implicit profit transfer, it is questionable whether the minimum of 15 percent is an adequate backing for the Bank's currency and demand liabilities. For the provisional advances, there is no collateral placed by the government with the Central Bank. Hence, they are akin to unsecured overdrafts given by a Commercial Bank to its customers. Since the risk weights given to such unsecured advances exceed even 100 percent, it is necessary for the Central Bank to plan for a higher level of reserves than the minimum 15 percent. The Central Bank management, having taken this prudential requirement into account, has decided, as a part of the Bank's modernization program, to raise the reserve level up to 100 percent of the domestic assets of the Bank. This is being continued by the Bank since 2003 and the reserve level today stands closer to 100 percent. However, it would be prudential to revisit even this percentage today in terms of its adequacy in view of the level of ever rising unsecured provisional advances and Exter's warning that the profits earned by inflating the economy should not be distributed.

The build up of reserves by the Central Bank to be equal to its domestic assets has another monetary dimension. On the liability side of Bank's Balance Sheet, it has liabilities on account of currency issue and demand deposits maintained by commercial banks. These liabilities are known as monetary liabilities, since they constitute the reserve money of the system. All other liabilities, including the capital and reserves, are, therefore, called non-monetary liabilities. When reserves are built-up to be equal to the Bank's domestic liabilities, its monetary liabilities would vary exactly in accordance with the movement of the Bank's net foreign assets. When the Bank raises its net foreign assets, monetary liabilities or the reserve money would increase by an equivalent amount. When the opposite takes place, reserve money would fall. This is similar to the operation of a partial currency board system on a voluntary basis in Sri Lanka.

It is considered a partial currency board system because it backs both the currency issue and the demand deposits of Commercial Banks by an equal amount of foreign assets. In a currency board system, only the currency issue has to be backed with foreign assets in this manner. Since the system voluntarily practiced by Sri Lanka provides a wider backing than the currency issue, it could be considered as a more prudential system than even a currency board system, provided that net foreign assets always remain a positive number. If they become negative due to the fact that Bank's foreign liabilities are greater than its foreign assets, it poses the bank to a new type of a risk. The risk becomes very much material in a situation where there are continuous balance of payments deficits and if the Bank is required to raise foreign loans to meet the emerging foreign exchange requirements. In this situation, the backing of the monetary liabilities by foreign exchange reserves would sever, making monetary liabilities highly vulnerable to emerging market developments, specifically what would happen to the net domestic assets of the Bank.

When the net foreign assets are negative, it exerts pressure for domestic assets to increase in a compensatory manner, for otherwise, there would be a huge liquidity crunch in the economy adversely affecting all the economic activities. Such a sudden and rapid increase in domestic assets would reduce the ratio of capital and reserves to the domestic assets to unacceptable levels. The corollary would be that both the foreign assets and reserves would fail to back the Bank's monetary liabilities. To mitigate this risk, it may be necessary to maintain the reserve level greater than the value of the domestic assets of the Bank. In other words, capital and reserves of the Bank should be higher than 100 percent of the domestic assets of the Bank.

The Independence of the Central Bank

Central banks have been created by societies to issue the medium of exchange and preserve its value. The power given to central banks as sole issuers of currency is similar to nationalization of money supply. This is an extraordinary monopoly power vested with a Central Bank. Hence, there is the possibility that this power can be abused by the masters who have given the power to a Central Bank. Since the history is full of examples of governments' abuse of this power, the question of the independence of Central Banks has come to the focus. Noble Laureate, F.A, Hayek, arguing that inflation throughout the history has largely been engineered by the governments, made even the suggestion that the Central Banks should be dissolved and money supply should be de-nationalized (***Denatinalisation of Money,*** Hobart Paperback No 70, 1978). Some have even cynically referred to Central Banks as 'necessary evils'. Against this background, the issue of the independence of Central Banks is of crucial importance. In this regard, the independence of the Central Bank of Sri Lanka has been raised by many at numerous public fora.

The question of Bank's independence has come to limelight due to the Secretary of Ministry of Finance sitting as a vote carrying member of the Monetary Board, the highest policy making body in the Central Bank. The critics have argued that, since he is a government official, he would steamroll all other members of the Board and get the Central Bank to comply with government wishes.

Many have found fault with Exter for making the Secretary to the Ministry of Finance a member of the Monetary Board. The criticism is that the Secretary, acting in his own self-interest, would get the Central Bank to fund the government budget through money creation, thereby permitting the fiscal policy to override the monetary policy. It has been equated by some critics to the case of permitting a child to put his hand into a cookie jar as many times as he wishes. While these criticisms may have some validity, Exter's wisdom was to create an environment for both the government and the Central Bank to have a peaceful and amicable cohabitation. Exter argued in his report that ***'....there are, however, many important problems of monetary policy, especially those relating to fiscal policy, on which a central bank should work in close harmony with the government'.*** Accordingly, a degree of independence has been afforded to the Central Bank unlike other governmental bodies. This independence extends to the budget of the Bank, job security of key Central Bank officials and power to make monetary policy without consulting the government. The wisdom of Exter was that the Central Bank should as far as possible work in consultation with the government, rather than in isolation. He believed that the true independence of the Central Bank could be preserved only through that consultative process. In the words of Exter, ***'the ideal is....one in which there will be continuous and constructive co-operation between the Monetary Board and the government. The principal instrument for achieving this co-operation should be the Permanent Secretary to the Ministry of Finance whose membership on the Board will ensure at all times that his Minister's views will be known to the other members of the Board'.*** However, Exter did not expect this arrangement to be effective at all times. Hence, he made the proviso that ***'it would depend on the men occupying the key positions'*** and not on any legal formula. He argued quite correctly that such complex and delicate relationships cannot be established full-blown by a piece of legislation. It must be the result of years of experience and the slow growth of political conventions.

Exter Report testifies to the fact that the independence of the Central Bank should be attained and maintained by people in both the Central Bank and the Ministry of Finance and working with a 'moral consciousness' regarding the well-being of the whole society rather than narrow self-interest objectives.

Conclusions

Six decades is a long period during which a society should necessarily undergo tremendous political, social and economic transformation. The onslaughts of new technology, globalization and advancements in fast communication systems have changed the ideals of the people of all societies throughout the globe. Hence, one may tempt to question whether the ideals expressed by Exter more than a half a century ago are still valid and relevant.

Though the ideals of societies have changed, the core principles that are embodied in the philosophy of Central Banking have not changed over the time. In fact, they have become much more hardened today than 60 years ago. Nations throughout the world have gone for price stability as a necessary prerequisite for continuous prosperity. Hence, the hands of Central Bankers have been strengthened much more today in all parts of the world to facilitate Central Banks to function independently and make appropriate policies for monetary stability. The wave of modernization that has swept over almost all central banks in 1990s and in the new millennium is a testimony to this new trend. Hence, John Exter still lives in the core of the hearts of Central Bankers throughout the world and will continue to do so in the foreseeable future as well.

DEVELOPING SRI LANKA AS A FINANCIAL CENTRE

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Although the idea of developing Sri Lanka into a regional financial centre (or hub) has been envisioned and discussed since the 1980s, achieving the transformation of vision into reality has proven difficult. The basic legal framework for setting up Sri Lanka as a financial hub was in place when the Banking Act came into effect in 1988. On the other hand, offshore banking, which is an integral part of a financial hub, existed in the country since the mid 1980s when foreign currency banking units (FCBUs) were established and the required legal framework was introduced to the Banking Act in the 1990s. Banks such as the Indian Overseas Bank and the Overseas Trust Bank initially used the FCBUs for offshore operations in taking foreign currency deposits from non-residents and lending or investing overseas and thereby building up significant balance sheets in their FCBUs. Another important initiative was the amendments made to the Banking Act in the 1990's to permit the operation of numbered foreign currency accounts by non-residents. It can be said that in the 1980's and 90's, Sri Lanka was positioned better than any other neighbouring country to stake its claim to be a financial centre for the region. The question is why we did not progress beyond those early initiatives.

The process of evolving into a financial centre first got derailed when the domestic market opened up for foreign currency assets with the Government deciding that Board of Invesment (BOI) approved export companies should be able to borrow in foreign currency. This resulted in the large domestic banks shifting their focus to build local relationships in this new sector almost totally ignoring the development of their relationships outside. They used the expatriate Sri Lankan remittances as their resource base to lend to domestic export businesses. The surplus, they just placed in deposits with overseas banks, which did not give them any institutional visibility in those markets. Much later some of the banks did some project lending in the Maldives but that was too little too late. While the banking system did meet the domestic development need at that time they did so at the expense of placing Sri Lanka on the international financial map. With hindsight we should have looked at getting our presence established in other markets by undertaking offshore business although some markets such as India were closed to foreigners until somewhat later. The numbered account scheme was also short lived. Due to international pressure, imagined or actual, the scheme was stopped in the late 1990's to comply with anti money laundering and anti terrorism regulations that were receiving the attention of the international community.

Another reason that impeded the evolution into a financial centre was the ongoing civil strife since 1983 and the political instability of successive governments since the late 1980s. Also, from a political perspective, a financial hub did not have much mileage because the benefits are not very tangible like building a road or a port. Thus, this aspect of development did not get the political priority it deserved. The net result is that despite being the first to start, we have allowed many opportunities to slip by with centres such as Mauritius, Labuan and Dubai entering the landscape. This article highlights the basic features of a typical financial centre, evaluates Sri Lanka's potential of becoming an international financial centre in the future, and presents some measures that could catalyse the realisation of such a vision.

Financial Centres

A financial centre or hub is a marketplace where those who need financial services of a kind not catered to by their own domestic financial markets meet others who supply such services. A location where international suppliers of financial services set up regional offices, providing a convenient concentration of financial services to those seeking them can also be defined as a financial hub. The common thread is that in a financial centre, the participating customers are significantly offshore. Typical activities of a financial centre would include foreign exchange trading, equity, debt securities and derivatives trading, wealth management, payments clearing and settlements, mergers and acquisitions, and securities underwriting. Not every centre will provide the same type of services or cater to the same range of participants, as there is some degree of specialisation amongst them.

London and New York can be considered global financial hubs that feature very liquid markets and provide a wide array of financial services and products to sophisticated offshore participants. Although Tokyo is a very big financial centre, its global role is limited. There are smaller centres such as Hong Kong, Frankfurt, Singapore and Dubai, which are regional in scope. Another type of centre includes Labuan and Mauritius, which primarily deal with the requirements of a limited number of countries. Finally, there are established centres such as Switzerland, Channel Islands, the Bahamas and Luxembourg, which are global in scope but cater mainly to niche products and services. More recently Dubai is emerging as an offshore centre for the Middle East, broadening its scope of activity beyond the limited services offered by Bahrain.

In general, successful financial hubs have some common characteristics. They function in a stable political environment and in an open macroeconomic environment with low budget deficits and stable interest rates and exchange rates. These factors, although not always directly relevant to offshore transactions, are critical for building confidence among potential users of the financial hub who need to feel very comfortable that local problems will not spill over to affect the security of offshore transactions. In such centres, there will be a free flow of international capital and capital account convertibility while the economy will be characterised by a high service sector contribution to GDP. The successful centres will be in accessible strategic locations close to large markets, and their domestic financial markets will be well developed and boast a wide range of instruments and a high level of human talent and financial sector skills among not only service providers but also regulators. Very importantly, financial hubs have efficient and equitable legal systems for property rights, contract enforcement and bankruptcy, and a transparent regulatory system with policy consistency to ensure integrity and efficiency in markets. Other features would include a sizeable market in tradable securities, financially strong and credible banks and capital market institutions, relatively easy entry to foreign banks, financial institutions and human talent that meet specified transparent criteria and minimum non-prudential bank regulation, a conducive tax regime with low taxation, an educated and literate workforce and good living conditions in terms of quality of life and cost.

Sri Lanka as a Financial Centre

Sri Lanka benefits from its excellent geographical location, which can enable it to cater to the South Asian region. The services sector contributes over 60% of GDP, and is bolstered by a fast growing financial services sub sector. The telecom infrastructure is well developed, the stock exchange is technologically advanced, and the country has a sophisticated payments system for domestic inter-bank settlements and SWIFT connectivity for international payments. The workforce is literate and trainable. There is an even playing field for local and foreign banks although there are some regulatory barriers to entry. These features are positive indicators of Sri Lanka's potential to become an international financial hub; however, it should be noted that many of these features are not competitive advantages as many other countries in the region can also boast of them.

Several factors impede Sri Lanka's chances of transforming itself into a financial hub. The ongoing conflict and the law and order situation that has deteriorated over time are significant deterrents, while the high budget deficit, double digit inflation (for much of the last 3 decades) volatile interest rate and perpetually depreciating exchange rates diminish the lustre of the fast-growing financial sector. Partial capital account convertibility and the fact that the economy is not entirely free-market works against the building of a critical mass of international capital flows. Apart from telecommunications and the Colombo port, local infrastructure is not up to standard and regional air access to the country was not, until recently, convenient.

Very importantly, the overall financial sector is not that well developed, and is dominated by commercial banking institutions that are very small by international standards and offer only plain vanilla financial products. The banking sector, in particular, is a cradle to grave employer and management generally resist lateral infusion of talent resulting in serious skill gaps in the industry. There is little diversity, liquidity and depth in capital market activities, with a relatively low volume of trade in equities, bonds, commodities and derivatives. Although regulations are fairly strong, they fall short in ensuring transparency, integrity and efficiency in markets, and are only weakly enforced. Despite the fairly comprehensive legal framework, there is insufficient legal knowledge and understanding of laws relating to new financial products and financial services delivery systems, with emphasis being on form and process rather than substance. Also, the legal administration system to resolve disputes is protracted and cumbersome.

Given all the above unfavourable factors we may be looking at a time frame of 5 to 10 years, perhaps closer to 10 years, before we can realistically establish Sri Lanka as a financial hub. That too would depend on the implementation of reforms and an action plan to upgrade the size, stature and sophistication of the domestic financial sector. We can only hope that by that time we will also have relative peace in the country, which is a fundamental pre-requisite for any financial centre.

Closing the gap

There are several preparatory steps that will have to be taken on the road to establishing Sri Lanka as a financial hub. Reducing the Government's share of the financial sector is one such step. The bulk of private domestic savings in the country is still captive to government-controlled entities, and the share of Government control on financial sector assets through state-owned banks and institutions is very high. The strength, depth and independence of the domestic financial sector is a key factor in attracting foreigners to participate in the financial market, and the Government's dominance of the sector could prove a potential stumbling block.

Allowing greater autonomy to the state banks to determine lending strategies, improving their efficiency to help reduce the financial intermediation cost, and commencing partial privatisation of these banks will be positive steps. Regulations should also facilitate the formation of larger private banks through consolidation, and the current policy of enabling consolidation only between the strong and the weak will not allow local financial institutions to become significant in an international context. Policymakers should encourage consolidation among strong institutions for the reason that even our larger financial institutions are weak and small compared to global and regional banks. Instead of concentrating on ownership, the sector would be better served through the imposition of more stringent measures to ensure good governance, in particular, greater management accountability, good practices, the composition of the board of directors, and stringent control over related party lending.

Encouraging the entry of global financial institutions and promoting the continuous training and exposure of local bankers and regulators at international level will also be important, as facilitating the growth of professional financial, legal and investment advisors whose expertise is on par with international counterparts will also be essential for the sector's development.

The regulatory framework will have to be revamped comprehensively, instead of tinkering with a 20 year old Banking Act, to enable the financial sector to function more efficiently in an increasingly sophisticated international financial milieu. Ensuring minimum non-prudential regulations to promote healthy competition for business amongst banks, perhaps through a common banking licence, and encouraging financial institutions to offer a wider range of investment products besides traditional deposits will be important. Initiating regulatory reforms governing the insurance sector will also be beneficial, as insurance companies gaining greater flexibility in asset allocations will increase the depth of the market with regard to investments in equity and derivatives. Apart from creating a sustained climate to attract foreign portfolio funds into Colombo's stock market, the Government should reduce its almost total hold of captive funds in EPF and ETF paving the way for substantial investment in the capital market and management of funds by private fund managers. Above all, ensuring policy consistency will be paramount. While the issues identified above relate mainly to the development of the domestic financial sector, as stated earlier, a strong and well developed domestic sector is required to build confidence among foreigners and project Sri Lanka to a hub status.

Looking Ahead

Even if the above measures are implemented, it will be necessary to proceed with caution and be realistic about the country's prospects as a financial centre. Instead of trying to compete with already established financial centres, the country would be better served by narrowing our focus on a more attainable goal: seeking to serve South Asia as our target market. The rapid rise of India as an economic giant is an opportunity that must be seized , and although Sri Lanka has been slow to capitalise on its growth, swift and decisive action may make up for lost ground. Given Sri Lanka's good relations with its other neighbours, especially Pakistan and Bangladesh, the potential of developing the country as a regional financial hub is encouraging. It may also be possible to position Sri Lanka as a provider of more diverse products in a wider geographical context. As some observers have pointed out, Sri Lanka can form a triangle with Dubai and Malaysia through which opportunities in Islamic Banking can be expanded.

One final consideration that must be taken into account in the current geopolitical landscape is the need for transparency and stringent restrictions relating to money laundering and international terrorism. Most countries that have become significant financial hubs such as Singapore and Hong Kong did not have to contend with these requirements in the early stages of their development. Those countries benefited from the general distrust that citizens of less developed countries had on their Governments and evading taxes and exchange controls were some of the main reasons why offshore centres started to develop. The situation today is different. We have to abide by international requirements that are imposed on us when handling financial assets and this can at times be cumbersome and make it difficult to take off. Of course, there is a lot of perfectly legitimate business as well and we will obviously have to restrict ourselves to that part of the business to avoid the risk of becoming international outcasts. Yet , with sufficient planning and prudence, the momentum of establishing Sri Lanka as a legitimate financial hub could be allowed to gather pace, however slowly.

IS MICROFINANCE THE PANACEA FOR POVERTY

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Introduction

Poverty is often the result of individual or collective play of factors such as unemployment, underemployment, disease, abuse, degradation, and disenfranchisement leading to physical, mental and emotional disability, limited skills, low educational levels, lack of confidence, resentment, aggression and truncated vision. As Amartya Sen has observed, "poverty must be seen as the deprivation of basic capabilities rather than merely as low incomes"[1]

Nonetheless, statistics on income provide us a fair guide to poverty as it exists in the world today. 60% of the world's population lives on 6% of the world's income while almost one half of the world's population lives on less than US$ 2 per day. 1.3 billion people live on less than US$ 1 per day[2]

In Sub Saharan Africa 48% of the population lives on less than US$ 1 per day while in South Asia more than half a billion people still live below the poverty line.

Governments worldwide have adopted various strategies at different times to address the complex and difficult task of alleviating poverty. Of these the most common macro economic strategy can be said to be the adoption of policies to achieve a steady high rate of growth in the economy over the long term in the expectation that its benefits such as high income, improved educational levels, better health facilities, and other improved standards and conditions of living, including improved access to financial facilities, will trickle down to those at the lower levels of income.

It cannot be denied that rapid and continuous macro economic growth is a necessary strategy to reduce poverty. However, countries experiencing such growth have had mixed results in achieving this objective in the absence of other strategies to ensure equitable distribution of the benefits of growth. While some countries do have success stories to relate, many others show ample evidence that macro economic growth has widened the gap between the haves and the have-nots and led to worsening the position of the poor, indicating that macro economic growth alone has not been successful in alleviating poverty. Often cited success stories come from Malaysia and South Korea which countries were able to reduce absolute poverty from over 50% to a very low level below 6% within about four decades[3]. It is also reported that China with its high growth rate and modest growth elasticity, reduced poverty headcount by 8% annually during

1990-2001[4]. However, in many other countries this process has ended up widening the gap between the rich and the poor leaving a challenge for governments to develop specific tools with respect to redistribution of income and to address poverty issues. India is a case in point. As "The Banker" of April 2007[5] points out, India's economy is growing at its fastest ever rate, at 9.2%, yet the poor have been left behind: endemic poverty persists and economic inequality is growing. In fact, this disparity was highlighted by none other than Prime Minister Manmohan Singh when, in his address to the nation on India's Independence Day this year, he stated that "India cannot become a nation with islands of high growth and vast areas untouched by development where the benefits of growth accrue only to a few" and declared that the eradication of this disparity is the foremost challenge faced by India today. Such experiences lend credence to the comment of Garson that "macroeconomic policies linked to structural adjustment processes, although subsequently oriented in ways that tended to limit or minimize social problems, could hardly bring about a lasting solution" [6]

Apart from targeting overall growth as a poverty alleviation strategy, many governments have also introduced safety nets in a variety of ways focused on the poorer segments of society. Outright grants to the poor have been widely practised over a number of decades as a means of alleviating poverty. This strategy had several inherent weaknesses, the main being the disincentive provided by the grant to unleash the economic potential of those who received such grants, especially those who are economically active. Public money transferred to the poor can provide only short term relief to the situation of the poor as public funds are not in infinite supply and although such measures provide short term relief, by and large, they have failed to bring any sustainable economic benefits to the poor, to society and to governments. In the long run they have had, in fact, greater negative social impacts.

In addition to grants, governments of many developing countries have, at various times, adopted different social welfare programmes targeting the poor. For instance, Sri Lanka introduced many such schemes over the years, including the Rice Ration Scheme, Food Stamp Scheme, Janasaviya and Samurdhi Programmes. In addition there were several other welfare programmes introduced to reduce malnutrition among school children and pregnant mothers as part of the strategy to address poverty issues. Basically, many such schemes are founded on a concept of 'hand-outs' rather than self help and while they provide immediate relief to those in need, are not designed to result in sustainable improvement of the quality of life of the poor.

In comparatively recent times, the lack of access to reliable financial services has also been recognized as a major constraint to the reduction of poverty, especially in rural areas. The lacunae in such services led to the intervention by governments the world over in the financial market by compelling or granting incentives to lending institutions to lend to targeted groups or sectors, by providing grants and subsidies to lenders to reduce the on-lending rates, and by making available to them back-to-back finance. International donor agencies and lending institutions, too, made available funds to governments, lending institutions and non-governmental organizations at concessionary rates of interest towards economic activities by these targeted groups or sectors. Nonetheless, these schemes remained very much a part of conventional banking and did not fall in to the category of 'micro' finance as understood today either in terms of quantum or social orientation.

Microfinance

The modern mainstream microfinance concept began in the mid '70s, in Bangladesh in response to abject poverty conditions, when the Grameen Bank, begun by Prof. Mohammed Yunus, began giving small loans to the poor, mainly to be connected to the formal financial systems to which they had no recourse. Since then, this micro finance model has been a source of ideas and models for many organizations in the field of microfinance which have sprung up internationally and is used in many developing countries as a key strategy for poverty reduction.

The basic principle on which microfinance is based has been described as a process in which poor families borrow relatively large amounts of money at one time and repay the amount in a stream of small, manageable payments over a realistic time period using social collateral in the short run and institutional credit history banking in the long run.[7]

From its inception, micro-finance has evolved in astounding ways, incorporating social and development concepts together with principles underlying financial markets. The concept has undergone a long period of innovation in an attempt to meet the varying challenges and needs of different target groups during several phases in the 80s, 90s and since 2000 and has therefore no single blueprint model.

While the exact definition of microfinance varies form country to country, the Asian Development Bank - (ADB 2000) defines microfinance as "the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor, low-income households and their micro-enterprises"[8]. The Consultative Group for Assisting the Poor (CGAP) states that "microfinance is the category of financial services offered to lower income people, where the unit size of the transaction is usually small (micro), typically lower than the average GDP per capita."[9]

A large number of different types of institutions with a varying degree in the extent of outreach are engaged in providing microfinance worldwide. They include "formal institutions such as, rural banks, co-operatives, semiformal institutions such as non-government organizations and informal sources such as money lenders and shop-keepers"[10] . In addition to credit and savings, the wide range of financial and non-financial services provided under microfinance world over include remittances or money transfers, insurance, leasing, market information, keeping its clientele afloat and getting them cohesively integrated into the society.

Perhaps, in this sense, none of the definitions or descriptions of microfinance given above capture, for us Asians, the essence of the almost revolutionary banking concept introduced by

Prof. Yunus in the same way that the term 'barefoot banking' does. Microfinance reaches out to the helpless at his/her own level in an environment which is familiar. It takes account not only of good banking principles, but also of cultural and social realities.

Thus a majority of microfinance programmes, implemented especially in the Asian region, has focused attention on women due to the wide belief that women are better borrowers and they are also the link to upgrading the economy of poor families. Professor Yunus in his 12th Anniversary speech at the National Development Trust Fund in Colombo in August, 2007 stated "I have seen that women are better handlers of money and the culture of South Asian countries is such that they give more to the family than the men. It is women who stay with the families in times of finance and famine. Thus, lending to women always brought more benefits to the family".

Microfinance - Expectations

Until the 1980s only a handful of organizations offered credit and savings services to poor people in developing countries. Today, microfinance institutions' membership is more than 7000 world over, a level unimaginable 20 to 25 years ago, serving more than 70 million people. "By 2005, microfinance covered at least 35 million of some 270 million families in the region (South Asia) and met around 15% of the overall credit requirements of low income families.[11]

Recently, international multilateral organizations such as the World Bank, the IMF, ADB and the United Nations and several other international donor agencies have focused their attention on different strategies to eradicate poverty - microfinance being the focus of their attention.

In December, 1998 the United Nations General Assembly designated the year 2005 as the "International Year of Microcredit" (resolution 53/197) stating that the year will be an important opportunity to give impetus to microfinance programmes throughout the world. Presently, microfinance is considered worldwide as "one of the practical development strategies and approaches that should be implemented and supported to attain the bold ambition of reducing world poverty by half [12].

Microfinance has also been identified as a major contributor in achieving the 7 Millennium Development Goals (MDGs) by 2015 i.e. (i) reducing the proportion of people living in extreme poverty by one half; (ii) enrolling all children in primary school (iii) eliminating gender disparities in primary and secondary education (iv) reducing infant and child mortality rates by two thirds (v) reducing maternal mortality ratios by three quarter (vi) providing access to all who need reproductive health services (vii) reversing the loss of environmental resources. The central theme of MDGs is reduction of poverty in all its forms. Microfinance underpins the achievement of these MDGs and plays a key role in many MDG strategies.

Microfinance had a prominent place on the agenda of the 60th High-level Plenary Meeting of the United Nations General Assembly (2005 World Summit) in 2005. The outcome document adopted by the gathering states "we recognize the need for access to financial services, in particular for the poor, including through microfinance and microcredit[13].

Support for microfinance has also been implied in the endorsement by the Summit of the 2002 Monterrey Consensus, which states: "Microfinance and credit for micro, small and medium-sized enterprises, including in rural areas, particularly for women, as well as national savings schemes, are important for enhancing the social and economic impact of the financial sector[14]

Thus it can be seen that microfinance has established itself as an important aspect of global strategies for poverty alleviation and that much hope is pinned on it in the world's battle against poverty.

Impact of Microfinance- Empirical Evidence

Measuring the impact of microfinance on development aspects on clients is a complex and difficult task and, due to this, such impact assessments have received wide attention. The ability of microfinance to make an impact on poverty requires continuous access to a wide range of financial as well as non financial services by a greater number of people and any study on the impact of microfinance on the poor has to undertake a rigorous investigation into a wide array of variables. Some argue that the provision of sustainable microfinance does not necessarily result in poverty alleviation and that debt financing is not a good tool. They maintain that although microfinance has demonstrated the potential to reduce poverty and has changed and revitalized the lives of a large number of people, its impact worldwide has varied. Unarguably, the positive impact of microfinance is not spread equally among all microfinance borrowers and they vary in different degrees even within the same institution.

There is a large number of microfinance impact assessment studies undertaken, mainly in Asian and African countries. Studies on Asia have tended to concentrate on Bangladesh and primarily assess impact on income levels.

A majority of the studies on microfinance have their own methodological flaws due to the complexities involved. Isolating the impact of microfinance and comparing clients to non clients of microfinance programmes are the most common problems encountered in such studies.

Based on MDG indicators, poverty eradication can be identified broadly as increase in savings and housing/household assets, improved diet, improved primary health care and education, reduced dependence on money lenders, increase in productive assets, improved profits, increased employment and other backward linkages from increased enterprises activity. On the above basis, several assessment studies have come up with evidence that the provision of microfinance services has responded to opportunities, assisted in organizing finances and thereby has helped to increase income and assets creating wealth and decreasing the vulnerability of poor in several countries.

Credito Con Educacion Rural in Bolivia found that incomes of two thirds of its clients had increased after joining the programme[15]. Clients of Bangladesh Rural Advancement Committee (BRAC) who stayed in the programme for more than four years increased household expenses by 28% and assets by 112%. Society for Helping Awakening Rural Poor through Education (SHARE) in India documented that 75% of its clients who participated for longer periods saw significant improvements in their economic well-being and that half of the clients moved out of poverty. By the end of 2005 it is reported that half of nearly 3.4 million borrowers of Grameen Bank in Bangladesh, which had granted loans with a value of more than $ 4.3 billion, had crossed over the poverty line[16]. Prof. Yunus in his speech at the Nobel Prize Award Ceremony in Oslo on 10.12.06, stated that according to Grameen Bank's internal survey of the nearly 7.0 million poor people to whom US$ 6 billion micro loans had been given, 58% had crossed the poverty line. The survey carried out by the Central Bank of Sri Lanka (CBSL) in 2005 on a sample of 1200 households comprising of beneficiaries from the districts of Kandy, Puttalam, Galle and Matara who had been in the Small Farmers and Landless Credit Project (SFLCP) for a minimum period of 5 years, indicates that around 63% escaped poverty while around 2/3rds of beneficiaries were satisfied with their improved living conditions. The annual sample survey carried out by the CBSL at the end of 2006 of the Poverty Alleviation Microfinance Project beneficiaries in 6 districts namely Kalutara, Hambantota, Nuwara Eliya, Badulla, Matale, Kurunegala indicate that the overall quality of housing, availability of latrine facilities, and access to safe drinking water have improved notably. Since these beneficiaries have been with the project for less than 2 years it was not sufficient a period to make a significant improvement in economic and living conditions. Microfinance also has the ability to shift clients from irregular, low-paid daily labour to more diversified sources of income with a strong reliance on small businesses.

In an impact of microfinance on poverty alleviation study undertaken by Khandker[17] based on two surveys in 1991/92 repeated in 1998/99 it has been revealed that each additional 100 taka of credit to women by Grameen Bank, BRAC and RD-12 with a large outreach in Bangladesh has led to an increase in total annual household expenditure by more than 20 taka, 11.3 taka in food expenditure, 9.2 taka in non food expenditure. It has further revealed that moderate poverty in all villages covered has declined by 17 percentage points and among programme participants who had been members since 91/92 poverty rates have declined by more than 20 percentage points, about 3 points per year. Khandker states that more than one half of this reduction is directly attributable to microfinance. The impact study of the SEWA[18] Bank in India carried out for the USAID-AIMSD project in 2001 indicated that credit services raise household income by increasing revenues of loan supported micro-enterprises. In Pakistan, a survey of about 3000 clients of Khushhali Bank showed an increase in income for both rural and urban members. Remenyi notes that in Indonesia a 12.9% annual average increase in income by borrowers compared to 3% increase in non borrowers.[19] In Mali, women borrowers have reported increase in income of 50%. There are numerous other studies carried out in Vietnam, Phillipines, China and several African countries indicating similar economic improvements in microfinance beneficiaries over the years inducing reduction in poverty levels.

Impact analyses also have strong evidence to indicate that microfinance has a positive impact on several specific socio-economic variables such as education, household nutrient status and women's empowerment in a large number of countries including in South Asia. Improved income derived from micro enterprises, together with the ability to save, allow poor people to better plan and invest in their children's future. "Insights 51" of December, 2004 reports that "one of the first things poor people all over the world do with new income from micro-enterprises is invest in their children's education". The magazine further reports that Bangladesh Rural Advancement Committee (BRAC), SEWA (India), Save the Children (Honduras) saw the clients' children were more likely to go to school, stay in school longer and have lower drop-out rates. A study in 1996 in two villages in Bangladesh has shown that all the girls from Grameen Bank member households had received some schooling, compared to only 60% in non member households. A longitudinal study conducted in BRAC, operational areas from 1992-95 had reported higher rate of improvement in basic competency of children in BRAC member households as compared to non members[20].

In Bangladesh, literary rates among the children of BRAC clients aged 11-14 at baseline 1992 and then 1995 increased from 12 to 27% in 3 years compared to 14% among children of non client households. H. Todd in "Women at the Center (1996) notes that 81% of the Grameen boys have had some schooling compared to just 54% outside after 10 years with Grameen Bank.

When compared with non borrowers The Impact Assessment Survey of the CBSL on the SFLC project 2005 states that "A substantial proportion of school going children in beneficiary families were found to be attending private tuition classes and weekend religious instructions classes. Over a quarter of all beneficiary households were found to have at least one computer literate member".

"In Pakistan, the study of microfinance clients of Khushshali Bank shows higher expenditure on schooling, especially for girls, and children of clients were more likely to remain enrolled in schools longer than their counterparts in non client households"[21]. Similar experience is witnessed in several other countries including Indonesia in the area of education especially in situations where the borrower is a woman. Studies in India, report slightly higher enrollment and literacy levels of sons and daughters of women borrowers, in comparison with children of non clients. It is reported that this is more significant at the primary school level and that women's group membership leads to more daughters attending school[22].

Although there is limited evidence for the impact of microfinance programmes on health, the conclusion reached in all these studies indicate that in the long run the impact indeed is positive. The most common benefit is the tendency of these clients to access better healthcare and educational facilities after being in microfinance programmes for some time. Access to microfinance leads to higher as well as more stable income thereby facilitating to preventive healthcare and treatment of health problems at an early stage. The study on Self Help Groups (SHGs) in India (GTZ-2005) has reported that SHG members accessed better health care facilities after joining the programme, resulting in higher expenditure on medical care[23] while the study of Khushshali Bank clients in Pakistan also has indicated results on similar lines. Almost 95% of clients of Foundation for Credit and Community Assistance in Uganda engaged in improved health practices for their children compared to 72% of non clients. Almost all the beneficiaries of the SFLC project in Sri Lanka have had improved latrines in all 4 districts in which the project was implemented. Evidence has also been drawn from several countries on improved diet, nutritional status, sanitary and other habits.

The other strong positive impact of microfinance in relation to alleviating poverty is in the area of gender equality and women's empowerment.

As pointed out earlier many microfinance programmes design their services focusing on women. For example, of the total 7.21 million borrowers of Grameen Bank as at end June, 2007, 97% were women[24]. This is not only because women are better borrowers, it is also with a view to addressing gender inequality. Helping women to gain additional income improves the condition of the entire household. Because of the interconnection of financial power, poverty and women, microfinance has an active role in improving economic equality. Research of UNDP and World Bank has shown that gender inequalities, inter alia, inhibit overall economic growth and development. Access to microfinance services opens up greater livelihood opportunities for women, leading to enhancement of their role in economic development. A recent World Bank report confirms that societies that discriminate on the basis of gender pay the cost of greater poverty, slower economic growth, weaker governance and a lower living standard for all people[25]. It is believed that increased economic power enables women to further improve several areas of their - and their children's - lives. In India, results from impact of SHG-Bank Linkage Programme report dramatic increase in self confidence and decision making habits of women after participation in the group credit and savings activities. At the High Level Policy Conference on microfinance in India in May 2005 the Chairman NABARD, Dr Y S P Thorat, stated that their project has empowered women by enhancing their contribution to household income, increasing the value of their assets and generally by giving them better control over decisions that affect their lives. In Nepal, the Women's Empowerment program has revealed that 68% of its members are making decisions hitherto made by men – Cheston and Kuhu (2002). In the provision of microfinance under group systems women develop the capacity to manage group transactions and find, through groups, opportunities for social networking.

In general in almost all microfinance schemes spread throughout the world with special attention on women have enabled social and economic inclusion of women. Susan Holcombe states that Grameen members were less likely to take informal credit from local money lenders and concludes that members were protected from impoverishing debt by the assets they had accumulated as a result of credit supported businesses[26]. Hashemi states that women's access to credit was associated with an overall reduction of domestic violence[27].

Khandker[28] having studied the impact of microfinance in Bangladesh in comparison with other social welfare programmes concludes that microcredit is more cost-effective than formal rural financial intermediation, targeted food interventions and rural infrastructure development projects in Bangladesh.

In addition, there are wider impacts of microfinance on borrowers. They result mainly from the provision of savings and insurance services by microfinance institutions. The Foundation for International Community Assistance in Uganda has demonstrated that micro insurance increases income stability of both clients and non clients within the community as the local economy benefits from a more stable circulation of money and increased trade. Bank Rakyat Indonesia, a MFI, although not recording strong direct impacts on poverty through provision of microfinance has recorded excellent indirect impacts through generation of labour market opportunities to the poor. Thus the benefits of expanding access to a wide range of financial services to the poor and underprivileged cannot be underestimated.

As opposed to the empirical evidence on the positive impact of microfinance, there is also some evidence of its negative impact. Loans for enterprises, asset acquisitions, consumption etc. lead to increasing debt and often over a long period of time, customers continue to be debtors. It is argued that in most cases, they have been unable to get out of the debt trap and that these micro loans also encourage debt for high non essential expenditure. Microfinance schemes focused on women increase pressure on them to take up low profit activities thereby increasing their work burden. It is also pointed out that these schemes encourage both parents to work increasing pressure on children or neglecting them. Another criticism leveled against microfinance programmes is that men use women as a conduit for loans.

In comparison to the empirical evidence of the positive impact of microfinance, the negative factors may appear generalized and almost unavoidable side effects for a minority of borrowers. Nonetheless, these factors have to be recognized in the longer term strategy for poverty alleviation. It must be recognized that while impact assessments carried out on the work of a large number of microfinance institutions world over underscores the ability of microfinance services to make a positive contribution towards alleviating poverty, for any such programme to have a significant contribution they must reach a wide clientele over a considerable period of time and must be complemented by infrastructural development programmes. In fact, many of the case studies on which the empirical evidence is based support this position.

Credit with Education is a development intervention created by Freedom from Hunger. It blends the provision of basic information on health, with the provision of microfinance. Surveys conducted on these programs in Ghana and Bolivia have provided evidence of very successful results in the areas of nutritional status, children's diet, breastfeeding, treatment of diarrhea and immunization. Graham Wright[29] says ill health is the biggest problem facing even those poor clients involved in microfinance programmes. For this reason Grameen Bank has started a health insurance along with credit while BRAC complements its credit with health programmes and special loans for latrines.

Susan Johnson and Ben Rogaly in their book titled 'Microfinance and Poverty Reduction 1997' perhaps sum up succinctly the viewpoint of many involved in the area of microfinance when they say: 'concentration on a single intervention mechanism, say credit, is much less effective in poverty reduction than simultaneous credit, primary health, and education work."

They argue that the particular combinations, that will be most effective, will depend on the nature of poverty in a specific context.

Literature on microfinance and its impact also brings out the point that microfinance, if it is to succeed, must be appropriately targeted. Rachel Marcus[30] state that "where market opportunities are constrained by low population density and limited purchasing power or are flooded with similar goods and services - training, technological development or assistance with marketing may have a greater impact than microfinance. Even where market opportunities are promising, basic services and infrastructure that improve the productivity of existing livelihood activities - such as agricultural extension or veterinary services - improved natural resource management, and irrigation, or health services which prevent sickness destroying livelihoods, may be more appropriate than microfinance". Basically, if a microfinance programme is to be successful, credit should be targeted at borrowers with entrepreneurial skills and ability to initiate activities with growth potential but who lack capital.

Eugene Versluysen in his book titled 'Defying the Odds: Banking for the Poor' - 1999 takes the argument further by saying: "banking for the poor cannot be a surrogate social safety net". He concludes that the aged, infirm and totally indigent who are unemployable do not belong in microfinance programs, because they would never be able to use loans productively, and would be burdened with debts.

Nimal Fernando (2004) has expressed the views of microfinance practitioners from one extreme of pessimism situation to the other extreme situation of optimism, with a group in the mid stream. Those in the pessimists' camp are of the view that microfinance on a sustainable basis is unable to reach the bottom half of the poor because their problems have been aggravated not due to unavailability of financing. Those at the other extreme firmly believe that microfinance reaches the bottom half of the poor and that there is an effective demand for microfinance from the poor. The group in the middle believes that microfinance reaches out to the bottom half to a limited level and hence the ability of microfinance to alleviate poverty is limited. It is therefore argued that building an effective model for the purpose of serving all poor categories alike has to be continued and microfinance in this regard has to be used with its known limitations.

Conclusion

Based on empirical evidence and literature on issues relating to microfinance, some of which are discussed here, one can conclude that micro finance in the modern sense is indeed a step forward in the fight against poverty. Its use, however, must be well targeted and must also be complemented by improved infrastructural facilities and interventions in areas such as education, health, transport, communication and natural resource management. It must also be recognized that the poorest of the poor requires more direct interventions to sustain even the minimum quality of life.

Macro economic growth is a sine qua non for the sustainability of any poverty alleviation programme, whatever form it takes. However, experience is now disclosing that such growth is not the 'be all and end all' of poverty alleviation but a tool to be used to bring about equity in a world where, as stated earlier, 60% of the population lives on 6% of the worlds income. The recognition by the world's leaders that overall numbers do not tell the full story, and that even greater challenges loom ahead, augurs well for the future.

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COMPANIES ACT NO. 7 OF 2007
THE BANKERS' PERSPECTIVE

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Introduction

The new Companies Act No. 7 of 2007, which came into effect on the 03rd of May 2007, repeals the earlier Companies Act No .17 of 1982 and The Companies (Special Provisions) Law No. 19 of 1974, which contained certain provisions relating to the registration of liaison offices.

Some of the more important features of this Act are that it seeks to simplify incorporation procedures, imposes new rules on capitalizations, minimize the intervention of Court with respect to recapitalizations and amalgamations, grants more responsibilities to Directors and hold them more responsible for their actions and provides minority shareholders with distinct rights in the event of there being disagreements with majority shareholders.

Incorporation and Registration of Companies

The Act provides for simplified procedures for incorporation and the promoters could incorporate a Company by filling up particular forms which can be obtained from the Registry web site and submit them in the Registrar of Companies ("Registrar"). Upon the issue of the Certificate of Incorporation a Company with a set of model articles would be deemed to have been incorporated. The printing of the Articles would therefore be an independent exercise and it would not be a document which has been approved as such by the Registrar. Similarly even if the Company does not wish to adopt the model Articles, the Registrar would not be involved in approving the draft Articles as was the practice under the Companies Act No 17 of 1982, ("previous Act").

Existing companies are deemed to be incorporated under the new Act under Section 485. However, Section 487 of the Act requires an existing company to apply to the Registrar and obtain a new number within 12 months from the coming into operation of the Act. In the event of the Company not having obtained the new number within 12 months from the coming into operation of the Act, the Registrar shall cause to be published in the daily newspaper the name of such Companies who are in default. Within a period of 6 month from such publication a Director of the Company, a Shareholder of the Company or person who has registered a charge (i.e. a person who is a secured creditor) or a person who has instituted action against the Company either in Court or in arbitration proceedings could apply for the new number for and on behalf of the Company.

In the event of the Company not having obtained a number by the expiry of the 6 month period referred to above, the Company's name shall be struck off the register and all its properties and rights shall vest in and be at the disposal of the State.

The new Act does not provide for a constitutional document called the Memorandum of Association. There is only an Articles of Association. In the case of existing companies, the Memorandum would be deemed to form part of the Articles with effect from 03rd May 2007. Such Companies would therefore have Articles which contain the Primary Objects of the Company, the Ancillary Powers and even an Authorized Capital even though the Act does not have such a concept of capital.

The Companies Act No 17 of 1982 read together with the Companies (Special Provisions) Law No 19 of 1974 provided for companies which were incorporated outside Sri Lanka to register themselves in Sri Lanka either as branch offices or as liaison offices. The distinction between the two were that it was only a branch office which could carry on business in Sri Lanka. The New Act only has provision for the registration of one category named overseas companies and accordingly the distinction between a branch and a liaison office would no longer be applicable.

General Business Purpose Companies

The Act permits the incorporation of general business purpose companies with no specific objects. In the event of a person incorporating a Company, based on the model articles which are provided for in Schedule 1 of the Act, such person would end up with a general business purpose company with no specific objects. Such a Company would have no restriction on the types of business which it could carry out.

The Act does not prevent the incorporation of companies with specific objects. The effect of having objects in the Articles of Association would be that in the event of the company seeking to act outside those objects, a dissenting Director or a Shareholder could take steps to prevent the Company from acting outside those objects. Section 17 provides that restrictive objects however do not affect a third party acting in good faith with the Company and such a party would have a perfectly valid and binding contract with the Company, notwithstanding the fact that the Company has acted outside its objects. There is however a distinction between acting outside ones objects and a person who is not duly authorized entering into a transaction on behalf of the Company. In the latter event a third party may not get a valid contract with the Company.

If a Company which has objects changes its objects and the proposed alteration imposes or removes a restriction on the business or activities in which a company may engage in a minority shareholders is entitled to invoke his minority buy out rights and the Company would be required to purchase his shares at an agreed price, failing which a price considered fair and reasonable by the Auditors or failing which a price determined by Court.

Notwithstanding the removal of the rule of *ultra vires* and the additional protection which it gives to third parties the requirement that a major transaction requires to be approved by a special resolution of the shareholders has created new challenges for third parties. In start up situations almost every transaction could be a major transaction and the consequences for third parties in the event a Company not complying with the same is not specifically mentioned in the Act.

Names of Companies and Contracts

A Private Limited Company could in addition to the current '(Private) Limited' use the abbreviated form of '(Pvt) Ltd.'. Similarly, a Public Company could use the term 'Ltd.' instead of the current 'Limited' at the end of its name. In the case of a Public Quoted Company, the name should end with either the words 'Public Limited Company' or 'PLC.'.

It is a mandatory under Section 12 that in addition to the name of the Company that the company number be used on all business letters of the Company, all notices and other official publications of the Company, bills of exchange, promissory notes, cheques, orders for goods, invoices, receipts and letters of credit and any other document which creates or evidences a legal obligation of the Company.

In terms of the Act there is no compulsion for the Company to have a company seal. Section 19 provides that a notarially attested instrument needs to be signed by either two Directors, a Power of Attorney holder or some person specifically authorized by the Articles. A normal contractual document could be signed by any person acting under the company's expressed or implied authority.

Section 24 of the Act provides for pre incorporation contracts, which are entered into by the promoters of the Company to be valid and binding on the Company if ratified by the Company after incorporation. The ratification should take place within the times specified in the contract and if no time is specified within a reasonable time after the incorporation of the company.

Capitalization of Companies

The Act has several new features with respect to the capitalization of Companies. These aspects have resulted in several controversies and there are several areas such as bonus issues, share splits, repurchase of shares and reduction of stated capital where there are either gaps or inconsistencies in the Act. The interpretations given by the Registrar as well as those given by the Colombo Stock Exchange have not been conclusive and various stakeholders are still groping in the dark with respect to these matters.

Section 49(4) of the Act specifies that no share in a Company shall have a nominal or par value. This does not result in any change to the concept of a share as understood in Company Law and the only major significance of not having a par value is that the connection between the number of shares in issue and the issued share capital account (referred to as stated capital in the Act) is no longer a multiplication of the number of shares by the par value.

Section 52 of the Act provides that before issuing any shares the Board should decide the consideration for the issue and resolve that in its opinion the consideration is fair and reasonable to the Company and to all existing Shareholders. Section 58 provides that the term 'Stated Capital' in relation to a Company means the total amounts received or due and payable to the Company in relation to issue of shares or in respect of calls on shares. Consideration for the issue of shares includes not only cash, property and services, but also 'future services'. At present the view seems to be that the value of the unperformed service for which the shares have been issued should be shown as a current asset/ long term asset and be written off to the profit and loss account as and when rendered.

The new Act provides for a much more liberal regime of returning capital back to its shareholders, than what was available under the Companies Act No. 17 of 1982. A Company can repurchase its shares in terms of Section 64 of the Act, if the Board resolves that the acquisition is in the interest of the Company, the terms of the offer are in the opinion of the Company's Auditors' a fair value and the Board is not aware of any facts which would be material to the value of the share which is not known to the Shareholders accepting the offer. A Shareholder is not compelled to give up his shares on a repurchase. In the event of there being an offer to repurchase to some but not all to the Shareholders, the Board must also resolve that the making of the offer to only some person is not unfair to those to whom the offer is not made. The accounting treatment for a share repurchase in most jurisdictions would involve a debit to the stated capital account either for the entirety of the consideration paid out on the repurchase or at least partly with the balance being debited against reserves. This however has raised a further issue whether Section 64 can be worked out on its own independently of Section 59 since any repurchase would result in a decrease of the stated capital. The latter section requires a special resolution by shareholders and 60 days public notice for any reduction of the stated capital. Since the accounting treatment for redemption of shares is identical a similar issue arises with regard to redemptions as well.

A Company can also reduce its stated capital in terms of Section 59 of the Act to such amounts as it thinks appropriate by way of a Special Resolution. Public notice of not less than 60 days must be given of the proposed reduction prior to the resolution being passed. This regime for reducing the stated capital is much more liberal than what was contained in the Companies Act No. 17 of 1982, which required Court confirmation of any capital reduction scheme. However the Company can enter into a written agreement with any creditor not to reduce its stated capital and any reduction in contravention of such agreement would be invalid and of no effect.

Redeemable Shares under the Act are not confined to Preference Shares and accordingly Redeemable Ordinary Shares could now be issued as well. The Act draws a distinction between shares which are redeemable at the option of the Company and shares which are redeemable at the option of the holder or on a date specified in the Articles. In the former case, the redeemable shares are treated more like equity and in the latter cases they are treated more like debt. In the event of Section 59 being applicable to redemptions the principle of treating the latter cases as debt also becomes impractical in view of shareholder approval having to be obtained to make the payment.

Distributions to Shareholders and Solvency Test

'Distribution' is defined as the direct or indirect transfer of money or property, other than the shares of a Company to or for the benefit of a shareholder or the incurring of a debt to or for the benefit of a shareholder. Accordingly, any payment of a dividend or redemption of a share or a repurchase of a share would fall within the definition of a distribution.

In the event of there being a distribution, there is a requirement for the solvency test to be satisfied. A Company shall be deemed to have satisfied the solvency test if it is able to pay its debts as they become due in the normal course of business and the value of the Company's assets is greater than the value of its liabilities and its stated capital. The Board should take into account the most recent audited financial statements and any circumstances which they know or ought to know which affects the value of the Company's assets and liabilities. Furthermore, they may take into account a fair valuation or other method of assessing the value of assets and liabilities. This grants the Board a discretion with respect to principles of fair value accounting or other method of assessing value in determining whether the solvency test has been satisfied or not. The members of the Board who vote in favour of the distribution would have to sign a certificate that in their opinion the Company will satisfy the solvency test immediately after the distribution is made and the Auditors too would need to issue a certificate of solvency for the distribution to be made.

The term 'able to pay its debts as they fall due in the normal course of business' seems to be very wide in its application. However based on similar terminology used in other jurisdictions in a legal sense it may not mean much more than an assertion that the going concern assumption is not in doubt immediately after the distribution is made.

In the event of a distribution having being made without the solvency test being satisfied, the Company could recover the distribution from the shareholders, failing which every Director who authorizes the distribution could be personally liable for such distribution.

The regime for the payment of dividends is more strict that other distributions since it has not only to satisfy the solvency test, but it must also satisfy the requirement that the dividend could only be distributed out of the profits of the Company.

The Act as well as current thinking on principles of accountancy either disregard or downplay the differences between capital reserves and revenue reserves and it is likely that both such categories would henceforth be referred to as reserves.

Financial Assistance for the purchase of Shares

The Companies Act No. 17 of 1982 contained a general prohibition on the grant of financial assistance for the purchase of shares. The only exceptions permitted were the loans granted to employees for the purpose of such purchase, employee share ownership schemes and loans granted by companies if its normal business included the granting of such loans. The new Act contains the same general prohibition but it provides a much more liberal regime for companies to grant financial assistance. Accordingly, financial assistance could be given if the Board has resolved that giving such assistance is in the interest of the Company, the terms and conditions in which assistance is given is fair and reasonable to the Company and to any shareholders not receiving such assistance and the Company which satisfy the solvency test. The exceptions contained in the previous Act are also applicable.

Amalgamations

The new Companies Act has much more liberal provisions with regard to amalgamations and no Court approval is required, unlike in the case of the previous Act. Two or more companies may amalgamate, provided that the shareholders of each of the companies have passed a Special Resolution to that effect and the amalgamated company will after the amalgamation satisfy the solvency test. The Board of each Company is required to prepare an amalgamation proposal setting out the matters specified in Section 240 of the Act and public notice should be given of such amalgamation at least 20 days before the amalgamation takes effect. The amalgamation proposal must be made available to every secured creditor of the Company and should be available for inspection by any shareholder, creditor or any person to whom the amalgamated company owes an obligation. Such a person can request for such proposal and is entitled to be supplied free of charge any such proposal.

A shareholder who is against the amalgamation is entitled to invoke his minority buy out rights and the Company would be required to purchase his shares at an agreed price, failing which a price considered fair and reasonable by the Auditors or failing which a price determined by Court.

If a creditor is of the view that an amalgamation proposal would be unfairly prejudicial to it, it could seek an Order from Court that the proposal should not be carried through.

Potential Insolvency and Serious Loss of Capital

Section 219 of the Companies Act requires a Director of the Company who believes that the Company is unable to pay its debts as they fall due, to forthwith call a meeting of the Board to decide whether the Company should continue or be wound up. If the Company is continued and is subsequently liquidated, all Directors other than those who voted in favour of the winding up would be liable for the loss suffered by creditors. This Section has very serious consequences for Directors *vis a vis* creditors and it is imperative that the procedural requirements as well as the assessment of its ability to pay debts is done correctly by the Directors in a timely manner. It is arguable that the term 'unable to pay debts its debts as they fall due' in this section should be given a more long term perspective than the term 'able to pay its debts as they become due in the normal course of business' which is provided for in the solvency test in Section 56 since the latter is dealing with a more short term issue than the former.

Section 220 of the Companies Act provides that if it appears to a Director that the net assets of the Company are less than half its stated capital, the Board should convene an Extraordinary General Meeting of the Shareholders. The notice calling the meeting should be accompanied by a report which advices the shareholders of the nature and extent of losses, the cause of the losses and the steps being taken by the Board to prevent such losses. The shareholders should be given a full opportunity of discussing the matters contained in such report. It should be noted that this section is entirely a shareholder issue and a breach thereof is not a matter which would by itself create any obligations to creditors.

Major Transactions

Section 186 of the Act provides that the Company shall not enter into a major transaction unless approval has been obtained by way of Special Resolution for such transaction or the transaction is subject to such approval or the transaction is expressly provided for in the Articles.

A 'major transaction' has been defined as an acquisition or disposal involving more than half the value of the assets of the Company or the acquisition of rights or obligations amounting to more than half the value of its assets or transactions which have the purpose or effect of substantially altering the nature of the business carried on by the Company. In the event of there being a major transaction, a minority shareholders is entitled to invoke his minority buy out rights and the Company would be required to purchase his shares at an agreed price, failing which a price considered fair and reasonable by the Auditors or failing which a price determined by Court.

Ranking of Claims

The position with regard to the secured creditor and its priority in respect of the secured asset has been clarified in the Act. Under the previous Act there was considerable uncertainty as to whether the claims of the secured creditor in respect of the proceeds from the secured assets were to rank in priority to preferential payments which were specified in the Act. This position has now been clarified and the priority of the secured creditor is established subject however that that employees' provident fund dues, employees' trust fund dues and gratuity dues which have become due prior to the creation of the security, fines for the commission of an offence, monetary penalties payable to the Government and costs in court proceedings would rank in priority to the claim of the secured creditor.

Private Company Dispensations

The Second Schedule to the Act contains a list of sections which would not be applicable to private companies if there is unanimous consent of its shareholders to that effect.

This list includes the following

Consideration for the issue of shares
Distributions
Purchase of own shares
Restrictions on giving financial assistance
Major transactions
Restrictions on loans to Directors

The reference to distributions above only exempts such a company from following the procedural formalities relating to the distribution but the liabilities attaching to the shareholders and the Directors from an improper distribution remain.

Conclusion

The new Companies Act have several provisions which are challenging to the banking community such as the more liberal provisions relating to distributions. It also provides many new opportunities with respect to recapitalizations such as repurchases of shares and financial assistance for the purchase of shares which could open up new lines of business and funding opportunities in a relatively low interest rate environment. The entire focus of the Act of permitting the Directors to carry out the affairs of the Company more freely whilst holding them more responsible is also likely to lead to better corporate governance practices within Companies which could be beneficial to creditors at large. Going forward the analysis of a company is likely to be a much more complex proposition for the banking community and more safeguards would need to be built in banking documentation so that it is not surprised by transactions which could be carried out by Companies which were hitherto not permitted under the previous Act.

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MONEY, INFLATION AND GROWTH

A REVIEW OF THE CONCEPTS AND PAST RELATIONSHIPS

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1. Introduction

Inflation is often referred to as the biggest man made enemy. While some argue that a certain rate of inflation is desirable, others are skeptic as to what such desirable rate is and if such a phenomenon exists. Money is often cited as the cause for inflation while there is also attribution to high oil prices, cost of imported goods and hence "cost push" inflation. Sri Lanka in the year 2006, recorded a rate of inflation of 13.7% p.a. annual average inflation which was the 18th highest in the world for the year 2006. As at end June 2007 the point to point rate of inflation was 13% p.a. with an annual average rate of inflation of 17% p.a.

The growth of money in year 2006, in terms of Broad Money Supply, (M_2), was 20.7% and the country recorded a real growth of GDP of 7.4%. The purpose of this article is to discuss the underlying relationships between money, inflation and the economic growth with supporting concepts and empirical evidence based on Sri Lankan context. A large volume of data for the period 1950 to 2007 have been analyzed to support the observations. In the context of the scope of this paper there appears several interesting relationships either affirming the theories and concepts or disputing popular myths. The research limitations are stated elsewhere in the paper and the author expects this paper to be a framework and basis for further research which will be useful for the analysis of the nitty-gritty within the broader issues.

2. Inflation - What is it?

Inflation is the rate of increase of the general price level. Inflation is measured in terms of changes in price indices. Such an index would indicate the relative cost of a specified basket of goods and services over time, compared with the cost of such basket of goods and services during a particular (base) year.

In Sri Lanka there are several price indices calculated by the Central Bank of Sri Lanka and the Department of Census and Statistics. Few main indices are Colombo Consumer Price Index (CCPI) which is the key index quoted for inflation reporting, Seasonally Adjusted CCPI, Colombo District Consumer Price Index (CDCPI), Sri Lanka Consumer Price Index, (SLCPI) and Wholesale Price Index (WPI).

A price index would consider a representative basket of goods and services of the particular population segment it addresses. The following Table I illustrates the geographical and population coverage of two of the commonly used indices.

Table I – Geographical and Population Coverage of Two Price Indices

Index	*Base Year*	*Geo graphical Coverage*	*Population Coverage*	*Price Collecting Centres*	*No. of Centres*	*No. of Items*
CCPI	1952	Colombo City	Lowest 40%	Pettah, Wellawatte, Kirulapone, Borella, Maradana, Dematagoda, Thotalanga	7	187
CDCPI	Nov. 1996- Oct. 1997	Colombo District	Lowest 40%	Pettah, Kolonnawa, Nugegoda, Maharagama, Homagama, Piliyandala, Dehiwela, Moratuwa, Padukka, Hanwella, Avissawella	11	197

Source : Staff Studies, Central Bank of Sri Lanka Volumes 31 & 32, 2001 & 2002

The Table II below illustrates the weightage given to different categories of expenditure and it is noteworthy that around 60% is allocated for food, and hence food prices will play a vital role in the movement of the indices.

Table II – Weightage given to Different Categories of Expenditure

Category	*CCPI*	*CDCPI*
Food	61.89	58.66
Rent	5.70	13.24
Clothing &Footwear	9.42	6.21
Fuel & Light	4.29	4.93
Transport & Communication	1.88	3.68
Education & Recreation	4.21	2.76
Personal Care & Health	2.87	3.83
Liquor, Tobacco & Arecanut	5.02	4.44
Miscellaneous	4.72	2.25
All Items	**100.00**	**100.00**

Source : Staff Studies, Central Bank of Sri Lanka Volumes 31 & 32, 2001 & 2002

An analysis of the coverage and the weightage of the different indices clearly demonstrate that inflation is only a general measure. People of different social and economic standings will have different expenditure habits and also people living in different geographical areas may encounter different prices. Hence the rate of inflation experienced by a rich man and a poor man, during a particular period, will not be the same. Further, the composition of goods within each category may in real life change over time but an index may fail to capture such changes. Regardless of such weaknesses, the inflation indices are fairly well representative of the price movements. Further, research has shown that there is high positive correlation between different measures of inflation as measured by different indices. Hence the author would use CCPI, which gives the largest history of data (since 1952) as the basis for measuring inflation, for the purpose of various analyses in this paper.

2.1 How Much Inflation?

The table below (Table III) provides the current inflation rates:

Table III – Inflation Rates

Item	BASE PERIOD	2006	2007	CHANGE	
				Absolute	Percentage
CCPI	1952 = 100				
June		4,730.5	5,344.3	613.8	13.0
12 Months ending June		4,260.7	4,983.1	722.4	17.0
Seasonally Adjusted CCPI	1952 = 100				
May		4,495.1	4,970.8	475.8	10.6
12 Months ending May		4,199.8	4,917.2	717.4	17.1
SLCPI	1995 – 1997				
June	=100	207.3	241.7	34.4	16.6
12 Months ending June		194.6	224.3	29.7	15.3
CDCPI	1996 Oct.-				
June	Sep.1997=100	178.7	203.6	24.9	13.9
12 Months ending June		167.4	190.0	22.6	13.5
WPI*	1974 = 100				
June		2,331.0	2,891.5	560.5	24.0
12 Months ending June		2,189.0	2,577.3	388.3	17.7

Source : Central Bank of Sri Lanka Monthly Economic Indicators.

The annual average inflation rate is based on the average index value during a given year as compared with the previous year for the same period. This figure is, as the name suggests, an average value and hence the values during the year are less volatile. The point to point inflation measures the percentage change of the index value as of the current point of time compared with the value an year ago. This rate tends to fluctuate during the year somewhat considerably as only the point of time is considered.

The inflation as at June 2007 as measured by CCPI was 17% on an annual average basis and 13% on a point to point basis. The figures were 17.2% and 17.6% respectively as of July 2007.

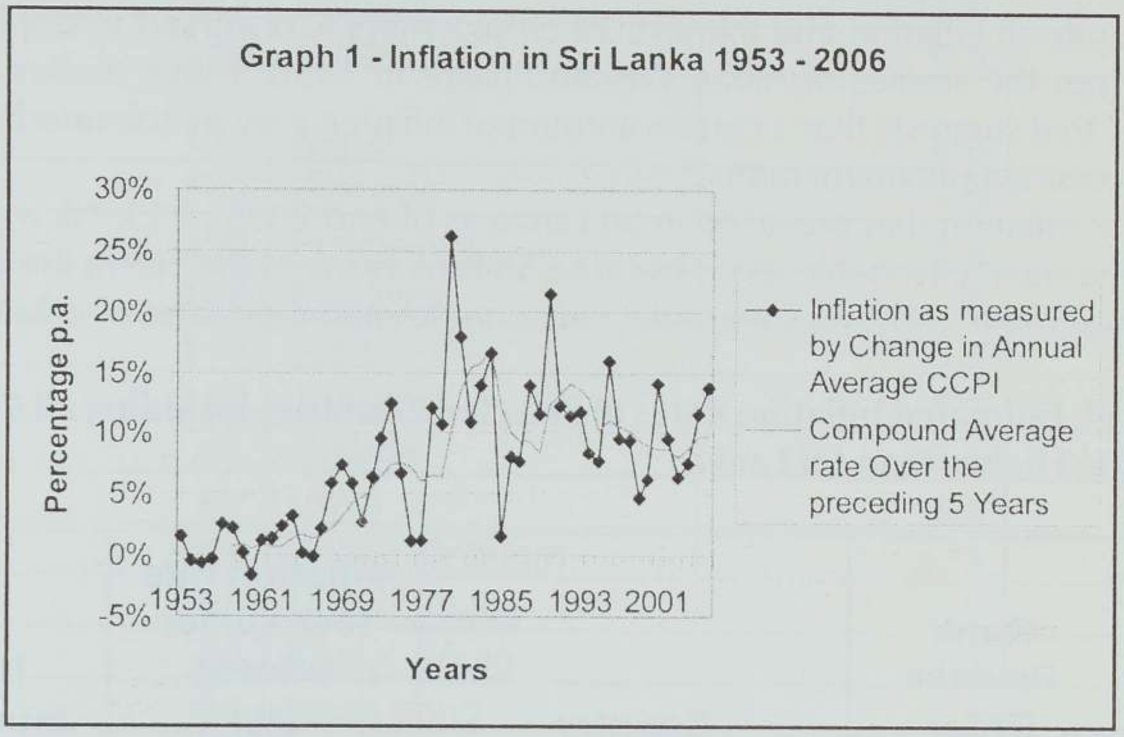
Inflation rates as measured by average CCPI over selected years in the post independence Sri Lanka are given below in Table IV.

Table IV - Inflation and Growth of Broad Money Supply

End of the Year	Colombo Consumer Price Index (CCPI)	Rate of Inflation based on Change of Average CCPI during the year	Broad Money Supply (M2) Rs Million	Growth Rate of Money during year
1952	100.00		996	-8.6%
1955	100.50	-0.6%	1,225	12.1%
1960	103.50	-1.6%	1,572	6.4%
1965	112.50	0.3%	2,283	6.6%
1970	138.20	5.9%	3,115	9.3%
1975	198.30	6.7%	4,777	4.6%
1977	203.20	1.2%	8,717	37.9%
1978	227.80	12.1%	10,891	24.9%
1980	318.20	26.1%	19,860	31.9%
1985	561.20	1.5%	48,409	11.5%
1990	1,008.60	21.5%	90,546	18.5%
1991	1,131.50	12.2%	110,575	22.1%
1992	1,260.40	11.4%	129,799	17.4%
1993	1,408.40	11.7%	160,136	23.4%
1994	1,527.40	8.4%	191,670	19.7%
1995	1,644.60	7.7%	228,536	19.2%
1996	1,906.70	15.9%	253,201	10.8%
1997	2,089.10	9.6%	288,258	13.8%
1998	2,284.90	9.4%	316,174	9.7%
1999	2,392.10	4.7%	358,076	13.3%
2000	2,539.80	6.2%	404,669	13.0%
2001	2,899.40	14.2%	450,727	11.4%
2002	3,176.40	9.6%	510,395	13.2%
2003	3,377.00	6.3%	580,747	13.8%
2004	3,632.80	7.6%	687,964	18.5%
2005	4,055.50	11.6%	822,932	19.6%
2006	4,610.80	13.7%	993,264	20.7%

Source: Compiled using data from the Annual Report of the Central Bank of Sri Lanka

The following graph (Graph I) shows the movement of the rate of inflation over the period 1953 - 2006.



Source : Compiled using Annual Report of Central Bank of Sri Lanka

The compound growth rate of CCPI between 1952 (=100) and 2006 (=4,610.80) was 7.35% p.a. . This low average shows the benefit of low inflation rates that prevailed in the earlier periods. The compound average inflation during the period 1978 to 2006 since opening up of the economy was 11.37% p.a. . The same rate from 1952 to 1977 was 2.88% p.a. . This of course should not lead to a quick favorable conclusion against the open economy, as the pre 1977 era may have the effect of price control on inflation figures. A further interesting analysis is to take a compound average inflation over such other different political eras. The following Table V illustrates the rates.

Table V - Compound Average Inflation Over Different Periods

Period	Annual Average CCPI - Beginning	Annual Average CCPI - End	Compound Average Rate of Inflation p.a.
1952-2006	100.00	4,610.80	7.35%
1952-1977	100.00	203.20	2.88%
1978-2006	203.20	4,610.80	11.37%
1978-1993	203.20	1,408.40	12.86%
1994-2006	1,408.40	4,610.80	9.55%

Source: Compiled by author using CCPI Data

2.2 Inflation in Sri Lanka in the Global Context

What level of inflation would be considered normal? It is a question very difficult to be answered. The rate of inflation and the level of employment is observed to display a negative relationship as per the studies of Alban William Phillips in 1958. These studies identified the "Phillips Curve" that suggests that a certain amount of inflation may be tolerated with a view to achieving a lower unemployment ratio.

The rate of inflation that prevailed in Sri Lanka as of end 2006 of 13.7% would definitely have been above such reasonable levels because Sri Lanka ranked the 18th in the world in terms of (high) inflation. Table VI shows some selected countries and their rates of inflation.

Table VI. Estimated Inflation Rates of Selected Countries including all Countries with an Inflation Rate Higher than Sri Lanka

Rank order of Inflation	Rank Reverse Order	Country	Inflation rate (consumer prices) (%)	Date of Information
1	224	Zimbabwe	976.4	2006 est.
2	223	Iraq	64.8	2006 est.
3	222	Guinea	29	2006 est.
4	221	Burma	21.4	2006 est.
5	220	Congo,	18.2	2006 est.
6	219	Afghanistan	16.3	2005 est.
7	218	Venezuela	15.8	2006 est.
8	217	Iran	15.8	2006 est.
9	216	Serbia	15.5	2005 est.
10	215	Sao Tome and Principe	15	2006 est.
11	214	Liberia	15	2003 est.
12	213	Yemen	14.8	2006 est.
13	212	Haiti	14.4	2006 est.
14	211	Moldova	14.1	2006 est.
15	210	Gambia, The	14	2006 est.
16	209	Eritrea	14	2006 est.
17	208	Malawi	13.9	2006
18	207	Sri Lanka	13.7	2006
19	206	Indonesia	13.2	2006 est.
20	205	Angola	13.2	2006 est.
21	204	Ethiopia	13	2006 est.
22	203	Mozambique	12.8	2006 est.

23	202	Paraguay	12.5	2006 est.
25	200	Madagascar	12	2006 est.
26	199	Ukraine	11.6	2006
37	188	Russia	9.8	2006 est.
48	177	Nepal	8.6	November 2006 est.
56	169	Pakistan	7.9	2006 est.
75	150	Philippines	6.2	2006 est.
77	148	Maldives	6	2005 est.
85	140	India	5.3	2006 est.
88	137	Thailand	5.1	2006 est.
130	95	Greece	3.3	2006 est.
134	91	Libya	3.1	2006 est.
144	81	United Kingdom	3	2006 est.
167	58	United States	2.5	2006 est.
175	50	Korea, South	2.2	2006 est.
176	49	Hong Kong	2.2	2006 est.
189	36	European Union	1.8	2006 est.
191	34	Germany	1.7	2006 est.
194	31	Austria	1.6	2006 est.
196	29	France	1.5	2006 est.
197	28	China	1.5	2006 est.
198	27	Sweden	1.4	2006 est.
203	22	Switzerland	1.2	2006 est.
208	17	Singapore	1	2006 est.
209	16	Taiwan	1	2006 est.
216	9	Japan	0.3	2006 est.
218	7	Israel	-0.1	2006

Source: CIA World Fact Book.

Note : The rank order could change because most of the inflation figures are based on estimates for 2006. The figure and rank for Sri Lanka has been changed from the estimate of 12.10% to the actual published rate of 13.7% as per the provisional figure in the Annual Report of the Central Bank. The inflation rate of Zimbabwe which has been changing rapidly, could well be above the estimate given.

3. Money and Money Supply

Money is generally referred to as anything that serves the functions of money i.e. to be a store of value, medium of exchange, unit of account and a means of deferred payment.

3.1 Commodity Money

Historically, people have used scarce things with intrinsic value as money, referred to as commodity money. Shells, ivory or precious metals, salt & pepper were few such examples. Wikipedia quotes instances of reference to pepper as money in 408 AD. In the modern world history, tobacco, cigarettes and Cola paste have been used as money. Gold, Silver & Copper have been used as commodity money for long periods.

3.2 Coinage

A development of the use of commodity money is the coinage where standardized coins were used for convenience and accuracy of the value.

3.3 Bank Notes

Use of Bank notes came into practice in the era of goldsmiths who practically issued money initially by way of goldsmiths' receipts. The goldsmith would accept custody of gold and issue receipts. Such receipts would normally be presented to convert back to gold. However, people found the easy way out and made an innovation of using the goldsmiths' receipts as money instead of converting the receipts back to gold. It is said that initially the goldsmiths made profits by debasing by clipping the edges of gold coins thereby saving additional gold for themselves. The coins would still fetch full value since the clipping would not make a material difference in weight. Later the goldsmiths turned into banking partnerships and created the origin of the modern day banking. These bankers set the foundation of the money creation process which prevails up to date. This aspect will be discussed in detail, later in this paper.

3.4 Fiat Money

The position of gold has been taken over by Fiat Money today. The government "Fiat" or decree makes such money the legal tender. Today's currency issued by the Central Banks around the world is on the basis of such money being recognized by law as legal tender.

However, even as Fiat Money came into existence, the Central Banks initially followed a gold standard where such money was backed by Gold Reserves. M.H. De Kock refers to two methods evolved by legislatures in connection with regulation of note issues by the Central Banks (Kock,1992;69).

The first was a partial fiduciary reserve requirement introduced in England in 1844 where a fixed amount was laid down by law from time to time which need only be covered by government securities. Any issues beyond this were to be fully backed by gold. However in England in September 1939, the gold reserves were transferred to an Exchange Equalization Account with the outbreak of war and the currency became total fiduciary issues.

The second method was to prescribe a minimum percentage gold reserve against currency issue as well as the deposits (of others) with the Central Bank. Accordingly the deposits with Central Bank were effectively recognized as no less than currency. By 1863, Netherlands had such system of 40% gold reserve against notes and deposits.

When Reichsbank was established in Germany a reserve ratio of one third against currency issues was imposed, with also an upper limit beyond which there would be 100% gold backing. With the setting up of the Federal Reserve System of United States in 1913, a similar proportional gold reserve system was introduced, (Kock,1992;70).

Most countries subsequently have evolved such systems also to include foreign currency reserves as part of the reserves similar to gold. The Currency Board system that prevailed in Sri Lanka between 1864 and 1949 was based on issue of Sri Lankan Rupee currency against gold or foreign exchange received by the Currency Board.

3.5 Bank Deposits as Money

The role of the goldsmiths had gradually been taken over by the banking partnerships where they issued currency notes. Due to failure of many such partnerships arising from excessive note issues not sufficiently backed by gold, the role of the note issues was made a government monopoly over time under the Central Banks of the countries concerned. Hence the currency issue became a Central Banking function. The banks however did not stop the innovation. They resorted to the maintenance of accounts instead. The account balances became an alternative to the currency and the currency (Fiat Money) issued by the Central Banks was the substitute for gold. Bank deposits are considered money as they perform all the functions of money equally well as the currency.

3.6 Money Supply

Money Supply is the stock of money held by public, chasing after goods and services. It is quantified so as to identify the effect of money on the price level that leads to inflation. It is important to note that inflation is caused by money held by public and not by money held in the vaults of the Central Bank or Commercial Banks because it is the money in the hands of the public that chases after goods and services.

The monetary systems and monetary economists have defined different stocks of money such as Narrow Money Supply (M_1), Broad Money Supply (M_2) and Consolidated Broad Money Supply (M_{2b}).

3.7 Narrow Money Supply (M_1)

Narrow money is defined as the sum of currency held by public (C_p) and the demand deposits held by public (DD_p).

$M_1 = C_p + DD_p$

In earlier stages of development of banking and money, the Narrow Money Supply was thought to be an adequate measure of the stock of money.

3.8 Broad Money Supply (M_2)

Broad Money Supply is defined to include Narrow Money Supply plus Quasi Money (QM). Quasi Money is Time and Savings Deposits held by public with Commercial Banks (TSD_p^{KB}).

$M_2 = C_p + DD_p + TSD_p^{KB}$

These two definitions (M_1 & M_2) have long been used by monetary authorities around the world including the Central Bank of Sri Lanka to quantify the stock of money in the country. However, with the advancement of banking and financial systems, other monetary assets may perform the functions of money. Hence is the need to review the composition and expand the scope while, of course, maintaining data relating to such different definitions of money so as to analyze the effect of money on other macro economic factors, particularly inflation.

3.9 Consolidated Broad Money (M_{2b}) and M_4 Money Supply

The M_{2b} measure of Money Supply adds foreign currency deposits held with Commercial Banks with certain adjustment to the M_2 definition to determine Consolidated Broad Money Supply (M_{2b}).

The M_4 definition of Money Supply includes the M_{2b} and incorporates the deposits of public with Licensed Specialized Banks which include National Savings Bank and other Savings Banks, the Development Banks and the Regional Banks and also the deposits of public with Registered Finance Companies.

3.10 Reserve Money (B)

Reserve Money is the total of sight liabilities of the Central Bank to the Commercial Banks and the Public. It is essentially the amount of currency issued by the Central Bank and held by public and Commercial Banks and also the deposits of Commercial Banks with the Central Bank. Earlier it was discussed that the note issuances of the Banks were taken away from Banks and entrusted with the Central Banks. The Central Banks in turn have followed various standards including the Gold standard, fractional (or proportional) Gold reserves and backing of foreign currency in the issuance of Fiat Money so as to ensure that the money has a good backing. The currency so issued is called Reserve Money. The deposits of Commercial Banks with the Central Bank are included in this definition because there is hardly any difference arising from the shift of the currency held by a Bank to a deposit with the Central Bank upon deposit or vice-versa upon withdrawal.

Accordingly,

Reserve Money (B) = $C_p + C_{KB} + D^{CB}_{KB}$

Where C_p = Currency held by public

C_{KB} = Currency held by Commercial Banks

D^{CB}_{KB} = Deposits of Commercial Banks with Central Bank

The Reserve Money is also referred to as High Powered Money, Base Money, Reserve or Monetary Base because of its ability to influence further creation of money through the multiple credit creation process that will be discussed in another section.

3.11 How much Money?

The following Table VII illustrates the amount of money held by public as defined under the different definitions of money supply in the recent past.

Table VII - Monetary Values for the Period 1950 - 2006

LKR Million

End of the Year	Currency held by Public (Cp)	Demand Deposits held by Public	Narrow Money Supply (M1)	Quasi Money TSDp	Broad Money Supply (M2)	Consolidated Broad Money Supply M2b	M4 - Broad Money	Reserve Money
1950	325	585	911	67	978			533
1955	385	688	1,073	152	1,225			576
1960	595	614	1,209	363	1,572			791
1965	901	814	1,716	567	2,283			1,154
1970	935	1,032	1,967	1,148	3,115			1,324
1975	1,610	1,478	3,088	1,689	4,777			2,144
1980	4,181	5,247	9,428	10,432	19,860			6,286
1985	9,816	8,946	18,761	29,648	48,409			16,895
1990	22,120	17,477	39,597	50,949	90,546			31,579
1995	42,198	33,019	75,217	153,319	228,536			78,586
1996	42,565	35,638	78,203	174,998	253,201			85,509
1997	45,679	40,172	85,852	202,406	288,258	333,667		83,736
1998	51,767	44,502	96,269	219,905	316,174	377,741	480,043	92,866
1999	58,481	50,073	108,554	249,522	358,076	428,319	546,520	100,444
2000	62,646	55,831	118,477	286,192	404,669	483,421	616,030	105,163
2001	65,536	56,675	122,211	328,516	450,727	549,138	699,734	112,522
2002	75,291	64,070	139,361	371,034	510,395	622,495	797,658	126,410
2003	85,601	76,034	161,635	419,111	580,747	717,855	928,274	141,447
2004	99,669	88,784	188,453	499,511	687,964	858,644	1,094,064	170,967
2005	114,070	16,632	230,702	592,230	822,932	1,022,278	1,293,974	197,932
2006	135,020	24,665	259,685	733,580	993,264	1,204,551	1,501,617	239,854

Source: The Annual reports of the Central Bank of Sri Lanka

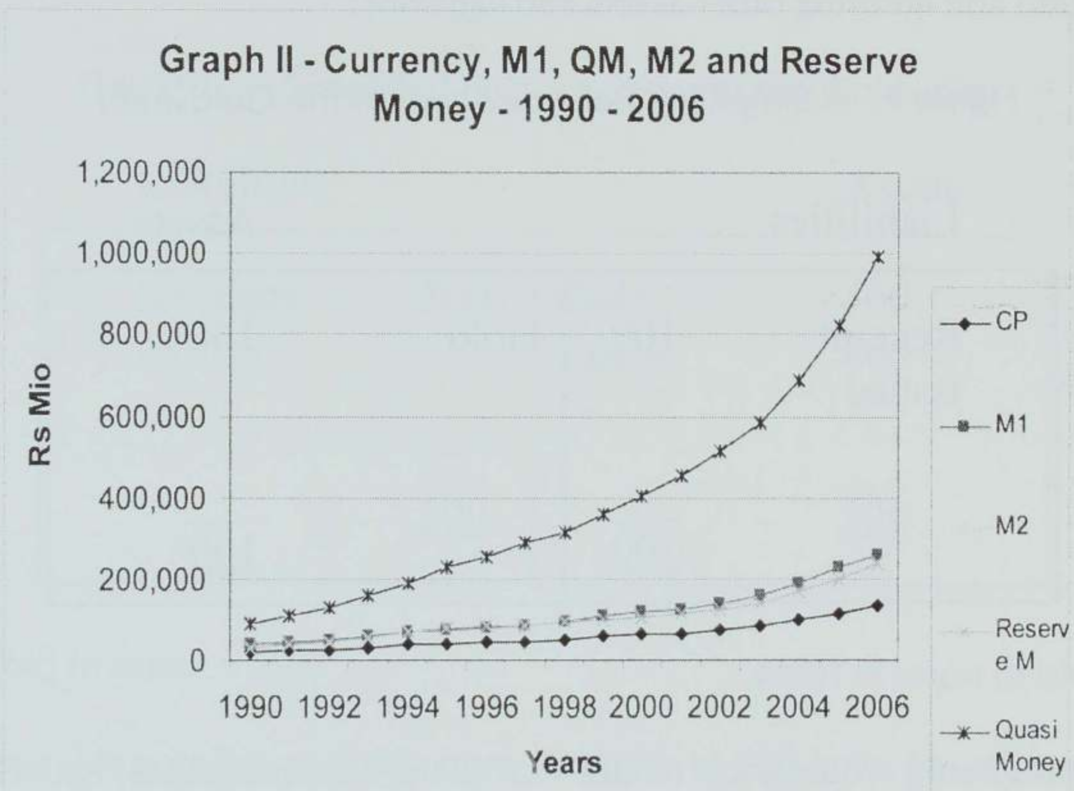
4. Money Earned or Created?

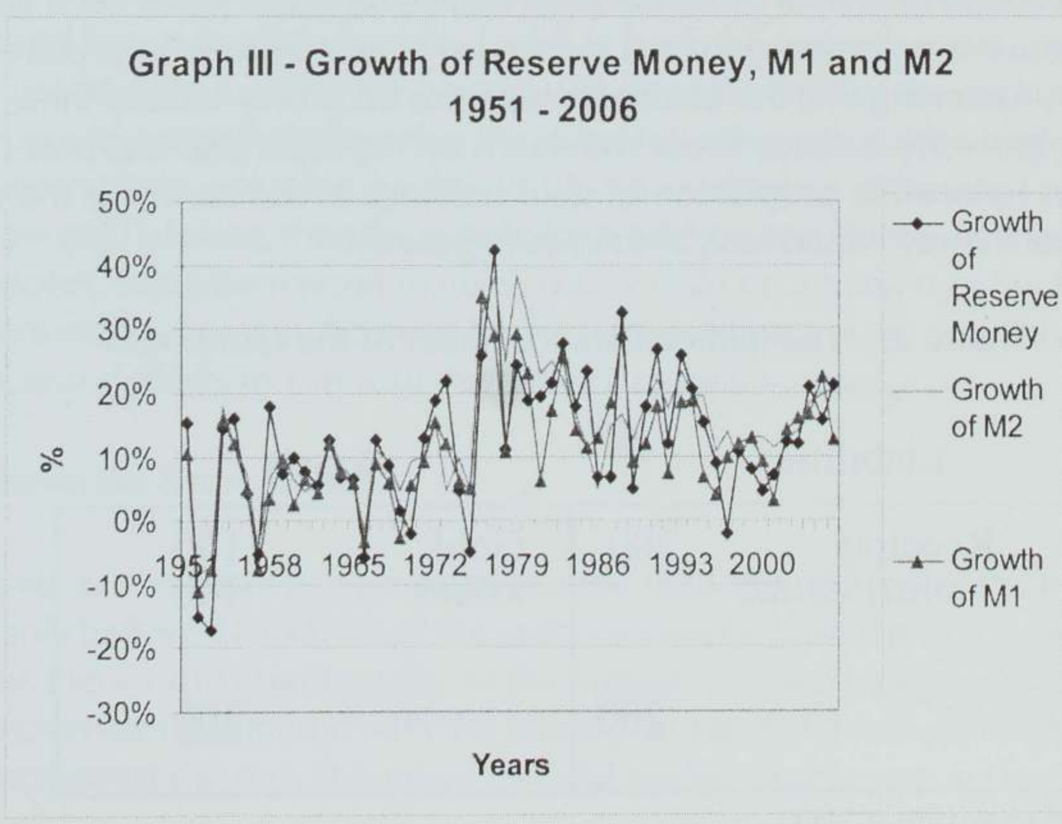
Who Creates Money?

A simple look at the level of Money Supply over the last 57 years since the establishment of the Central Bank of Sri Lanka would show that there had been phenomenal growth of money.

The compound average growth of Narrow Money from 1950 till 2006 was 10.62% p.a. from a mere Rs. 911 Million to Rs. 259.6 Billion. Broad Money (M_2) has grown from Rs. 978 Million to Rs. 993.2 Billion during the same period at a compound average of 13.16% p.a. Similarly the Reserve Money has grown from Rs. 533 Million to Rs. 239.8 Billion at an average of 11.53% p.a. Who causes such growth of money? What are the sources of such growth? What is the process involved in creation of money? These are some of the aspects we will discuss.

The following graphs (Graph II and Graph III) illustrate the growth of money:





Source : Compiled using Annual Report of the Central Bank of Sri Lanka.

4.1 Multiple Credit Creation – Goldsmiths' Era

Not only the invention of paper money but also the creation of multiple credit and money are both attributed to (somewhat errant) innovation by the goldsmiths who later transformed into Bankers.

A goldsmith would issue a receipt for each unit of gold actually received and such receipts would trade as money. Hence the receipt would be 100% gold backed with effectively a full reserve system. A balance sheet would typically look like the following, (Figure 1), assuming 100 units of notes issued and ignoring other assets and liabilities:

Figure 1. A Simplified Balance Sheet of the Goldsmith

Liabilities		Assets	
Receipts issued	100	Gold	100
	100		100

Ratio of Gold to notes = 100%

The goldsmith (Bank) would soon realize that all the receipts (notes) issued would not be presented for conversion to gold at the same time. Hence he issues notes even without actually receiving gold where it is considered to be a loan given with a promise to receive the gold later from the borrower. Assuming that the goldsmith wants to back only 50% of these notes by gold it will allow him to grow the balance sheet with loans on the asset side and notes issued on the liability side. Let us ignore the proportion of gold holdings in the hands of the public for this moment. The balance sheet would look as follows (Figure 2):

Figure 2. A Simplified Balance Sheet of the Goldsmith

Liabilities		Assets	
Receipts (Notes) issued	200	Gold	100
		Loans	100
	200		200

Ratio of Gold to notes = 50%

The balance sheet in Figure 2 gives him more profits as he earns interest on the loans. Hence his desire is to grow the loan book with more profits and have less liquidity support by having a lower proportion of gold. Of course, again, the ratio of preference for gold in hand against the total notes in the hands of the public will also influence this process, with however the overall effect being the same; grow by giving more loans for better profits!

A somewhat more aggressive banker (goldsmith) would issue more notes (receipts) say holding only 20% against the receipts issued. His balance sheet will then look like the following (Figure 3):

Figure 3. A Simplified Balance Sheet of the Goldsmith

Liabilities		Assets	
Receipts (Notes)	500	Gold	100
		Loans	400
	500		500

Ratio of Gold to notes = 20%

He has grown his note issues 500% from 100 units to 500 units. He enjoys interest on the loans of 400 units. It obviously made sense to grow even more. However as one would grow with too much greed and hence too little liquidity (gold) to back the notes there would be one fine day when he would not be able to meet the normal withdrawal needs of the receipt (note) holders. The note holders would normally believe that the issuer has adequate gold to back the withdrawals. However if in one remote occasion he fails to do so or displays difficulties due to excessive growth and too low gold backing, then the note holders will be panic driven and demand withdrawal of all notes, the notes being converted to gold. Thus would be a bank run! Such was the fate of the aggressive bankers. Hence was the need for the governments to take over this serious function and entrust the Central Banks to carryout the issue of currency notes.

4.2 Central Banks on the Same Habit!

Central Banks as note issuers have not been too different. The notes issued by the Central Banks were not only believed to have had the gold backing but also the character of legal tender being Fiat Money. Hence the credit quality of the currency issued by Central Banks would be a tremendous improvement compared with the private issuers. A default would almost never arise because the government decrees the notes as legal tender and hence acceptable as good as gold.

Reference is made elsewhere in the article to the different levels of gold reserves and different methods of specifying such gold reserves adopted by the Central Banks in the nineteenth and twentieth centuries. In the early stages of Central Banking, all the currency issues were convertible back to gold and the Central Banks maintained higher if not 100% gold reserves. In 1863 Belgium had 40% gold reserve on the Central Bank notes and deposits. In 1875 Germany had 1/3 (33 1/3%) gold reserve requirement.

M.H.De Kock refers to various reserve percentages required to be maintained in 1920's in different countries as follows: "The Federal Reserve had to maintain minimum reserve of 40 percent against their notes issues and 35% against their deposits, while most countries adopted the same percentage for deposits as for notes, e.g. 33 1/3 percent in Belgium and Bulgaria, 35% in France, Rumania, Yugoslavia, 40% in Netherlands , Italy, Greece and South Africa, 50% in Chile and Peru and 60% in Colombia" .

The balance assets for backing the notes issues and deposits of Central Banks were mainly Government Securities meaning lending to government, and foreign assets. The governments availing themselves of credit from the Central Banks would facilitate the Central Banks issuing more and more notes as well as having more deposits particularly when the requirements for gold and foreign currency reserves are relaxed.

4.3 Economic Depression, War and Lowering of Gold Reserve Requirements

Countries suffered severe losses of gold and foreign currency reserves during the severe depression of 1930 - 33. Hence the Central Banks were unable to meet the reserve requirements and had to pay additional penalties and taxes. Kock (1992;72) refers to such relaxation of reserve requirements as "not only due to the impact of the world depression of 1930 - 33 but also because it was in line with the continuing trend towards greater elasticity in monetary policy and the recommendation made by the International Economic Conference of 1933 in favor of a 25% reserve ratio". Several countries lowered the reserves to a level of 25% in the mid 1930's.

After the outbreak of war in 1939 most countries including France, Canada, Denmark, Norway, Holland, Belgium, England and Japan suspended their reserve requirements. The trend continued with more countries relieving Central Banks of such reserves and also providing Central Banks more discretion with regard to the determination of the level of reserves by way of gold and foreign currency.

In Sri Lanka, prior to establishment of the Central Bank of Ceylon in 1950, there existed the Currency Board System where the issue of currency was backed by gold and foreign currency. The note issues were rigidly linked to the accumulation or disposal of currency which largely was affected by exports and imports and then the overall balance of payments. Following the trend of the time, emphasis in late 1940's was also placed on the balance of payments. Kock (1992;75) refers to the establishment of Central Bank of Ceylon with less stringent reserve requirements as per the prevailing trend in most countries. He states "Likewise the new Central Bank of Ceylon

(1950) was only required to maintain international reserves adequate to meet any foreseeable deficits in the balance of payments; but various criteria were laid down to which the Bank must have regards in judging the adequacy of the reserves, including the estimates of the prospective receipts and the payments of foreign exchange, the volume and maturity of the Central Bank's own liabilities in foreign exchange and the volume and maturity of the foreign exchange assets and liabilities of the government, banking institutions and other persons in Ceylon".

All in all the currency issues and deposits of Central Banks were increasingly made independent of the gold reserves. Such scenario would enable Central Banks to issue more currency and hold more deposits of Commercial Banks thereby increasing the monetary base (Reserve money or high powered money referred to earlier) comprising of currency held by public, currency held by Commercial Banks and deposits of the Commercial Banks with Central Bank.

The Reserve Money in Sri Lanka as at end 2006 was Rs.239 Billion and net foreign assets of the Central Bank was Rs. 229 Billion. More will be discussed on the growth of Reserve Money, its impact on Money Supply and the factors influencing the Reserve Money, later.

4.4 Commercial Banks into Creation of Money

When goldsmiths, who turned into banking partners, were to discontinue issue of notes with the taking over of this function by the Central Banks it would have appeared that the business of money creation would only be within the Central Banks. The outcome was different. The place held by gold is today held by the Reserve Money created by the Central Banks. Banks began to accept currency issued by the Central Banks and create deposit accounts where the deposits could originally have been intended to be fully backed by the currency issued by the Central Banks. A balance sheet of a Commercial Bank under such 100% backing of currency (or deposits with Central Banks as an equivalent) would look like the following (Figure 4):

Figure 4. Simplified Balance Sheet of a Commercial Bank
100% backed by Reserves

Liabilities		Assets	
Deposits of Customers	100	Currency and deposits with the Central Bank	100
	100		100

Such a balance sheet would not make much business sense as there is no room for profits. Besides, Banks would have in no time realized that there was no need for 100% backing because not all the depositors would come for withdrawal at once. Hence the banks made the innovation again. Instead of the earlier method of creating money, banks began to do so by creating more deposits and loans with the help of the Reserve Money. If a bank was to have only 50% of its deposits backed by Reserve Money then the bank could grow the balance sheet by 100% now with loans generating interest income (Figure 5).

Figure 5. A simplified Balance sheet of a Commercial Bank
50% backed by Reserves

Liabilities		Assets	
Deposits	200	Currency and Deposits with the Central Bank	100
		Loans	100
	200		200

The additional deposit of 100 units in the above example is money created by the Commercial Bank. Hence is multiple credit and money creation!

4.5 Multiple Credit and Money Creation in Today's Context

The relationship between money (Money Supply (MS)) and Reserve Money or Base Money (B) can be given in the following equation:

$$MS = m \times B$$

Where MS = Money Supply which can be M_1, M_2 or any other measure of Money Supply

m = Money multiplier (as appropriate for M_1 or M_2)

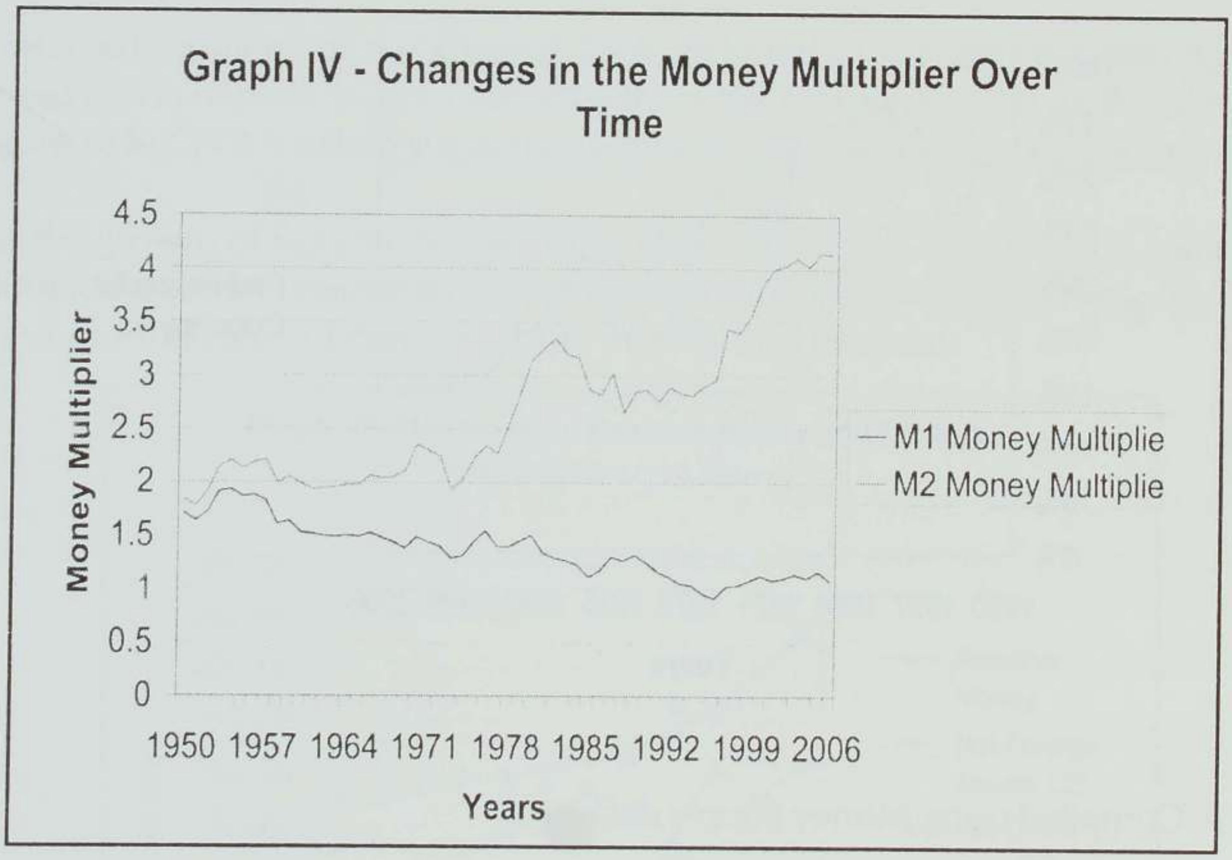
B = Base Money (Reserve Money)

Although the equation suggests an instantaneous relationship, there is a causation effect where there is a lag period over which a given additional amount of Base Money may turn into a stock of money.

The Base Money or Reserve Money as stated earlier, substitutes the function of gold in the hands of the Commercial Banks. This is the raw material provided by the Central Bank to the banking system that helps create more money.

Mainly arising from the fact that Commercial Banks maintain only a fraction of their deposits in the form of currency, liquid assets and reserve deposits with the Central Banks, Commercial Banks are in a position to create multiple deposits and credit with a given amount of Reserve Money. The fact that deposits with Commercial Banks are recognized as Money, enables a bank to grant a credit facility by simultaneously debiting a loan account and crediting a current account. While the deposits go up by the full amount of the transaction the resources required for this by way of liquid assets and statutory reserves to be maintained with the Central Bank are only fractions (20% and 10% respectively at present) of the new deposit created. This process is also affected by the preference for currency of the Public.

As per the current monetary data, the magnitude of the money multiplier was 1.08 times for Narrow Money Supply (M_1) and 4.14 times for Broad Money Supply (M_2). There had been a tendency of the M_1 money multiplier going down while the M_2 money multiplier has been going up. The following Graph IV shows the changes of the two money multipliers over time.

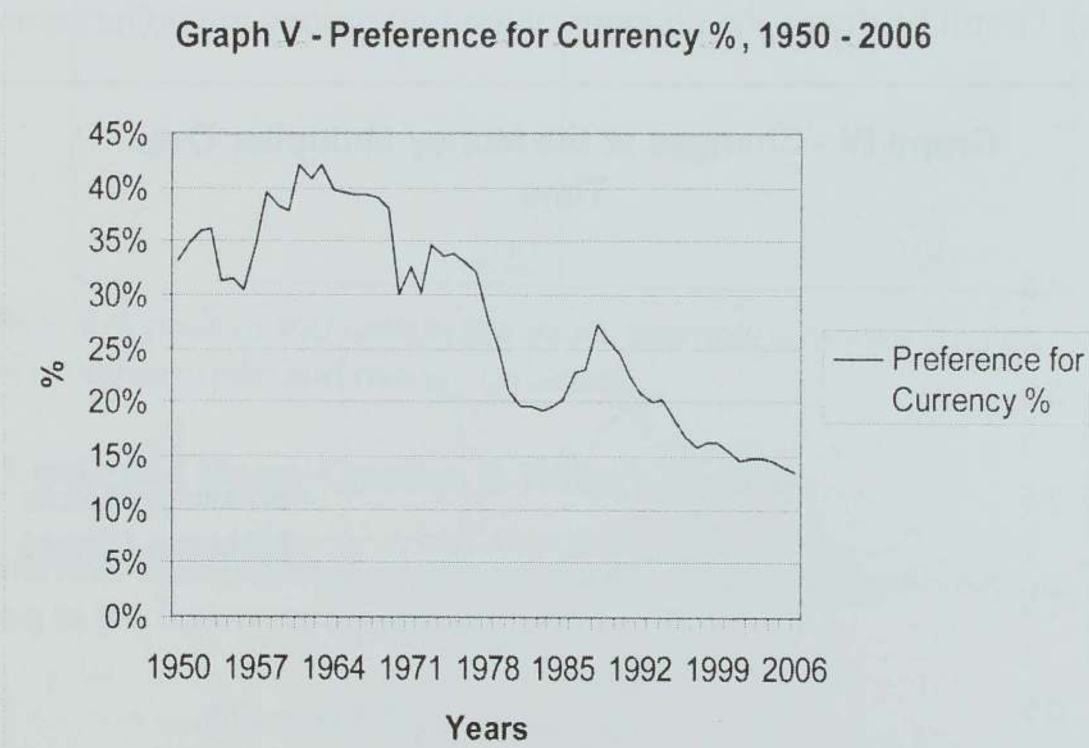


Source : Compiled using published data of the Annual Reports of the Central Bank

The reason for the reducing M_1 money multiplier can be explained with the suggestion that a good share of the Reserve Money will be in the statutory reserve deposits with the Central Bank and also in the vaults of Commercial Banks and hence the portion left out for currency held by Public which is counted under M_1 would be less. The Reserve Money supports both M_1 and M_2

but the reserve requirement is based on M_2. Further, with new banking innovations such as sweeping accounts and internet banking, the need to maintain high current account balances which is the other key component of M_1 can be minimized. The Growth of M_2 money multiplier can be mainly attributed to a continuous reduction of the ratio of currency held by public to total deposits which is called preference for currency. With Banking development and reach, people would be comfortable having their money in bank deposit form than in currency. Hence the ratio goes down. With the reduction of the ratio, the ability for the system to create more deposits with a given amount of high powered money goes up and the money multiplier goes up accordingly. The correlation coefficient between the preference for currency (%) and M_2 multiplier considering the data between 1950 and 2006 was (-0.9318). This proves the strong negative relationship. In 1950, the preference for currency was 33% and M_2 money multiplier was 1.83. In 2006 the preference for currency was 14% and the M_2 multiplier was 4.14.

The following graph (Graph V) illustrates the reduction of preference for currency over time.



Source: Compiled using Money Supply data

5. Factors Affecting Reserve Money, Money Supply and the Trends

5.1 Factors Affecting the Reserve Money

Reserve Money represents the sight liabilities of the Central Bank. By simplifying the other items in the balance sheet of the Central Bank the contributing factors affecting the Reserve

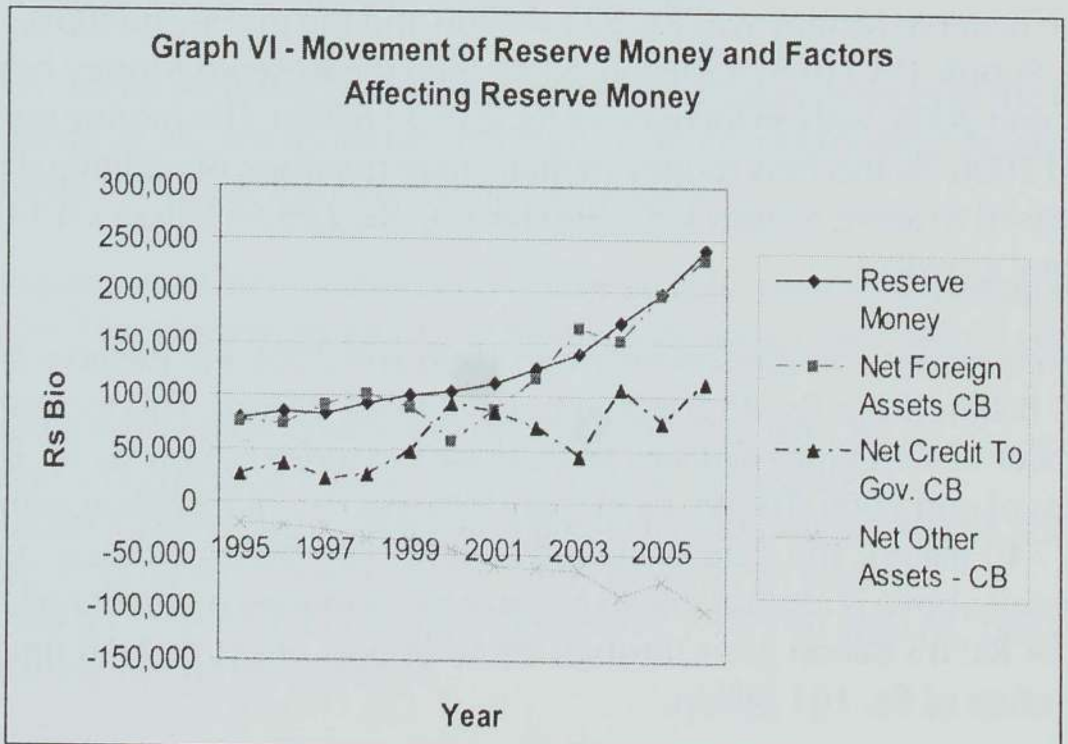
Money are identified as Net Credit to Government by the Central Bank (NCGCB), Net Foreign Assets of the Central Bank (NFACB), Advances to Commercial Banks by Central Bank(AKB), if any, and the Net Other Assets of the Central Bank (NOACB). Any growth of these four factors will increase the Reserve Money.

The contribution of these factors to the Reserve Money over the last 12 years is given in Table VIII, along with the growth of these factors. Net Foreign Assets of the Central Bank has grown from Rs. 74.3 Billion to Rs. 229.8 Billion over the period. It has at times fully backed the Reserve base, while at times it has gone below the Reserve with a share of 96% by end 2006. Net Credit to government by Central Bank has gone up from Rs. 24.4 Billion in 1994 to Rs. 112.9 Billion by 2006. The percentage contribution has gone up from 31% to 47%. This provides evidence on the government's role in adding to the Reserve Money, which is called printing money, that has continued, of course with a reduction in the percentage share between year 2000 - 2006.

The Net Other Assets figure has been a negative figure suggesting it is a Net Other Liability. This figure mainly represents the capital and equity reserves of the Central Bank. In 2006, the Net Other Liabilities was Rs. 102.9 Billion whereas the capital and reserves (equity) was Rs. 103.3 Billion.

The retained earnings of the Central Bank included in the above equity figure acts to reduce the expansion of base money caused by the other two sources, NFACB and NCGCB. The NCGCB figure of Rs. 112.9 Billion suggests a virtual borrowing against the equity.

While the growth of Reserve Money through foreign assets may provide some backing to Reserve Money, the growth caused by Government borrowings would definitely result in adverse effects in terms of the value of currency, both internal and external.



Source : Compiled using published statistics

Table VIII - Movement of Factors affecting Reserve Money

Table VIII - Movement of Factors Affecting Reserve Money

LKR Bio

Year	Reserve Money	NFA CB	% Growth	NCGCB	% Growth	NOA CB	% NFACB over Reserve Money	% NCGCB over Reserve Money
1995	78,586	74,301		24,418		(20,132.90)	95%	31%
1996	85,509	73,786	-0.7%	34,291	40.4%	(22,568.00)	86%	40%
1997	83,736	89,936	21.9%	20,300	-40.8%	(26,500.00)	107%	24%
1998	92,866	101,744	13.1%	25,909	27.6%	(34,787.00)	110%	28%
1999	100,444	89,287	-12.2%	46,716	80.3%	(35,559.00)	89%	47%
2000	105,163	57,947	-35.1%	91,956	96.8%	(44,740.00)	55%	87%
2001	112,522	84,346	45.5%	84,668	-7.9%	(59,438.60)	75%	75%
2002	126,410	117,377	34.5%	70,934	-16.2%	(61,900.70)	93%	56%
2003	141,447	164,596	40.2%	42,149	-40.6%	(65,298.00)	116%	30%
2004	170,967	151,694	-7.8%	107,144	154.2%	(87,871.00)	89%	63%
2005	197,932	196,925	29.8%	74,423	-30.5%	(73,415.90)	99%	38%
2006	239,854	229,860	16.7%	112,942	51.8%	(102,947.38)	96%	47%

Source: Compiled by Author using the data published by the Central bank of Sri Lanka

Source: Compiled by Author using the data published by the Central bank of Sri Lanka

5.2 Factors Affecting Money Supply; Reserve Money and Multiplier Effect

Growth of Money Supply is essentially an outcome of the additional Reserve Money supplied and the effect of any change in the size of the money multiplier.

In 1950, the Reserve Money was Rs. 533 Million and the money multiplier was 1.83 times making a Money Supply (M_2) of 978 Million. Since then the Reserve Money has gone up to Rs. 239.85 Billion by end 2006, with an increase of Rs. 239.32 Billion. The money multiplier has gone up to 4.14 by end 2006. At this new money multiplier the quantum of additional money supplied through the increased Reserve Money is Rs. 990 Billion, (Rs. 239.54 Billion x 4.14) which virtually explains the money growth.

Taking a more recent comparison between 1996 and 2006 the Reserve Money has gone up by Rs. 154.35 Billion (from Rs. 85.5 Billion to Rs. 239.85 Billion). This increase multiplied by the money multiplier of 4.14 times explains an increase in Money Supply by Rs. 639 Billion out of Rs. 993.2 Billion as of end 2006. The M_2 as of end 1996 was Rs. 253.2 Billion with a total increase up to now of Rs. 740 Billion. The difference between Rs. 740 Billion increase and the figure Rs. 639 Billion explained above is attributable to an increase in money multiplier where the previous Reserve Money of Rs. 85 Billion goes through an additional effect of 1.18 times (4.14 - 2.96) making the difference of Rs. 101 Billion.

While money multiplier itself could be controlled through measures such as Statutory Reserve Ratio (SRR), the growth of Money Supply is by and large an outcome of the growth of Reserve Money. Hence if the need is control over monetary growth, then there need to be a control over growth of Reserve Money. While the causation relationship was already discussed, it is also possible to look at the correlation between the two. During the period 1950 to 2006 the M_2 and Reserve Money displayed a correlation coefficient of 0.9935 (99.35%). M_1 and Reserve Money had a correlation coefficient of 0.98 (98%). Hence it is no doubt that Reserve Money targeting is an important aspect of monetary policy. This in fact is the basis of the current monetary policy framework of monetary targeting. Reserve Money is the immediate and intermediary target with resultant targets of Money Supply and price level.

5.3 Factors Affecting Broad Money (M_2) – The Source Side

While the growth of M_2 is caused by the availability of excessive quantum of Reserve Money it will be interesting to see how this excessive growth has got converted into Money Supply. For this purpose, let us analyze the sources of Money Supply M_2.

A consolidated balance sheet of all the Commercial Banks further merged with the balance sheet of the Central Bank would give us a total picture of the assets and liabilities of the banking system. When the components of the M_2 which are on the liability side of this balance sheet are isolated then we would have the following as the causing factors or sources of M_2.

1. Net Foreign Assets of the Baking System (NFABS)
2. Net Credit to Government by the Banking System (NCGBS)
3. Credit to Government Corporations by the Banking System (CCBS)
4. Credit to Private Sector by the Banking System (CPSBS)
5. Net Other Assets of the Banking System (NOABS)

The causation can be explained using the consolidated balance sheet of the banking system, as all the components of M_2 are monetary liabilities with corresponding assets in the balance sheets. It is also useful to look at the correlation of the data.

When the above stated factors affecting Money Supply were analyzed against the growth of Money Supply (M_2) for the period 1950 - 2006 the following observations were made

1. NFABS had a correlation coefficient of 0.977 (97.7%) with M_2
2. NCGBS had a correlation coefficient of 0.974 (97.4%) with M_2
3. Credit to corporations had a correlation coefficient of only 0.848 (84.8%) with M_2
4. CPSBS had a correlation coefficient of 0.9973 (99.73%) with M_2
5. NOABS had a correlation coefficient of (-0.989), (-98.9%) with M_2 because the figures were negative meaning net other liabilities.

The above strong correlations suggest that these factors do contribute to the Money Supply.The following table (Table IX) shows the factors affecting Money Supply in selected years over the period 1950 - 2006

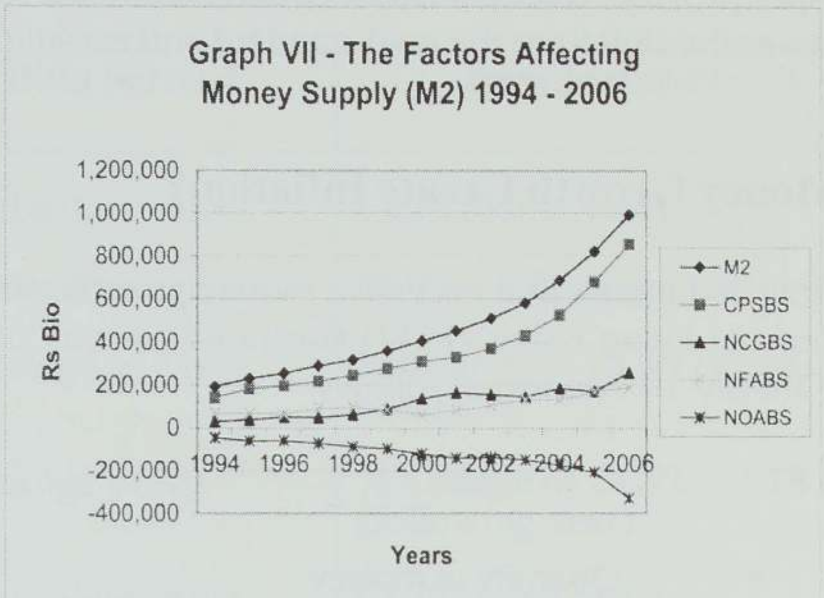
Table IX – Factors affecting (Sources of) Money Supply (M2) 1950 – 2006

Rs Million

End of the Year	Broad Money Supply (M2)	Factors Affecting (Sources of) M2				
		NFABS	NCGBS	CCBS	CPSBS	NOA BS
1950	978	739	66	-	148	25
1955	1,225	868	186		270	(99)
1960	1,572	232	1,004	46	468	(178)
1965	2,283	106	1,711	54	732	(320)
1970	3,115	(599)	2,559	297	1,320	(462)
1975	4,777	(362)	2,810	1,013	2,390	(1,074)
1980	19,860	3,631	8,972	4,123	12,709	(9,575)
1985	48,409	9,273	20,348	4,438	34,441	(20,091)
1990	90,546	3,419	35,357	15,636	64,970	(28,836)
1995	228,536	66,532	35,447	8,527	179,825	(61,795)
1996	253,201	61,861	48,537	9,938	193,842	(60,977)
1997	288,258	89,292	46,365	10,278	216,090	(73,767)
1998	316,174	93,724	58,591	8,681	244,353	(89,175)
1999	358,076	83,892	85,881	12,707	275,532	(99,936)
2000	404,669	59,448	134,484	26,986	307,613	(123,862)
2001	450,727	80,019	161,602	22,934	328,788	(142,616)
2002	510,395	101,717	153,171	28,010	367,397	(139,900)
2003	580,747	129,487	143,444	28,879	430,575	(151,638)
2004	687,964	129,152	181,111	27,258	526,236	(175,793)
2005	822,932	167,147	168,048	15,651	680,693	(208,608)
2006	993,264	185,005	256,553	25,410	856,842	(330,546)

Source: Compiled using data published in the Annual Reports of the Central Bank.

The following graph (Graph VII) shows the changes of the factors affecting Money Supply (M_2) during the period 1994-2006:

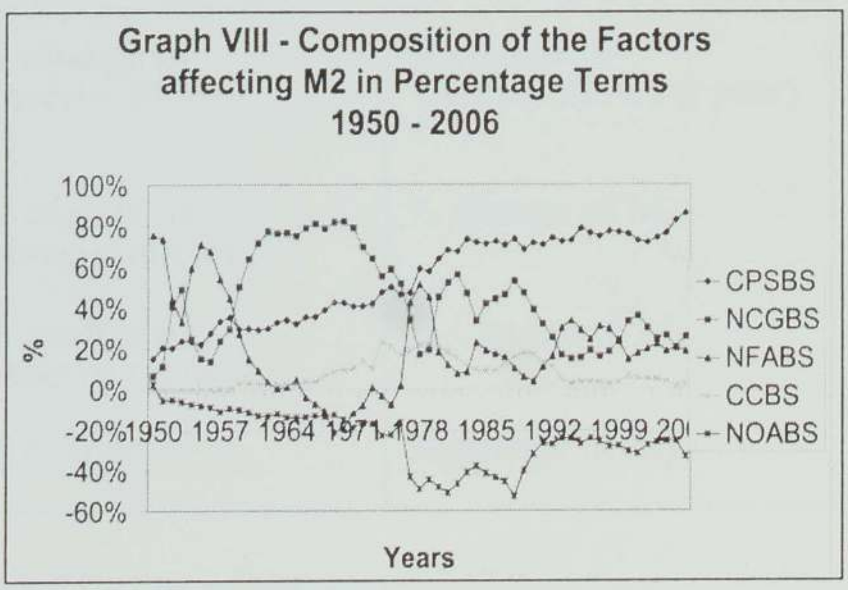


Source: Compiled using data published in the Annual Reports of the Central Bank

5.4 Changes of Composition Over Time

The different components of Money Supply had changed the significance over years except for the CPSBS. CPSBS has grown steadily and accounted for 86% by end 2006. NCGBS has varied from a high level of even 82% of the total M_2 to 26% by end 2006. So has been the fluctuations of NFABS. The NOA which has mostly been a negative figure (NOL) has had some fluctuations as a percentage of total but has shown some steady share ending with (-33%) by 2006.

The graph below (Graph VIII) shows the percentage changes of the composition over time.



Source: Compiled using data published in the Annual Reports of the Central Bank

5.5 The Evolving Process of Money Creation

Annex 1 to this paper provides a schematic presentation of the evolving process of money creation. This encompasses the shift from the gold standard and evolution up to the current day Money Supply.

6. Does Excessive Money Growth Create Inflation?

It is very well established theory that excessive money growth creates inflation. A.D. Bain quotes the famous theory of Irving Fisher (1911) illustrated by way of the quantity equation suggested by Quantity Theory of Money, as follows:

$$MV = PT$$

Where,	M	=	Quantity of money
	V	=	Velocity of circulation
	P	=	Price level
	T	=	Volume of transaction

If "V" is considered a constant and if the economy is at full level of employment then

$$P = \frac{V \quad M}{T}$$

Hence, any increase in quantity of money will lead to an increase in the price level, causing inflation.

6.1 Relationship between Rate of Inflation and Monetary Growth

A statistical analysis of the historical data from 1950 - 2006 showed the following correlations (Table X):

Table X – The Correlation between Different Items

Observation	Data Series 1	Data Series 2	Correlation coefficient
(1)	M_2 absolute value	CCPI (Same year)	0.982 (98.2%)
(2)	M_2 absolute value	CCPI – following year	0.986 (98.6%)
(3)	% change of M_2	% Change of CCPI (same year)	0.440 (44.0%)
(4)	% change of M_2	% Change of CCPI (following year)	0.597 (59.7%)
(5)	M_1 absolute value	CCPI (same year)	0.991 (99.1%)
(6)	M_1 absolute value	CCPI (following year)	0.994 (99.4%)
(7)	% change of M_1	% Change of CCPI same year	0.28 (28%)
(8)	% change of M_1	% Change of CCPI following year	0.46 (46%)
(9)	Reserve Money Absolute value	CCPI (same year)	0.9924 (99.24%)
(10)	Reserve Money Absolute value	CCPI (following year)	0.9954 (99.54%)
(11)	% change of Reserve Money	% change of CCPI (same year)	0.28 (28%)
(12)	% change of Reserve Money	% change of CCPI (following year)	0.435 (43.5%)
(13)	% change of Reserve money	% change of M_1	0.820 (82%)
(14)	% change of Reserve money	% Change of M_2	0.793 (79.3%)
(15)	% change of M_1	% change of M_2	0.845 (84.5%)

Source : Compiled by the author

The above correlations amply illustrate the links between Reserve Money, Money and Prices.

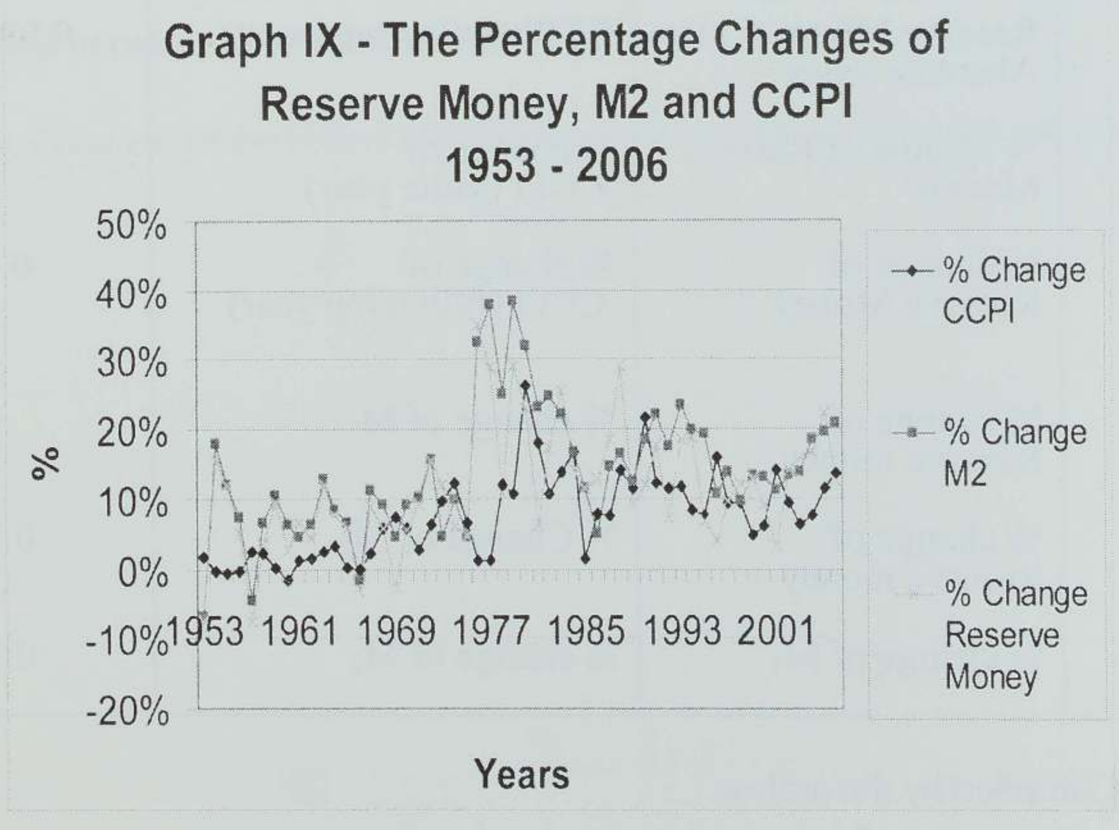
In terms of absolute values the Reserve Money, M_1, M_2 and CCPI are highly positively correlated.

However, a better analysis could be to look at the correlation of percentage changes. In this regard though quarterly or monthly figures could have given a better insight, annual figures were used to cover a long period.

With a one year lag, 59.7% correlation is shown between rate of inflation as measured by percetage change in CCPI and the percetage change of M_2. This is somewhat high positive correlation. Similarly, with a lag of one year percetage change of M_1 and percetage change of CCPI showed a positive correlation of 46%. Though this is not high it is neither too low to ignore. Similar comparison with change of Reserve Money also showed a positive correlation of 43.5%. Percentage changes of Reserve Money, M_1 and M_2 are strongly positively correlated.

The weakness of using annual data, where appropriate with a one year lag, is that the lag period may not be properly taken. Hence is the desirability for the more frequent (quarterly or monthly) data to perform the analysis. However the above analysis itself suggests that money causes inflation, a well accepted phenomenon.

The following graph (Graph IX) shows the movements of the percentage changes of Reserve Money, M2 and CCPI over the period 1953 - 2006



Source : Compiled using published data

7. Does Money Help Growth?

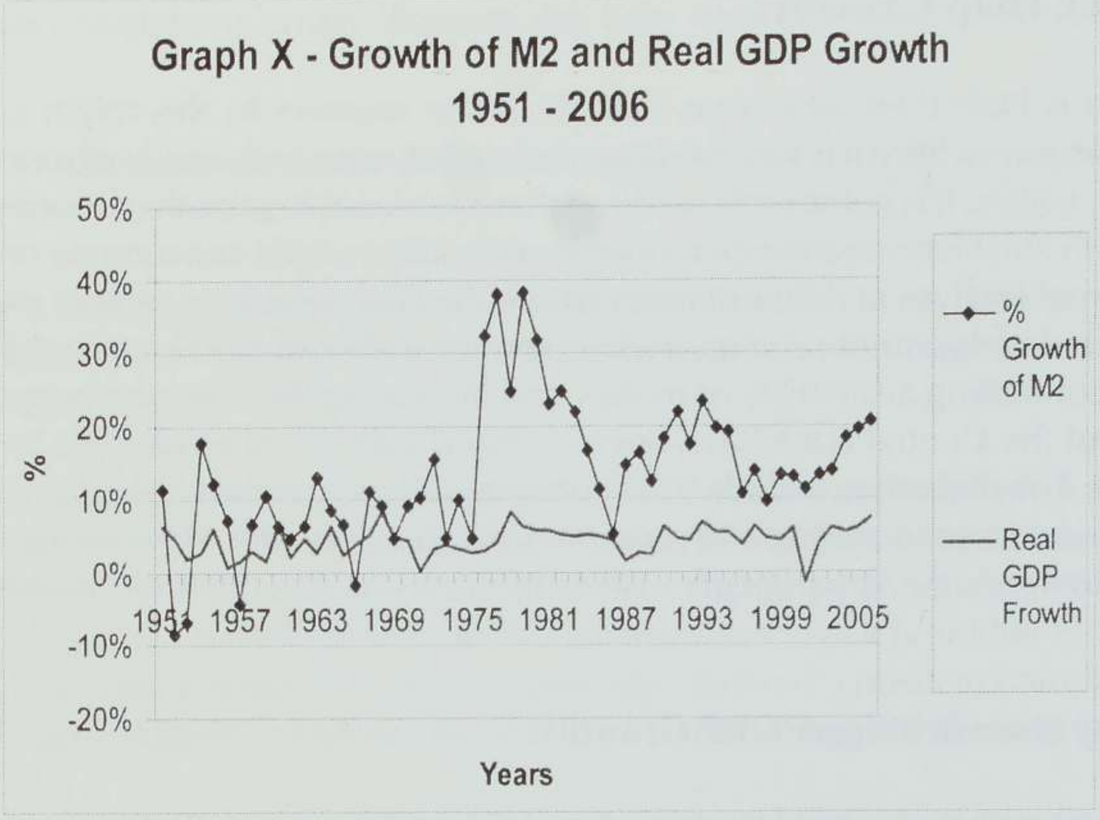
If inflation is bad, then why have it at all? Some answers to this might come from the Keynesian economics where it is believed that deficit financing and supply of money would kick -off economic activities. It is commonly believed that a reasonable growth of money will stimulate economic growth and vice-versa hence monetary authorities would concentrate on development and stabilization objectives at different times where the two objectives require exactly opposite approaches. The development requires making money available at low cost while stabilization would require controlling availability of money and increasing the cost of money (interest rate). The objectives of the Central Bank have been changed with the amendments to the Monetary Law Act in 2002. The objectives include "(a) Economic and price stability; and (b) Financial system stability, with a view to encouraging and promoting the development of the productive resources of Sri Lanka". However the key principles of using money as an economic stimulant would still prevail.

7.1 Does Money Growth Trigger GDP Growth?

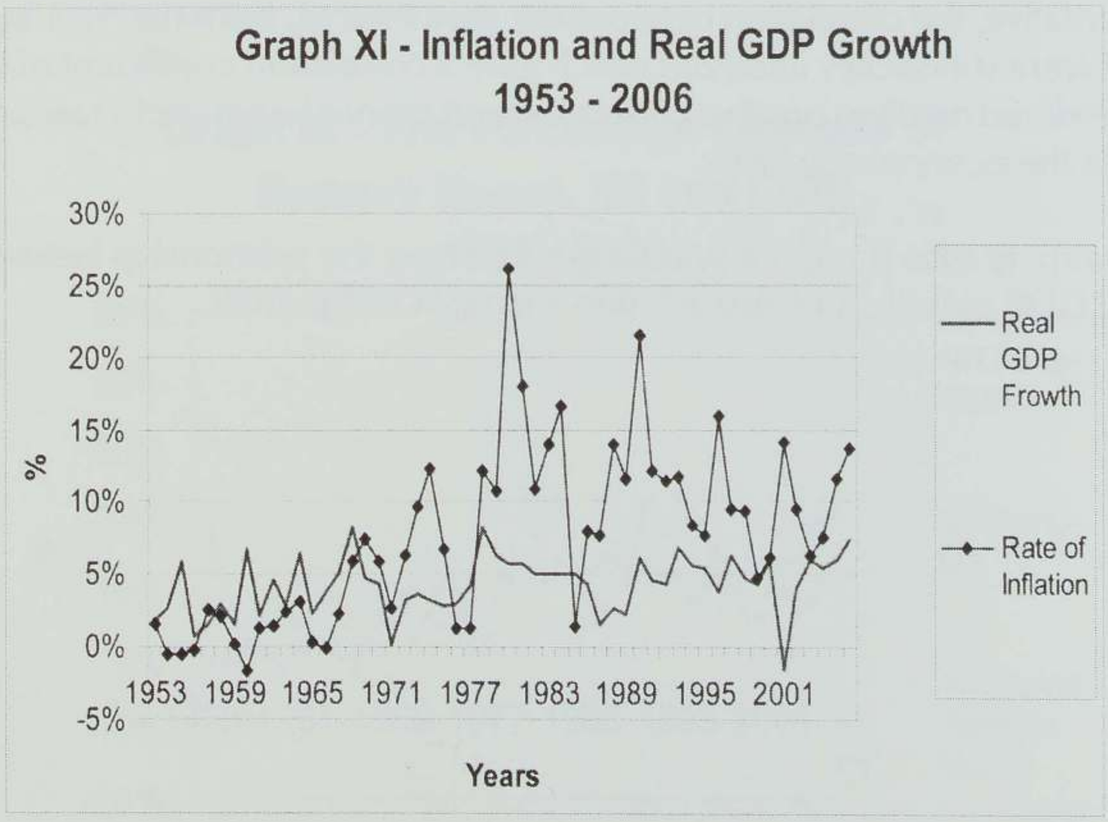
The underlying theory would be that when economy is not in full employment, availability of money will trigger increased economic activities. Let us look at empirical evidence by analyzing the data of Sri Lanka. The correlation between GDP at constant prices and the money supply was observed to be 0.87 or 87%. This however is not the best measure because both numbers tend to go up over time in any case even without a causation.

In the alternative, the correlation between the growth of M_2 (with one year lag) and the real growth of GDP were statistically analyzed which gave a correlation coefficient of 0.470 or 47%. This can be considered medium positive correlation and cannot be ignored as an indication of the role of money in the economic growth.

The following graphs (Graph X and Graph XI) show the relationship between growth of money and real GDP growth, and also inflation and real GDP growth.



Source : Compiled using published data



Source : Compiled using published data

A study by Michael Schedlock referring to similar studies looks at the possibility of changes of money supply being used as a predictor of economic growth or recessions. The study provides some significant evidence of the relationship. This study has been based on the use of a revised definition of money using different types of monetary assets, having evaluated the relationships with standard definitions of the Money Supply as well. His study shows a significant relationship between low growth of money and recessions that follow.

7.2 Inflation and Growth Rate; Any Observations Across Countries?

A very basic study was carried out by the author using the inflation data and the real growth of GDP of 184 countries. The data available were the estimates of inflation and estimated real GDP growth for the year 2006 or 2005, most cases being for 2006.

The country ranking as per the GDP growth (higher growth lower number) and the country ranking as per the inflation (higher inflation lower number) gave a positive correlation of 0.375 (37.5%) suggesting a weak but possible relationship of high inflation and high growth. It also gave a very low positive correlation of 0.125 (12.5%) between inflation rate and the growth rate suggesting very weak correlation. This study cannot be conclusive due to the vast diversity of the economies and also the non incorporation of lag effects. However it may be useful to form a basis for further research.

8. Conclusion

The discussion is a preliminary attempt to revisit the relationships between money, inflation and growth. Evidence reconfirms the monetary growth through the growth of high powered money. Further, the factors that have contributed to high powered money growth were identified. The evidence also confirms a strong positive relationship between money and prices. Money has caused inflation.

The study also looked at the conceptual relationships between the different variables. This includes a discussion on how banks create multiple deposits and credit and the evolution of the credit creation process.

A weak relationship could be established between growth of money and the real economic growth.

While the study has been largely based on the annual data of the economic variables, further refinement and incorporation of lag effects will be possible with monthly or quarterly data.

Money is created and inflation is also created, by man. Despite both being man made, there is still a lot of debate as to how the ill effects of inflation can be dealt with.

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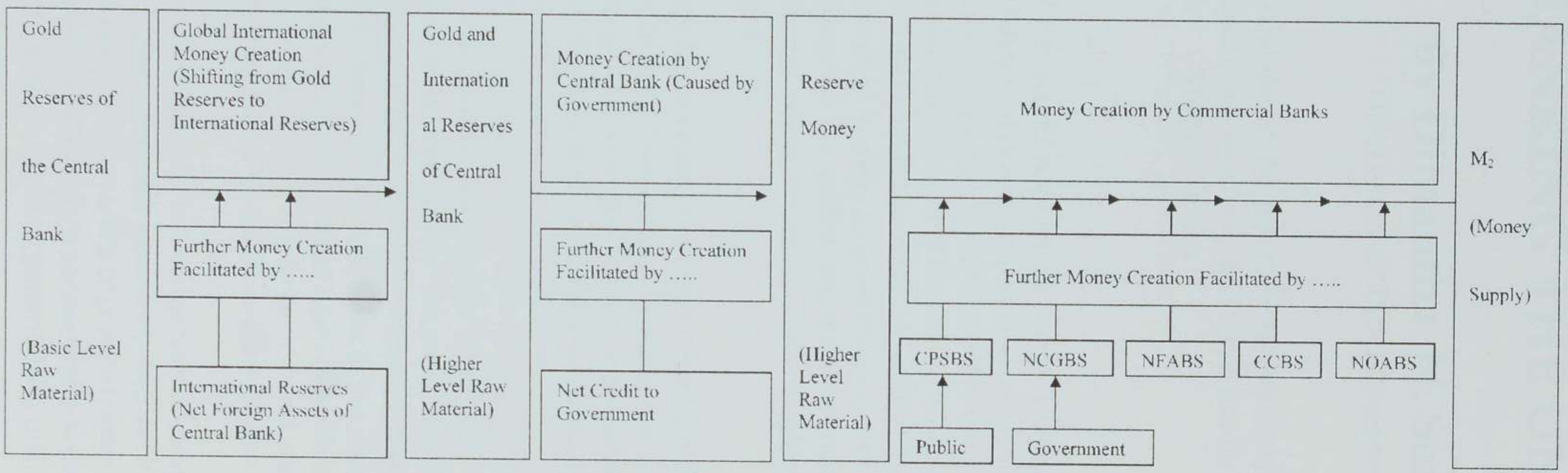
Annex - 1

A Schematic Presentation of the Evolving Money Creation Process



Source : Compiled by the author

Central Banks, Governments, Commercial Banks and the General Public, all contribute to this process!

BANKING THE UNBANKED

By Dimantha N. Seneviratne

Head of Credit Risk Management - HSBC

"Let us touch the dying, the poor, the lonely and the unwanted according to the graces we have received, and let us not be ashamed or slow to do the humble work" - Mother Teresa

1. Introduction

Nearly half of the world population, some 3 billion people live on less than $2 a day. Despite pledging of billions of dollars of aid in the name of helping the poor by the Governments of the developed nations and global multilateral lending institutions, the position still remains unchanged. In Sri Lanka, things are no different. 42% of our population earn less than USD2 per day and a further 6% below USD1 per day. No matter the amount of aid pledged, unless there is an effective well directed strategy to uplift the poor out of poverty, the results will hardly bear fruit. Instead of pouring aid, the global organizations have now realized that a well structured microfinance programme, where the low income people participate and improve their quality of life, is the way forward.

Recent research has revealed the extent to which individuals around the poverty line are vulnerable to shocks such as illness of a wage earner, weather, theft or other such events. These shocks produce a huge claim on the limited financial resources of the family unit and non-availability of effective financial services to these unbanked, can drive a family deeper into poverty that it can take years to recover.

The poor and low income households need tools to lift themselves out of poverty and Microfinance is often considered one of the most effective and flexible strategies in the fight against global poverty. The poor and their microenterprises in the region are a diverse group. Their demand for micro-financial services reflects this diversity. The collective demand of these groups for financial services is large and the types of services they demand vary across households and microenterprises and over time. This large demand and the heterogeneity of services needed over time have created scope for financial intermediation on a commercial scale.

The interest in microfinance has burgeoned during the last three decades; multilateral lending agencies, donor agencies, governments, NGOs all support the development of microfinance. More importantly, a variety of private banking institutions has also joined the group in recent years. As a result, microfinance services have grown rapidly during the last decade, from initial low level to the forefront of developmental discussions on poverty reduction.

However, researchers and practitioners generally agree that the poorest of the poor are yet to benefit from microfinance programs in most countries partly because most MFIs do not offer products and services that are attractive to this category. Thus, to increase the overall impact of microfinance on poverty reduction, it is essential to extend a wide range of services on a continuing basis to the poor who are still excluded from the benefits of microfinance.

This paper will broadly discuss about Microfinance, the need for a development strategy for bringing banking to the unbanked through microfinance, the opportunities for the commercial banks and the challenges it poses. Some financial institutions and NGOs have already started microfinance in Sri Lanka in a limited way and the paper will discuss some of the practical aspects and scope for growth of this untapped area.

2. Why Would the Poor Need Financial Services?

It is easy to imagine that poor people do not need financial services, but when we think about it, they are using these services already, although they might look a little different. They do save although mostly in informal ways. They invest in assets such as gold, jewellery, domestic animals, building materials and things that can be easily sold for cash. They bury cash in the garden or stash it under the mattress. They participate in informal saving groups where everyone contributes a small amount of cash each day, week or month and is successfully awarded the pot (Seeitu) on a rotating basis. Some groups allow members to borrow from the pot as well.

2.1 Demand for Savings

Poor and low-income households and their microenterprises have a large demand for safe and convenient deposit services. This demand reflects the importance of savings for these households and microenterprises for a variety of reasons. The poor need to save for emergencies, investment, consumption, social obligations, education of their children and many other purposes. They have the capacity and willingness to save. Savings are important for microenterprises and provide them with a major source of investments funds. The large demand for deposit services among the poor is confirmed by empirical evidence. The cooperative rural banks in Sri Lanka had 5 million deposit accounts at the end of 2005. Extensive use of informal savings arrangements by poor households is another indicator of their demand for savings facilities. In some countries, the poor pay high prices to those providing deposit services. The demand for deposit services is particularly strong among poor women in the region.

However widely used, these informal savings mechanisms have serious limitations. In kind savings are subject to fluctuations in commodity prices, destruction by insects, fire, theft or illness (in the case of livestock). Informal rotating saving groups tend to be small and rotate limited amounts of money. Often these groups require rigid amounts of money at set intervals and do not react to changes in the members ability to save. Perhaps, most of the time poor are more likely to lose their money through fraud and mismanagement in informal savings arrangements than depositors in formal financial institutions.

2.2 Demand for Credit

The demand for microcredit that originates both from households and microenterprises is also large. Poor households in the region require microcredit to finance livelihood activities, for consumption smoothening, and to finance some lumpy nonfood expenses for purposes such as education (e.g. school fees and books), housing improvements, and migration. Many Asian countries have numerous small farms and their operators also require microfinance services. The other source of demand is nonfarm microenterprises, which cover a wide array of activities such as food preparation and processing, weaving, pottery, mat and basket making, furniture making, and petty trading.

2.3 Demand for Insurance & Other Services

The demand for other financial services among poor and low-income households and their microenterprises could also be significant. A good share of rural households borrow, many more save, but all seek to insure against the vagaries of life and therefore the demand for insurance services among the poor is vast. A private insurance company in Bangladesh that started to provide micro-insurance services to low-income households on a commercial basis, for example, found that its client base was expanding rapidly. At the end of 1999, this company had over 800,000 clients, about 50,000 of which are considered poor. This experience shows that the supply of such services creates its own demand because the real demand for such services remains hidden when suitable products are not available in the market.

2.4 Why there is limited access to financial services for the poor?

There are a number of reasons for the limited access of formal financial services by the poor.

(i) lack of money to open savings accounts
(ii) lack of knowledge about various savings products
(iii) not having collateral to secure a loan
(iv) no credit record or no formal employment to be eligible for a personal credit line
(v) inability to complete necessary paper work, since illiterate.

On the other hand, traditional Banking System or the formal institutions are not designed to help those who do not already have finance records. In summary a variety of reasons contribute for financial exclusion of the poor and low income households. In remote, hilly and sparsely populated areas with poor infrastructure, physical access itself acts as a deterrent. From the demand side, lack of awareness, low income / assets social exclusion, illiteracy act as barriers. From the supply side, distance from branch, branch timings, cumbersome documentation and procedures, unsuitable products, language, staff attitudes are common reasons for exclusion. All these result in higher transaction cost apart from procedural hazards. Hence, the poor usually approach informal commercial and non-commercial money lenders without getting into the formal financial service market. The ease of availability of informal credit sources makes them popular even if they are considered costlier.

The informal credit market is thriving and in Sri Lanka, total money circulated is estimated at almost 50% of the formal financial market and the interest rate charged is enormous, between 5% - 15% per month (ie effective rate of 60% - 180% p.a.). Sometimes on a daily basis the effective interest rates charged are much higher, reaching 300% p.a. On the other hand, research indicates a very high recovery rate for such informal facilities due to various recovery practices, ruthless in a sense, and used by the informal lenders. The informal finance market in Sri Lanka is the subject of another paper in this volume.

3. What is Microfinance? How it Defers from Microcredit?

To most, microfinance means providing very poor families with very small loans (microcredit) to help them engage in productive activities or grow their tiny businesses. Over time, microfinance has come to include a broader range of services (credit, savings, insurance, etc.) as we have come to realize that the poor and the very poor who lack access to traditional formal financial institutions require a variety of financial products.

As per ADB's definition of microfinance, it includes provision of a broad range of financial services such as deposits, loans, payment services, money transfers, insurance to poor and low income households and their micro enterprises.

ADB categorise microfinance service providers as

(i) formal institutions such as rural banks and Corporations
(ii) semi informal institutions, such as NGOs
(iii) informal sources such as money lenders and shopkeepers

3.1 Emergence of Microfinance

Whilst microfinance refers to loans, savings, insurance, transfer services and other financial products targeted at low-income clients, "Microcredit" refers to a small loan to a client made by a bank or other institution. Microcredit can be offered, often without collateral, to an individual or through group lending.

Microcredit came to prominence in the 1980s, although early experiments date back 30 years in Bangladesh, Brazil and a few other countries. The important difference of microcredit was that it avoided the pitfalls of an earlier generation of targeted development lending, by insisting on repayment, by charging interest rates that could cover the costs of credit delivery, and by focusing on client groups whose alternative source of credit was the informal sector. Emphasis shifted from rapid disbursement of subsidized loans to prop up targeted sectors towards the building up of local, sustainable institutions to serve the poor. Microcredit has largely been a private (non-profit) sector initiative that avoided becoming overtly political, and as a consequence, has outperformed virtually all other forms of development lending.

With the emergence of Microfinance those who were previously considered "un-bankable" because of lack of collateral were offered financial services. Once given the opportunity, not only did clients of Microfinance Institutions (MFIs) expand their businesses and increase their incomes, but their high repayment rates demonstrated that the poor are capable of transforming their own lives given the chance. This model of lending disproved all conventional thinking. Thus, microfinance was born. Since then, microfinance has become one of the most sustainable and effective tools in the fight against global poverty.

Developing countries in the region have used microfinance services to reduce poverty. About 21 percent of the Grameen Bank borrowers and 11 percent of the borrowers of the Bangladesh Rural Advancement Committee, a microfinance NGO, managed to lift their families out of poverty within about four years of participation. These services also had a significant positive impact on the depth (severity) of poverty among the poor. Extreme poverty declined from 33 percent to 10 percent among Grameen Bank participants. The studies have, in general, shown that microfinance services have also had a positive impact on specific socioeconomic variables such as children's schooling, household nutrition status, and women's empowerment. MFIs have also brought the poor, particularly poor women, into the formal financial system and enabled them to access credit and accumulate small savings in financial assets, reducing their household poverty.

3.2 How Microfinance Works

The most common microfinance product is a microcredit loan - usually less than $100. These tiny loans are enough for hardworking micro-entrepreneurs to start or expand small businesses such as weaving baskets, raising chickens, or buying wholesale products to sell in a market. Income from these businesses provides better food, housing, health care and education for entire families, and most important, additional income provides hope for a better future.

In addition, the poor, like all of us, need a secure place to save their money and access to insurance for their homes, businesses and health. MFIs are now innovating to help meet these needs, empowering the world's poor to improve their own lives. The global repayment rate for microcredit loans is higher than 95 percent, which allows MFIs to re-lend these funds to even more clients. By giving the world's poor a hand up, not a handout, microfinance can help break the cycle of poverty in as little as a single generation.

3.3 Why Microfinance is Successful

The traditional banking system requires that a borrower has collateral to obtain a loan. The world's poorest people have no such collateral. Further, traditional banks are not generally interested in issuing small loans - $50 to $150 - as the interest benefits do not exceed the transaction costs.

Then how has microfinance been so successful?

Microfinance institutions exist in many forms - credit unions, commercial banks and, most often, non-governmental organizations (NGOs). Many microfinance institutions (MFIs) use social collateral in the form of peer groups to ensure loan repayment. Borrowers take out loans in groups of five to eight individuals. If a borrower defaults on her loan, the entire group typically is penalized and sometimes barred altogether from taking further loans. This peer pressure encourages borrowers to be very selective about their peer group members and to repay loans in full and on time, resulting in the higher than 95 percent repayment rates industry-wide.

Microcredit loan cycles are usually shorter than traditional commercial loans - typically six months to a year with capital payments plus interest, payable weekly. Shorter loan cycles and weekly payments help the borrowers stay current and not become overwhelmed by large payments.

Clearly the transaction-intense nature of weekly payment collections, often in rural areas, is more expensive than running a bank branch that provides large loans to economically secure borrowers in a metropolitan area. As a result, MFIs must charge interest rates that might sound high - the average global rate is about 35 percent annually — to cover their costs.

For a financial institution to scale and remain sustainable, at a bare minimum it has to cover its costs. In the example below, a large bank (big lender) can charge anything over 14 percent to recoup its costs, whereas the MFI has to charge a rate of at least 31 percent to cover its costs.

TOTAL COST OF ADMINISTERING A LOAN		
	Big lenders (eg.Banks)	Microfinance Institutions
Cost of Capital	10%	10%
Loan loss	1%	1%
Total cost of capital	11%	11%
Total amount of loan disbursed	$1,000,000	$1,000,000
Loan size	$1,000,000	$100
Number of loans	1	10,000
Yearly transactions	4-12	120,000-520,000
Cost of administering loan	3%	20%
Total Cost to Institution	**14% (11% + 3%)**	**31% (11% + 20%)**

Source: www.unitus.com

It should be noted that although MFIs may charge rates of 30 to 70 percent to cover their costs, these interest rates are still significantly lower than the 300 percent to 3,000 percent annual rates that many borrowers were previously paying to informal money lenders, and are typical of the local credit card interest rates.

3.4 Impact of Microfinance on Women

There are many reasons why women have become the primary target of microfinance services. At a macro level, it is because 70 percent of the world's poor are women. Women have a higher unemployment rate than men in virtually every country and make up the majority of the informal sector of most economies. They constitute the bulk of those who need microfinance services.

Targeting women has also proved to be a successful, efficient economic development tool. Research performed by the United Nations Development Programme (UNDP) and the World Bank, among others, indicates that gender inequalities inhibit overall economic growth and development. A recent World Bank report confirms that societies that discriminate on the basis of gender pay the cost of greater poverty, slower economic growth, weaker governance, and a lower living standard for all people.

Women are usually the primary or sole family caretakers in many developing countries. Helping them gain additional daily income improves the condition of their entire household. Putting extra income in women's hands is often the most efficient way to affect an entire family, as women typically put their children's needs before their own. Children are more likely to complete their education and escape the poverty trap than their parents. Giving women access to microcredit loans therefore generates a multiplier effect that increases the impact of a microfinance institution's activities, benefiting multiple generations.

HSBC in Sri Lanka together with SAPSRI (an NGO assisting low income women in urban and rural areas) commenced a microfinance programme in 2006 to assist 400 low income families to achieve a sustainable livelihood. All beneficiaries are women who are engaged in small scale businesses such as operating small salons, sewing apparels, selling of lunch packets, fish, etc. In addition to microfinance, they are also taught to manage their money. Disbursement is carried out by HSBC whilst loan monitoring and recovery is handled by field officers attached to SAPSRI. So far this project has shown very good progress and is promising.

3.5 When Microfinance is not an Applicable Tool

Running a program with substantial default rates undermines the very notion of credit and destroys credit discipline among those who could repay promptly but who look foolish given that many do not.

Microcredit is only useful in certain situations, and with certain types of clients. As we are finding out, a great number of poor, and especially extremely poor clients exclude themselves from microcredit as it is currently designed. Extremely poor people who do not have any stable income - such as the very destitute and the homeless - should not become microfinance clients, as they will only be pushed further into debt and poverty by loans that they cannot repay. As currently designed, microcredit requires sustained, regular, and often significant payments from poor families. At some level, the very cause of poverty is the lack of a sustained regular and significant income. Even though a family may have a significant income for extended periods, it may also face months of no income, thereby reducing its ability to enter into the type of commitment demanded today by most MFIs. Some people are just too poor, or have incomes that are too undependable to enter into today's loan products. These extremely poor people, at the bottom percentiles of those living below the poverty line, need safety net programmes that can help them with basic needs; some of these are working to incorporate plans to help 'graduate' recipients to microfinance programmes.

Microcredit serves best, those who have identified an economic opportunity and who are in a position to capitalize on that opportunity if they are provided with a small amount of ready cash. Thus, those poor who work in stable or growing economies, who have demonstrated an ability to undertake the proposed activities in an entrepreneurial manner, and who have demonstrated a commitment to repay their debts (instead of feeling that the credit represents some form of social re-vindication), are the best candidates for microcredit. The universe of potential clients expands exponentially, once we take into account the broader concept of 'microfinance'.

4. Banks Entry to Microfinance and their Strategies

In the 1970s, a new wave of microfinance initiatives introduced many new innovations into the sector. Several pioneering enterprises began experimenting with loaning to the poor and underserved.

The first fully-incorporated microfinance and community development bank was ShoreBank, founded in 1973 in Chicago.

Economics professor Muhammad Yunus is often credited with disbursing the first microloan in Bangladesh in 1974. He later went on to found the Grameen Bank and was awarded the 2006 Nobel Prize for his efforts.

Grameen Bank pioneered the model of providing small loans, usually to groups of five rural women for economic activities such as small-scale textile production. Commercial banks have shunned the concept, but its success speaks for itself. Of the $5.72 billion total Grameen has disbursed over the years, over $5.07 billion has been repaid (as at August 2006). Grameen is unique in that it would extend its loan repayment time by six months, or even a year if the borrower is unable to pay back and never writes off a loan. Given that social alienation from a peer group can be detrimental to survival in a rural community, borrowers are said to always repay their loans. The loan recovery rate exceeds 98% and presently they have 6.67Mn of borrowers of which 97% are women. The bank has 2,250 branches covering over 72,000 villages with total staff of over 18,000 and now has branches in India, Pakistan, China, Indonesia, Philippines, USA, Latin America and the Middle East.

Given the success of these models, several MFIs stepped in and now banks are striving to bring banking to the poor. Empowering the unbanked, who comprise some 80 percent of the world's population, is a mission some of the world's biggest players also have taken on. The sector, growing between 20-40 percent per year for the last 10 years has attracted the likes of global banking giants Citigroup, Deutsche Bank and HSBC to name but a few, so much that this phenomenon is "not so micro" anymore.

In the case of Citigroup, microfinance has not only proven lucrative, but has staying power. The bank first became involved in the field back in 1965 with a $5,000 grant and today has been active in over 50 countries providing grants to 178 microfinance partners. In 2004, it launched Global Microfinance, a business group that focuses on developing commercial relationships with MFIs enabling the latter to offer a wider range of services to the poor.

Citigroup uses a wholesale strategy - develops commercial relationships with MFIs. Their approach has been not to go direct to microlending. In fact, we bankers have a lot to learn before embarking on microlending. However, the cost of originating loans through this model of dealing directly with MFIs is higher than say a Grameen or a financial institution devoted to the cause. The losses associated with the strategy are mainly connected to high risk of penetration from the outside.

The model, however, is win-win for both sides: for banks without the network, domestic knowledge, and grassroots know-how reach to enter this hitherto untapped sector, while MFIs strive to accomplish their noble mission of empowering the poorest of the poor. As downscaling is difficult for global banks, Citi indirectly reaches the poor and books both the assets and risks on their balance sheet, while MFIs continue to conduct the intimate day-today handling of the loan disbursement and repayment process among microfinance loan recipients.

Some banks however are going straight for the bulls-eye. Those with ground presence and ambition can afford this strategy.

In Sri Lanka, HNB started Microfinance way back in the 1990s through their "Gami Pubuduwa" scheme where loans ranging from LKR25,000 are being distributed for borrowing groups and individuals through the branches. At present HNB employs approximately 100 field officers to disburse and monitor payments and so far over LKR5Bn have been disbursed with a very high recovery rate of over 95%.

Ceylinco Grameen is another institution involved in Microfinance in a larger scale employing over 2400 field officers operated through 81 branches. Over LKR11Bn has been disbursed by Ceylinco Grameen to-date with an average loan size ranging from LKR30,000 to 350,000. A unique feature in this microfinance scheme is the insurance cover provided to the recipient of microcredit. The recovery rate is near 100% whilst interest rate of approximately 25% is charged.

5. Microfinance - Current Position

The World Bank estimates that there are now more than 7,000 microfinance institutions, serving some 16 million poor people in developing countries. Experts estimate that 500 million households benefit from these small loans. Cambodia and Kenya were put forward as examples. Asia and the Pacific region represent 83% of the opened accounts in developing countries, which is equivalent to 17 accounts for 100 persons. In November 1997, more than 2000 delegates from 100 countries gathered at a Microcredit Summit in Washington DC, with the goal of reaching 100 million of the world's poorest families, with credit for self-employment and other financial and business services by the year 2005. Support for these goals has come from prominent world leaders and major financial institutions.

Numbers of MFIs and Total Client Numbers Reporting to
Microcredit Summit

Year	Number of MFIs	Number of Total Clients	Number of "Poorest" Clients*
1997	618	13.5 million	7.6 million
1998	925	21 million	12.2 million
1999	1,065	23.6 million	13.8 million
2000	1,567	30.7 million	19.3 million
2001	2,186	55 million	26.9 million
2002	2,572	67.6 million	41.6 million
2003	2,931	80.9 million	54.8 million
2004	**3,164**	**92.3 million**	**66.6 million**
***(< $1 per day or bottom half of those living below national poverty line when first loan is received)**			

Source: State of the Microcredit Summit Campaign Report 2005

The Economic and Social Council of the United Nations proclaimed the year 2005 as the International Year of Microcredit to call for building inclusive financial sectors and strengthening the powerful, but often untapped, entrepreneurial spirit existing in communities around the world. There are five goals associated with "The Year of Micro Credit" which are:

1. Assess and promote the contribution of microfinance and microcredit to the MDGs;
2. Increase public awareness and understanding of microfinance and microcredit as vital (parts of the development equation;)
3. Promote inclusive financial sectors;

4. Support sustainable access to financial services, and
5. Encourage innovation and new partnerships by promoting and supporting strategic partnerships to build and expand the outreach and success of microcredit and microfinance for all.

6. Market for Microcredit

The prospect for the microcredit industry in general is strong. The market is growing rapidly and supply can hardly keep up with demand. It is estimated that only 4 percent of global demand for microfinance services is being met. It is noted that the potential global microfinance market is worth roughly $300 billion, although estimates vary widely. Also with the growing development of the microfinance sector, sources of funding for MFIs have diversified. Official donors are no longer the primary source, as tens of microfinance funds and more and more private sector investors are also offering capital to MFIs and are rapidly commercializing microfinance. These investors are typically private-sector funding arms of donors and socially motivated, privately-managed investment funds financed by public and private capital. Although both types of investors generally take a commercial approach in the rigor of their investment analysis and monitoring, they are not always fully commercial in the sense of trying to maximize profit.

Microfinance has great potential to financial institutions in the region provided traditional models are changed. "Barefoot Banking" which is a new concept for the financial institutions to approach rural areas, understand the lifestyles and provide microfinance is fast emerging. These institutions have realized that it is the traditional and established way of doing microfinance centrally, that makes it a costly challenge for the banks. However, if both deposit and lending sides of the consumer is captured, a lender would be in an ideal position to monitor the credit.

For example, in Fiji where difficulties of penetrating the market with branches are synonymous with rural areas, ANZ Bank goes direct to the poor people with mini kiosks in the back of small banking trucks traveling in convoy from village to village providing banking to the poor, not just micro credit. Deposit taking activities are also carried out as these visits are made on regular basis at a prefixed time / day of the week.

7. Challenges for the Future

If we truly wish to succeed in providing microfinance services to the poor on a large scale, further contributions are desperately needed. This is not only an issue of financing. Regulators and governments, in particular, need to develop legal and regulatory frameworks for microfinance, consumer protection, and financial infrastructure. Also prudential supervisors can contribute to the growth of microfinance by defining clear criteria for microfinance institutions.

Recent developments in the industry is opening new opportunities. Today, microfinance institutions are providing a wide range of services to their clients such as savings, remittances, transfers and increasingly, micro-insurance. In the Philippines, advanced technology is being used as new vehicles for delivery of microfinance services. The use of mobile phones in selected microfinance transactions is a specific example. Here low value payments that characterize microcredits are linked with electronic cash platforms of telecommunication companies to lower transaction costs, increase productivity, minimize cash on hand risk and to increase overall accessibility of financial services. Microcredit model is now extensively used in the Philippines to deliver micro-agric credit (to cater to the needs of agriculture sector, especially poor farming households). The regulators in Philippines, Bangkok are now reviewing the provision of housing microfinance which could boost the needs of low cost housing sector.

The regulator in Philippines has conducted networking meetings between commercial banks and microfinance institutions. To encourage lending to this sector, it now recognizes microfinance loans of commercial banks to non-bank microfinance institutions as alternate compliance to the mandatory credit allocation to small enterprises.

7.1 Regulatory Developments In Sri Lanka

Given the diverse entities including NGOs that are carrying out microfinance services in Sri Lanka, establishment of a regulatory and supervisory mechanism for this sector has been a long felt need. Since funds held by MFIs are those of the poor and vulnerable, if such funds are mismanaged, the poor will inevitably sink further into poverty and lose confidence in the financial system, thereby impeding their savings activities. Given the growing microcredit sector, failure of several MFIs could also pose a threat to financial system stability. On these considerations, drafting of Microfinance Institutions Act has been formulated.

Microfinance for the purpose of this act is defined to be the "acceptance of deposits or receiving and/or obtaining external funds and providing financial accommodation in any form and other financial services, particularly to low income persons and to small and micro enterprises". The act is expected to cover licencing of MFIs and regulation of their activities by the Central Bank. However, licenced commercial banks, specialised banks, finance companies, cooperative societies registered under the Cooperative Societies Law and non-profit organizations which accept deposits only from registered members with the approval of the Monetary Board are exempt from licencing requirement. Further the Act recognizes MFIs operating at 4 different levels, namely the National Level, Provincial Level, District Level and Divisional Secretariat Level and specifies a minimum capital requirement for each operating level. The core capital requirement for operating at National Level is expected to be LKR 50 Mn.

Going forward, once enacted Licenced Microfinance Institutions (LMFIs) are required to publish their financial statements within 5 months after the expiry of each financial year. Another important aspect of the Act is the requirement that LMFIs maintain a Deposit Protection Fund and the power given to the Monetary Board to take necessary action to safeguard the depositors through deposit insurance. The MFI Act is now being finalized and is expected to become law in latter part of 2007, which is a welcome move.

8. Conclusion

A new microfinance paradigm is taking shape, with the goal of developing full-service for-profit banks for all poor people. These banks and financial institutions will be able to support their clients' effort to control family risks as well as capitalize on business opportunities. They will offer saving, insurance, remittance services, and personal and business loans, to help clients grow their assets while increasing their incomes.

There is however, criticism towards microfinance institutions as well. On a larger scale, some argue that an over-emphasis on microfinance to combat poverty will lead to a reduction of other assistance to the poor, such as government welfare. Some argue that microcredit as a privatization of public safety-net program. There is also criticism that success of the microcredit model has been judged disproportionately from a lender's perspective (repayment rates, financial viability) and not from the borrowers. For example, high repayment rate does not reflect the numbers of women who are repeat borrowers, and have become dependant on loans for household expenditure rather than capital investment. Some experts argue that microfinance institutions are overly dependent on external capital.

Despite the criticism, Microfinance as a financial solution has grown in the last decade and is fast catching up in the Asian and South American regions since it helps the poor to increase income, build viable business and reduce their vulnerability to external shock. It is a powerful instrument for self empowerment of the poor, especially women, to become agents of change. Some local banks and financial intuitions have already made in-roads into microfinance and before long other financial institutions will enter into this untapped economic segment to bear promising results not only for fiscal purposes but also to develop the wider socio-economic fabric so that they all build a financial community on egalitarian principles.

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INTERNATIONAL REMITTANCES AND FINANCIAL INCLUSION: ROLE OF BANKS[1]

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1. Abstract

This paper examines the nature and causes of financial exclusion in the remittance industry and the role that banks can play to facilitate financial inclusion. Remittance services are considered to be an area of public policy (considering the potential contribution to the welfare of recipients, their families and their society). Though the market is served by different categories of remittance service providers (RSPs), banks can play a prominent role as RSPs to make the remittance market contestable, transparent, accessible, competitive and reliable. The role of banks is explained in the light of 'General Principles for International Remittance Services' drawn and issued by the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements (BIS) and the World Bank (WB) in 2007. The paper also examines the opportunities available and the challenges that banks have to face in developing the remittance market and in facilitating financial inclusion.

An 'International remittance transfer' refers to the portion of the earnings that an international migrant worker earns in the country of employment, and sends back to another individual, often a family member who remains in the home country. Therefore, they are cross border person to person payments of relatively low value. The majority of recipients largely depend on remittances to meet day to day living expenses, emergency needs, housing, education of children, healthcare, investments in small businesses, repayment of debt etc. Accordingly, remittances play an important role in improving the standard of living of recipients.

Though the value of individual remittance transfers is small, the total value of global remittances is substantially high due to the large number of remitters and the frequency with which they send remittances. It is difficult to estimate the exact total value of remittance flows due to transfers taking place through informal channels and hence remaining unrecorded. According to the World Bank Global Economic Prospects Report, 2006, the total value of official global international remittances sent by about 175 million migrant workers exceeded US Dollars 232 billion in 2005. Remittance flows tend to be more stable than capital flows and appear to be counter-cyclical as they tend to increase when the migrants' home countries experience economic

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[1] The views presented in this paper are those of the author and should not be interpreted as necessarily indicating the views of the Central Bank of Sri Lanka.

downturns, natural disasters or similar events. In many developing countries, foreign remittances are a major source of external financing. In some countries more than a third of GDP comes from foreign remittances. In the case of Sri Lanka, the total value of worker remittances amounted to US Dollars 2.3 billion in 2006, which is 8.6 per cent of GDP. The foreign remittances were sufficient to cover about 70 per cent of the trade deficit.

Any person or institution providing remittance services as a business is known as a remittance service provider (RSP). The sender, the recipient and the remittance service provider (RSP) constitute the nexus in a remittance transfer. Generally two RSPs are involved in a remittance transfer. The RSP operating in the sending country is called the 'capturing RSP', while the other RSP in the receiving country is called the 'disbursing RSP'. Both RSPs work jointly to provide the service, with or without own offices/branches/agents. The RSPs are networked to send and receive remittances. Each has physical or virtual access points in the remittance delivery chain.

A typical remittance transaction takes place in three steps. In step 1, the sender/remitter pays the remittance to the capturing RSP using cash, cheque, money order, debit card or a debit instruction. The channel of instructions could be sent by e-mail, phone or through the Internet, providing the essential information to the capturing RSP, enabling it to forward the same along with the funds to the recipient. The funds transfer relating to a remittance too involves a messaging arrangement to channel information from the capturing RSP to the disbursing RSP and a settlement arrangement for the fund movement. These arrangements vary between different types of remittance services, but will always have common features, i.e., a network and a procedure to interact with access points to capture and disburse funds, depending on the way the network of access points is created and linked. In step 2, the capturing RSP instructs the delivering RSP to deliver the remittance. In step 3, the delivering RSP makes the payment to the recipient. In most cases settlement between RSPs takes place periodically following a mutually agreed schedule, through a bank that participates in the national clearing and settlement system. Most of the banks that act as RSPs provide settlement or other payment services.

There are formal and informal RSPs. The formal RSPs include a few major money transfer operators, banks and a large number of smaller RSPs that cater to niche markets in specific geographic remittance corridors. The informal RSPs constitute of informal fund transfer agents, unregistered money transfer operators such as *hawala* or *hundi* dealers, trading companies and friends (through hand delivery). Typically, informal channels are inexpensive. The hand delivery system is often slow and has risk of loss or theft.

The money transfer operators account for the largest share of the remittance market mainly due their fast, reliable and convenient service (with presence in immigrant communities and convenient locations, opened in evenings and during weekends, providing other services such as cheque encashing and money orders, extensive distribution networks in receiving countries and thus providing easy access). These money transfer operators tend to charge higher prices than other RSPs.

The cost of remittance includes a fee charged by the capturing RSP, generally paid by the remitter (when initiating the transaction) and a currency conversion fee for delivery of local currency to the recipient in the home country. Some RSPs require the recipient to pay a fee at the delivery point to cover any unexpected exchange rate movements. Currency conversion charges are less transparent when compared to fees and depend on competitors, corridors and the channels of remittance. Industry cost estimates show that the cost of providing remittance services varies also with the business model used by the RSP, country of origination, country of disbursement and the speed at which funds are available to the recipient. Typically, the cost consists of expenses on the channel and network involved in transaction processing, franchise licensing, compliance with regulatory requirements, marketing and administration (staff cost, security and rental of premises).

Remittances are attracted not only by lower prices, but also by safety. Since banks are regulated, they offer safer methods to send money. However, there are drawbacks in banks' remittance programmes, too. First, most programmes are available only to customers who have bank accounts. This requirement poses a barrier for immigrants who are reluctant to open bank accounts for reasons such as unfamiliarity, distrust of banks, the cost of maintaining an account, or identification restrictions. Second, banks tend to have limited business hours, a limited presence in immigrant communities, and less institutional commitment to meet language and cultural needs. Third, banks have relatively weaker distribution networks in receiving countries and longer processing times than money transfer operators.

According to the network type, remittance services could be categorized into 'unilateral', 'franchised', 'negotiated' and 'open'. It is important to understand these categories to analyze issues, which act as barriers for financial inclusion.

1.1 Unilateral Services

A unilateral service is a remittance service provided by a single RSP, which acts as capturing as well as disbursing agent. In order to provide unilateral service, the RSP should have physical access points in both sending and receiving countries or virtual access points to operate in both countries (to capture, message, settle and disburse). Unilateral services are provided by global banks, credit unions or other financial institutions that have established branches in countries where the migrants are concentrated. However, efficient unilateral service providers are scarce due to factors such as non availability/uneven distribution of physical access points or remitters' inability to access electronic banking, in particular and banking in general. But unilateral services have a potential to grow.

1.2 Franchised Services

A franchised service is a remittance service extended by a central provider of infrastructure for messaging and settlement of funds without necessarily having any of the physical access points. Such a RSP obtains the required access points from other institutions who wish to act as franchisees on standard and contractual terms. Global money transfer operators such as Western Union, provide franchised services. The partially franchised RSPs make available their infrastructure to other RSPs.

1.3 Negotiated Services

The RSPs which provide negotiated services, have a network of access points by negotiating with a limited number of institutions in other countries. Negotiated services are provided by banks (which have established bilateral arrangements) or credit unions or *hawala* services provided by individuals. Under the negotiated service, the proprietary product is negotiated between non-competing organizations. In most of the negotiated services, often the messaging and disbursement of funds take place before the settlement, on the expectation that the capturing RSP will settle them in the future. This kind of remittance services charge higher fees when compared with those of other formal RSPs.

1.4 Open Services

The 'open service' provides a remittance service to its customers in the sending country and uses an open network in the receiving country (any RSP can have access) to make fund transfers to the recipients. The message and the transfer of funds take place simultaneously.

2. Informal Remittance Services

An array of informal modes of international remittances exists. It is very difficult to estimate the remittances that take place through these informal channels. According to the World Bank Global Economic Prospects Report 2006, the total value of remittances transferred trough unofficial or unrecorded channels is believed to be high as about 50 per cent of the official statistics recorded in the balance of payments.

The widespread use of non bank RSPs and informal remittance channels is mainly due to numerous factors, including: problems with access, conditions, prices, marketing strategy of remittance services provided by banks, and self exclusion.

Access exclusion: Remitters are more likely to have limited financial access due to their immigrant status. Banks often favour relatively well to do beneficiaries/recipients. On the other hand, the standards that are applied have made it somewhat difficult for remitters and recipients to access banks' remittance services.

Condition exclusion: Where the conditions attached to remittance products have made them unsuitable to meet the demand of some people.

Price exclusion: Where some remitters and recipients cannot obtain remittance service at the prices quoted by banks. According to the World Bank Global Economic Prospects Report 2006, in the case of smaller remittances, particularly remittances below US Dollars 200, remittance fees are often high and may be around 10-15 per cent of the principal.

Marketing exclusion: Where relatively low value remittances are effectively excluded by targeted marketing and sales.

Self exclusion: Where people themselves decide not to obtain formal remittance services from banks due to numerous reasons, including negative experiences and perception, low level of financial literacy, language barriers, and to avoid commission, fees of banks, official exchange rates, government regulation and immigration status.

These exclusions often act as barriers, particularly to low income remitters, to enter into the mainstream of banking services to get the banking services in an appropriate form at an affordable cost. People who resort to obtaining remittance services outside the main financial stream may get an immediate benefit, but may find it difficult to manage their financial assets efficiently and take informed saving and investment decisions. The consequences of such exclusion are expensive to the poor/disadvantaged remitters as well as recipients and can generally exacerbate other kinds of financial social exclusion. Since banking services are in the nature of public goods, all-out efforts are required to ensure financial inclusion of remitters and recipients, without any discrimination.

The inclusion of the remitters and beneficiaries in the financial system is only a starting point of a broader client relation to integrate them in the development process of the society and the country. In order to understand the challenges faced by banks in this regard, it is important to understand the market for remittances and the role that banks can play in improving its efficiency.

Recognizing the importance of remittances to improve access to finance (or the lack thereof) for migrants, their beneficiaries and communities in their home countries, and finally the economic growth, and the difficulties that can be associated with them. G8 countries, regulatory bodies, international standard setters of payment and settlements, national governments and financial institutions have shown a special interest in recent years to make remittance services safer and more efficient.

One of such actions taken by the international community is the move of the Bank for International Settlements' Committee for Payment and Settlement Systems (CPSS) and the World Bank (WB) to convene a task force in 2004 to develop principles for international remittance services, in order to promote a sound, efficient and competitive market in remittance services. This task force consisted of payment system experts from the BIS, the World Bank, Central Banks of both remittances sending and receiving countries and from financial institutions. The 'General Principles for International Remittance Services'[2] (Box 1) prepared by the task force for CPSS and the WB, provide a guidance for RSPs and public authorities who intend to improve the market for remittance transfers.

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[2] General Principles for International Remittance Services, Committee on Payment and Settlement System, The World Bank, January 2007. p.4

3. General Principles for International Remittance Services

Remittances are considered to be an area of public concern, since they play an important role in maintaining and improving the standard of living of recipients living in developing countries. The 'General Principles for International Remittance Services' have been designed with the public policy objective: *Remittance services should be safe and efficient*. In order to achieve this public policy objective, the markets for the remittance services should be contestable, transparent, accessible and sound. Such market should give remitters and receivers:

- clear information about the price and other features of the remittance services (the remittance industry should be transparent);
- easy access to remittance services (the remittance industry should be accessible); and
- reasonable protection from operational failures and criminal abuse (the remittance industry should be sound and safe).

To address the major issues, particularly the high cost of remittances, competition needs to be enhanced. Since markets for remittances are not always functioning optimally, competition needs to be on the basis of a level playing field with a sound legal framework and increased awareness. International remittance services are a part of the national payment systems. Accordingly, development of payment system infrastructure is important to achieve the public policy objectives for international remittance services.

Having considered these factors, 'General Principles for International Remittance Services' addresses five key areas in the market for remittance services to achieve the public policy objectives:

- transparency and consumer protection;
- payment system infrastructure;
- legal and regulatory environment;
- market structure and competition; and
- governance and risk management.

4. Transparency and Consumer Protection

General Principle 1. The market for remittance service should be transparent and have adequate consumer protection.

The market for remittances is not always very transparent. As in any other market, for an individual to make an informed decision on selecting a remittance service, full information (transparency) on the price and service features is required in advance. It is useful to have full information, including the total price (fee charged to remitter and recipient, foreign exchange rates including margins applied, any taxes and other hidden charges), the time that it will take the funds to reach the recipient, and the location of the RSP's access points in sending as well receiving countries. Principle 1 calls the RSPs to provide information relating to their own remittance services in an easily accessible and understandable manner and the public authorities to provide comparative price information and background knowledge to senders/recipients. Full transparency would mean that RSPs disclose the information without imposing any requirements on the recipient such as opening an account or committing themselves to using the remittance service. Educational campaigns to educate users are important, since many migrants in developed foreign countries may experience difficulties in accessing the main financial stream, due to their inability to understand foreign languages, provide adequate evidence to prove their identity to open a bank account, or lack of time and financial literacy to compare costs and benefits of different payment services.

In addition, both remitters and recipients should have adequate rights and appropriate protection as consumers of remittance services.

5. Payment System Infrastructure

General Principle 2. Improvements to payment system infrastructure that have the potential to increase the efficiency of remittance services should be encouraged.

The efficiency and safety of remittance services depend largely on the adequacy of the financial system infrastructure, particularly the payment system infrastructure needed to effect a fund transfer at the desired speed with minimal risk. If the domestic financial system and retail payment systems are underdeveloped and do not support inter-operability, transferring of funds to access points may become slow and unreliable. If the payment service is highly concentrated in urban locations, the majority of recipients who live in rural areas would not be benefited. On the other hand, underdeveloped payment infrastructure makes it much more difficult for potential RSPs to find suitable partners in the receiving countries. Further, correspondent banking, which is widely used to make remittance services, is much costlier for transfers of small value remittance payments. The RSPs could often make better use of the payment infrastructure if there were greater standardization of payment instruments, more automation of their processing and increased inter-operability of the associated networks.

Though the improving of remittance payment infrastructure is a huge task, it will help to improve access to finance, including remittances.

6. Legal and Regulatory Environment

General Principle 3. Remittance services should be supported by a sound, predictable, non discriminatory and proportionate legal and regulatory framework in relevant jurisdictions.

Like any other financial service, remittance services are likely to grow best under the appropriate laws, regulations and well founded legal base. Remittances are generally regulated to ensure safety and to prevent of their misuse for purposes such as money laundering or terrorist financing. There is a need to have regulation which is proportionate to tackle specific issues and create a level playing field between equivalent remittance services.

7. Market Structure and Competition

General Principle 4. Competitive market conditions, including appropriate access to domestic payment infrastructures, should be fostered in the remittance industry.

Greater competition has a potential to bring down cost and increase efficiency of remittance services. Competitive markets can help limit monopolistic practices. Competition can be assured by discouraging RSPs from imposing exclusivity condition(s) on agents (whereby an RSP requires its agents or other RSPs to offer its remittance service subject to a condition that they do not offer any other remittance service). In addition, the regulatory regime should also not lead to market distortions and result in any unnecessary cost, thus causing imperfect competition. The RSPs need to use the domestic payment and settlement system (PSS) infrastructure to provide remittance services. Therefore, it is important that the PSS is available to RSPs on a fair and competitive basis, to promote competition.

8. Governance and Risk Management

General Principle 5. Remittance services should be supported by appropriate governance and risk management practices.

Whether the RSPs are big or small they are vulnerable to financial, legal, operational, fraud and reputational risks. Remittances may pose a money laundering or terrorist financing risk because they allow for quick transfer of funds across borders. Therefore, the adoption of proper governance and risk management practices that are appropriate for the size and type of the remittance business of RSPs is important to protect themselves and recipients in order to ensure the safety and soundness of remittance services, and the credibility of the remittance industry.

9. Implementation of General Principles

Since the importance of remittances varies from country to country, these General Principles could be applied considering the specific needs of each country. But effective implementation of the General Principles requires cooperation of the sending and receiving countries of remittances. If a country decides to implement the General Principles, RSPs as well as the authorities have to play a role. The General Principles do not distinguish differences between formal and informal RSPs. Though these informal modes of remittance transfers fulfill the immediate requirements of remitters and recipients, they do not provide for underprivileged remitters or recipients to enter into the basic banking services. Where the remittance services are provided by the banks, they have a potential to expand access to finance to both remitters and recipients. The provision of remittance services gives an opportunity for banks to reach un-banked/under banked recipients, increase the levels of financial literacy and participation of these individuals in banking services (to save, invest and borrow). On the other hand, the entering into remittance industry and actively participating in developing the remittance market will help to increase competition. Such increased competition will help to increase transparency and reduce fees and charges, with obvious and immediate benefits to recipients. The Inter American Development Bank (IADB) has taken steps to increase competition among RSPs to reduce the average cost of a remittance transaction by about 50 per cent, resulting in an increase of the share of funds available to the recipient. Banks can bring additional advantages over and above those of other formal and informal RSPs.

10. Opportunities for Banks

The migration of people across international borders will continue as long as the developing countries are not in a position to offer a sufficient number of well paid jobs meeting the demand. Accordingly, remittance payments will continue to grow. Currently, the majority of remittance payments take place outside the banking system. These un-banked remittances generally take place through a framework of money transfer operators, agents, local post offices or shops that disburse funds generally in cash to the recipients. Undoubtedly these non - bank RSPs provide immediate cash, the prime need of the recipients. But this mode of remittance disbursement has several concerns, mainly whether the recipients, particularly in developing countries, receive the full potential benefits. Where remittance transfers are accompanied by banking services, such remittances tend to increase the familiarity that recipients have with banks, the level of financial literacy and, in turn the likelihood that these recipients will become loyal customers of the banks and willingly open accounts, save and invest. Such access to finance will help to improve the economic maturity and financial independence of recipients in developing countries. Therefore, the role of the banks in the remittance market is to attract this sizable untapped pool of customers towards the banking sector and tap the full potential in the remittance business, providing greater benefits to the wider community.

Since more than half of the total remittances seems to be routed through informal channels, vast opportunities exist for banks to enter into the market. Increasing the inclusion of such remitters in the banks' remittance channels would be beneficial for banks as well as remitters/ recipients. Since most of the remitters are young and their incomes are growing, remitters likely to create a higher demand for loans and other products. Such a move will also help banks to obtain a steady and substantial fee income as any economic downturn in either sending country or receiving country generally would not affect the remittance business.

11. Challenges for Banks

A vast majority of remitters rely on informal or formal non bank RSPs to send their remittances, because non-bank RSPs have a widespread network to deliver remittance in cash, conveniently and speedily to remote locations in home countries where access to banks may be limited. Therefore, obtaining the services of a non-bank RSP is not considered as a poor choice in all circumstances. But the quality of service varies widely among non-bank RSPs, and remitters who transact with less scrupulous RSPs may incur a significant financial cost. Generally, non-bank RSPs' fees tend to be high in absolute terms. The impact of high fees can be huge, vis-a-vis the small value remittances, often sent by immigrants who earn lower wages. Since remitters are unable to send large value remittances and the transaction cost is high, the final outcome is that less money is received by the recipient. This raises a number of issues - first, the high fees charged at the point of origination; second, that charges are less clear or transparent. Both issues could be addressed by greater competition. There is significant scope for banks to reduce both costs and fees on remittances, particularly small remittances without a significant investment. In recent years, with the increased competition and the automation of the remittance processing systems, fees have declined, particularly in the high volume remittance corridors. A number of banks in source countries of remittances have announced aggressive price reductions in recent years and even geared to provide free remittance services to attract migrants. Reducing remittance costs and improving access to the financial system for migrants and recipients of remittances would be an alternative way to compete with non-bank RSPs that provide expensive modes of remittances with the advantages such as speed and convenience.

Although a larger proportion of remittances is used to meet basic needs, recipients are in a position to save some money. Banks can create a channel for such savings by offering special housing, business or savings accounts for immigrants in their country of origin to facilitate payment for mortgage loans, starting businesses and saving for the future education of children.

A large number of remitters as well as recipients remain unbanked mainly due to social or cultural distrust of banks. But using non-bank RSPs for remittances, migrants incur a high cost and also forego the opportunity to enjoy the wider benefits that come from an established relationship with banks (for example, non-bank RSPs cannot accept deposits or extend loans). Banks are aware of the potential financial return in the remittance industry, but delivery of banking services goes beyond facilitating remittances and addressing a barrier such as distrust is a real challenge to banks. First, it requires that remitters and beneficiaries be respected and their needs understood. Second, banks have to offer the right mix of innovative financial products tailored to their needs, with awareness programmes, effective outreach programmes and a strong commitment to serve this segment of remitters. With the regular remittance flows into recipient bank accounts, they will be able to accumulate savings, accessing other banking services such as loans and establishing a credit history.

The majority of unbanked recipients prefer cash transfers which require a physical presence at both access points (i.e. originating country and receiving country). All international banks do not operate or have branches at both destinations relevant to a remittance. Domestic banks too may not be in a position to provide efficient cash remittances in all countries, due to the cost involved in maintaining correspondent accounts. The majority of recipients of remittances live in rural areas. They are often underserved by banks and have to pay a high cost, particularly to obtain the services of formal RSPs. Global money transfer operators, informal RSPs and *hawala* operators, have established networks of agents worldwide to support fund transfers in the form of cash relatively easily. Therefore, one of the biggest challenges for banks that wish to establish a remittance business is covering both origination point and disbursement points. The success of banks in providing remittance services depends on their ability to meet the preference of remitters and recipients for cash and deliver service as close as possible to the domicile of the remitter as well as the recipient. A simple bilateral partnership is not adequate to offer an alternative mode to remittance using informal RSPs. To provide such a service, a more integrated network, which supports a variety of payment methods that are popular in both destination countries, is required.

To address this problem, a number of major international banks have geared to provide 'targeted' remittance services to meet the needs of migrants. The formal RSPs offer 'targeted' remittance programmes such as bank to bank partnerships, ATMs, or money transfer networks. Some banks have established bank partnership remittance programmes by establishing a relationship with one or more foreign banks. Fund transfers relating to remittances take place directly between accounts at the partnering banks. Remitters pay a flat fee and receivers get the remittance within 24 hours. These kinds of programmes require the remitter and the recipient to have bank accounts. This requirement has helped banks to bring the un-banked remitters and recipients into the banking stream and offer them an access to banking products. However, the account requirement has acted as a limiting factor for some remitters as well as recipients. In order to minimize such barriers, banks have to strategically select their partnering banks. These kinds of 'targeted' programmes carry a little risk to parties to the transaction. Based on strong cultural and historic ties, a number of remittance 'corridors' exist between countries of employment and countries of origin of remitters (examples: France to Morocco, Saudi Arabia to Pakistan, England to India and USA to Mexico). Though these partnerships have increased competition and reduced prices in specific ethnic groups, they are not sufficient to compete with global non-bank RSPs. More effective and integrated networks are required to supply consistently high quality worldwide services. Banks and financial institutions have established links with foreign financial service providers who control a large network of ATMs in remittance receiving countries to establish the required widespread distribution network. Under an ATM remittance programme, a remitter creates a dedicated remittance account at a bank in the country of employment that can be accessed by two ATM cards- one is used by the remitter and one is used by the recipient in the home country. Remittance services that use ATMs have a number of benefits. First, once the remitter deposits money into the account, the recipient can withdraw immediately. Second, ATM programmes provide greater convenience and flexibility with 24 hour availability. Some of the disadvantages of this programme are: the limited availability of ATMs in certain areas, maximum value limits for ATM withdrawals, and card abuse. Some banks and financial institutions use existing money transfer networks to provide remittance services at a relatively lower price.

Though the potential benefits of entering into remittance services are huge for banks, financial institutions and their customers, remittance services are not always an ideal business for every bank or financial institution. The challenge to the banks is not to replace the non bank RSPs, but to provide competitive remittance service. Banks have to overcome a number of challenges to develop banking based remittance services. The banks' task is extensive. Therefore, before establishing a remittance service, banks should identify a very precise niche in the market, assess the financial feasibility of the proposed program and their institutions' capacity and the ability to manage numerous risks.

Operating a remittance programme involves a cost:

- Customer service costs at sending and receiving ends;
- Cost involved in electronic transfer of money;
- Capital requirement to back each remittance disbursement; and
- Cost associated with maintaining a distribution network in the disbursement country.

The cost of operating a remittance programme varies from bank to bank. Though the cost of operating a remittance programme is relatively modest, banks contemplating a programme must first identify the remitting behaviours of specific immigrant groups to evaluate the volume of remittances originating in the potential market and the concentration of remittances in particular destination and niche groups unique to the region, to make the remittance programme viable. Once the viability of the market has been identified, a distribution network could be established in the receiving country to provide a fast and reliable service to the area where a majority of recipients live.

Once the essential elements of a remittance programme have been established, the success of the programme depends on the ability of the bank to build the required capacity. First, banks need to ensure that their disbursement networks match the remitters/recipient client bases. Second, banks require to have capacity for: setting up high tech infrastructure that can process large volumes of remittances; managing distribution networks; establishing data warehousing facilities; straight through processing; various payment means in different countries of destination; a mechanism to monitor transactions; and after remittance services. If banks can provide multiple customer interfaces that permits users to access remittance services through means such as ATMs, the Internet, cards or phone at their convenience, will help banks to compete with the global non-bank RSPs. Third, staff must have skills, including language skills to communicate with immigrant remitters and give a 'personal touch' to the service. Fourth, banks' officials must learn the customs and traditions of the targeted remitters to address their issues such as inherent distrust of banks or negative perception of certain bank products. To address the issue, banks may partner with religious, social and civil institutions to improve their knowledge of specific needs of the community, establish a rapport and trust with the community or society. Fifth, banks have to build the capacity of their customers by training them to acquaint themselves with the banking mainstream, provide them with knowledge to make informed decisions about managing their family budget and to help them to build their wealth. Such a process will help remitters to use bank products and services when their income grows. As surveys have found a gap between banks and remitters/beneficiaries, banks have to identify media outlets and conduct an effective marketing campaign to reach the target group. Further, as the success of remittance programmes lies with effective marketing, banks may take other measures such as sponsoring community activities and partnering with immigrant organizations to build awareness, recognition and goodwill for the banks and to popularize remittance programmes and banking products.

Banks have to compete with other non bank formal and informal RSPs to establish remittance business. Banks have to deal particularly with the following areas, which have helped non-bank

RSPs to provide a convenient service and attract remitters:

- Majority of non-bank remitters and recipients prefer cash dealings;
- Convenience attached to longer operating hours of non-bank RSPs;
- Non-bank RSPs do not have requirements to open an account; pay a fee, or maintain a minimum balance; and
- Non-bank RSPs do not focus strongly on proper identification and legal status of the remitter/recipient.

Another challenge that banks have to overcome is that of regulatory compliance. A breach of regulatory compliance affects the reputation of the bank. Regulatory requirements are now not considered a barrier as most banks already have the compliance systems to meet regulatory requirements relating to customer identification, verification, money laundering and terrorist financing.

Banks may face several risks that may emanate with remittance programmes. First, remitters may use remittance programmes for money laundering, terrorist financing and illegal activities. To make sure that the remittance channels are not abused by criminals or terrorists, RSPs have to adhere to regulations to curb money laundering and terrorist financing. Banks have a role to play in making formal channels more efficient and attractive for users so that legitimate remittances need not flow outside the formal RSPs. Second, banks also have to take extra care to deliver the promises announced in their marketing programmes and have security to protect their networks and systems as they have to deal with personal and financial details of remittances. The building of such confidence has the potential to enhance a bank's brand name of the remittance business and build up a loyal customer base. Third, banks have to establish contingency and exit plans to address risks that could emanate from political, economic and social instability in the disbursement country. Fourth, remittance programmes carried out with third party service providers, such as money transfer operators have a potential to introduce risks. Therefore, banks who have such remittance programmes must have a system to monitor the transactions of such third party service providers. Fifth, banks should have a strategy to handle any potential losses that could be created by a failure of a remittance programme.

Banks are not intended to simply follow the business model of other RSPs. While the other RSPs focus on speed and convenience, banks can offer an alternative, efficient mode to provide a more secure service at a lower cost, together with other banking products.

12. Conclusion

International remittances are expected to grow in both absolute and relative terms. Non-bank RSPs are very active in providing remittance services and banks have a relatively smaller market share. The profits that are enjoyed by a few non bank RSPs are expected to decline continuously in the long run amidst competition from new entrants.

On the origination side of the remittances, migrant workers are becoming more financially aware, more technically competent in using electronic payment means and more closely integrated into society. That being the case, close proximity and community ties that have characterized the remittance services of non bank RSPs no longer have the same attraction that they once had. In the light of these developments, banks are in a position to offer remittance services with speed and convenience, in parallel to services of non-bank RSPs. In addition banks can offer services with greater security, at a lower cost. Further, banks can leverage on electronic payment systems as a means to transfer funds in cash. To that end the role of banks is clear:

- Create competition in the remittance market. The greater involvement of banks in the remittance business is not to replace in its entirety the services of non-bank RSPs of whatever size and type; and

- Banks are not expected to simply follow the practices of non bank RSPs and charge typically high fees, commissions and excessive margins to cover exchange rate movements. The role of banks should be to compete with non-bank RSPs with more price transparency. Banks who participate in payment and settlement systems can play a major role in increasing efficiency of the remittance market by facilitating safe and convenient fund transfers at a reasonable cost. There is also an opportunity for banks to leverage migrants' remittance services into a broader banking relationship, and that will be profitable for banks, immigrants and their beneficiaries. If the market becomes more competitive, it is inevitable that prices will fall and the community will benefit.

Accordingly, in the long term, banks and other financial institutions will gain from the new customer base generated by the remittance programmes. This trend is already observed in the remittance industry. Therefore, remittance programmes could be viewed as an advantageous proposition for most retail banks to facilitate financial inclusion of international remitters and recipients, the under-served or untapped customer base. Considering the potential benefits, banks have to adopt right strategies to attract and retain these new customers.

Box 1
The General Principles and Related Roles

The General Principles are aimed at the public policy objectives of achieving safe and efficient international remittance services. To this end, the markets for the services should be contestable, transparent, accessible and sound.

Transparency and consumer protection

General Principle 1. The market for remittance services should be transparent and have adequate consumer protection.

Payment system infrastructure

General Principle 2. Improvements to payment system infrastructure that have the potential to increase the efficiency of remittance services should be encouraged.

Legal and regulatory environment

General Principle 3. Remittance services should be supported by a sound, predictable, non-discriminatory and proportionate legal and regulatory framework in relevant jurisdictions.

Market structure and competition

General Principle 4. Competitive market conditions, including appropriate access to domestic payment infrastructures, should be fostered in the remittance industry.

Governance and risk management

General Principle 5. Remittance services should be supported by appropriate governance and risk management practices.

Roles of remittance service providers and public authorities

A. *Role of remittance service providers.* Remittance service providers should participate actively in the implementation of the General Principles.

B. *Role of public authorities.* Public authorities should evaluate what action to take to achieve the public policy objectives through implementation of the General Principles.

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INFORMAL MARKETS FOR FINANCIAL SERVICES IN SRI LANKA

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Introduction

Informal sector is a worldwide phenomenon. Efforts to ease problems associated with mismatch between resource endowments and needs encourage people to invent different methods leading to informal financial transactions and related institutions. With the evolution of societies more formal arrangements and institutions have been created. Overtime they have become sophisticated with advanced institutional arrangements and products. However, informal sector institutions and activities also exist along with formal sector developments. The formalization of informal sector activities depends mainly on infrastructure developments, policy adjustments and awareness of the benefits of formal sector facilities.

This paper intends to examine the nature and the operations of informal financial activities, with special reference to Sri Lanka. There is no clear and established definition for the informal sector, be it related to financial or any other types of activities. In this paper informal sector refers to the non-institutional or unorganized financial sources, which consist mainly of friends and relatives, moneylenders, traders, pawnbrokers, and landlords, engaged in lending activities and borrowings from such sources. Like in other countries, these informal activities operate in clusters throughout the country where the operations related to a particular cluster is limited to a particular geographical area or group of people most of the time. The operations of such informal financial systems move along with other services, which may have both formal and informal characteristics. Though the entry to the market as a supplier of such services is not restricted, the entry is not completely free of barriers, as the incumbents tend to resist new entrants at least at initial stages. Though anybody can be a lender, some kind of monopolistic characteristics could be seen in these markets. Similar services can be seen, in all such markets and prices of loan are almost similar.

This paper will consist of six sections. Section 2 is devoted to review of the theoretical and empirical literature on various aspects and issues associated with informal financial services. The salient features of informal financial transactions in Sri Lanka are discussed in section 3. Section 4 examines the extent of formal and informal financial activities in Sri Lanka at present. It also gives a summary of historical developments at the beginning. The Legal and Social factors that contribute to the existence of informal financial markets are discussed in section 5. Section 6 focuses on the costs and benefits of the formalizing informal financial activities. The final sections present major findings and conclusions.

2. Literature Review

The literature on the informal financial markets in Sri Lanka is limited to a few studies compared to them in the formal sector. However, the studies conducted in other countries can be used to shed some light in this regard, as the characteristics of informal transactions are quite similar across countries, worldwide

The existence of informal financial markets is a wide spread global phenomenon. However, the degree of their importance is largely associated with the degree of economic development. As was explained in the introductory chapter, informal financial markets play a very vital role in fulfilling financial needs of less advanced societies, especially in Less Developed Countries (LDCs). The size and the degree of informality of the activities in this sector differ among LDCs and also among different regions of a given LDC too.

According to a paper by ILO, an informal market consists of small-scale units in the production and distribution process of goods and services with the primary objective of generating employment opportunities and incomes to their participants not withstanding the constraints on capital, both physical and human and know-how. Jeganathan defines informal sector further as being outside the pale of the organized sector covering economic transactions of any type. Informal capital markets for credit in developing countries consist of two segments, the non-commercial sector and commercial sector. Non-commercial sector consists of friends and relatives, and generally they do not charge interest on loans. The commercial segment constitutes of a range of people like input dealers, crop buyers, landlords and moneylenders involving in financial activities, charging interest on loans (Padmanabhan). In addition, in most LDCs informal sources still meet 50-80 percent of the credit needs of the community though there has been a general decline in the importance of this sector with the expansion in the formal sector. General perception among masses including the governments about the suppliers of informal financial services is that they are "exploiters of helpless peasants". Despite this rather negative image, informal financial sector provides a vital and significant service to the masses to meet their financial needs through ways more convenient to them. Further, they adapt to the changing conditions compared to rigid rules and regulations that guide the formal sector financial transactions and have secured a higher rating among the poor, Padmanabhan emphasizes.

Following are the benefits that clients of moneylenders accrue from their transactions with moneylenders, according to Pathmanabhan

1. Proximity
2. Comfortable atmosphere
3. Quick credit
4. All-time access
5. Freedom of deployment
6. Repayment flexibility
7. Lower transaction cost

However, he admits that the above benefits are not free. Borrowers have to pay relatively higher interest rates. Especially for short-term funds the effective annual interest rates could well exceed 100 per cent. Further, sometimes consumption credits are available with some conditions where the borrowers are compelled to purchase their needs from the lender at relatively higher prices. This situation could hold them in a vicious circle of debt and poverty.

Referring to the market structure in money lending Padmanabhan explains that there is a considerable difference of opinion as to whether moneylenders enjoy monopoly profits in their lending operations. Most believe that moneylenders in informal sector earn high profits by virtue of monopolistic positions. Others, on the contrary, believe that the moneylender is a victim of unfair prejudice and that his income just covers the cost and risk associated with informal lending. Others argue that informal money lending is complementing the formal sector lending and there is no exploitative relationship between the informal lender and the borrower. Therefore there is no hard evidence of monopsonistic exploitation by informal lenders as the interest they charge include cost of capital, risk and administrative cost etc.

Padmanabha provides some important statistics on informal financial services and associated costs in India during 1980s. (Table 2.1)

TABLE 2.1 Costs and Interest Rates (%) of loans

Informal lender	Opportunity cost	Average administration cost	Risk premium	Average lending cost	Average nominal interest rate charged
Pawn shop	7	3	2.64	12.64	14.07
Shop keeper	7	3	2.64	12.64	16.38
Money lender	7	3	11.4	21.4	27.44
Rice Miler	7	3	5.3	15.3	11.74
Relatives	7	2	5.4	14.4	4.62
Friends	7	2	5.4	14.4	6.84

Source: Rural Credit, K P Padmanabhan

According to the above data the loans are available at relatively lower costs from relatives and friends. The moneylender is the highest cost source of borrowing.

The Rural Credit Survey of 1954 in India identified the following advantages of moneylenders in extending credit to rural people...

1. Moneylender plays a more supervisory role at all times.
2. Moneylender has different yardsticks to choose whom to lend. Least important

of all for him is the possibility of having recourse to the law and almost as unimportant is the possibility of acquiring debtor property.

3 It does not follow that he will not invoke the forces of compulsion the moment payment has become due. This is a matter on which, being unaffected by institutional codes, he can be as rigid or as elastic as realism dictates.

4 Having, in the light of all possibilities, decided on whether and how much he is going to lend on what terms, he is free to follow as flexible a procedure as he likes in regard to the actual operation of lending.

5. He is able to hand over the money promptly in order that some expenditure which brooks no delay may be met at once, without having to obtain another's sanction or authorization.

According to the 1986 report on the seminar on unorganized money market in the SEACEN countries, Chandravakar states that term "informal financial sector" or unorganized Money Market covers all financial activities outside the orbit of institutional and regular finance and this sector is highly heterogeneous since it covers lending and borrowing transactions involving varied types of individuals and intermediaries. Therefore, it is difficult to give an exact definition and description of the sector. But there are basic institutional and behavioural features of the sector that can be identified as follows.

1. The absence of regulation and presence of informality. There are no legal barriers in the sector
2. There is interlocking relationships among the credit, commodity, land, and factor markets. This implies that the interest rates on loans, which may be very high, are not determined by the market forces alone.
3. A quantity adjustment, that is the amount of credit available, is more important than price or interest rate adjustment. It is evident that in spite of the high interest rates, there continues to be credit rationing in the market
4. The working of the informal financial market exemplifies the Lemon principle in that the market requires complete knowledge of the borrowers' credentials and credit worthiness. This is in contrast to the lending in the formal market with relies mostly on collateral and incomplete information.

Further, Chandravakar states that there are useful and distinct services provided by this sector especially in the rural areas of the countries and they have existed long before the formal sector came into being. Even after the emergence of the formal sector the informal sector continues to exist. This to some extent, may be a response to the prevalence of financial repression in the formal sector and also emergence of the underground economy. More importantly, it may imply a very important and useful role that informal financial sector plays in financing micro, small and medium farmers who have no recourse to the formal financial sector. Furthermore, he states that informal financial sector probably reflects a stage of economic development in which the function of various sectors of the economy is not yet specialized.

The important factors influencing the interest rates in the informal financial markets can be grouped into behavioural and institutional components. The behavioral part refers to the pure rate of interest or liquidity preference, which is conceptually the price of parting with liquidity. There can be proxies by the interest rate of the longest maturity and most risk free securities such as treasury bills or in its absence, the saving deposits interest rate offered by the commercial bank. The institutional component comprises four major factors namely risk premium, administrative cost, opportunity cost of lender's capital and the profit.

According to Sandaratne, informal or non-institutional sources of credit continue to be perhaps the more dominant source of credit to small farmers, despite several improvements having been made in recent years in provision of institutional credit in Sri Lanka. He further states that the inability to recover loaned funds result in a declining number of creditworthy borrowers, which could in turn result in lesser inputs and lower production. But informal lenders were substantial in their lending and contributed a little less than half the credit borrowed by paddy farmers. The informal sector lends at interest rates ranging from zero to over 250 per cent per annum. In fact one third of informal credit was interest free, over 10 per cent at interest rates of 15 per cent. About 12 per cent of credit was borrowed at interest rate over 50 percent per annum and less than 1 per cent was above 150 per cent according to Sandaratne. He further explains that due to the presence of high interest rates of 150 per cent, informal lenders are branded as usurious. There are several other factors that account for the characterization of informal lending as usurious, which are as follows.

1. High Interest bearing loans
2. Interest rates based on causal investigations
3. Large number of loans are of short duration

Sandaratne describes that informal financial services are free of transaction cost and over 70 percent of informal lending was for production purposes during 1970s and 1980s. Cultivation purposes alone accounted for over half their volume of lending and 10 per cent of fund lends to the trading sector. Informal loans have a wide range of sizes and non-interest facilities are smaller sized but moneylenders grant somewhat larger loans. 93 per cent of the non-interest loans are unsecured but other lending covered by immovable assets, jewellery, durable consumer goods, machinery and equipment. Sandaratne further elaborates that informal lenders, like institutional sources had recovered only a small proportion of loans and moneylenders recovery is worse than non-interest charged lenders. In addition, he described that the importance of the informal sector's role in production credit may not have been adequately recognized owing to the fact that informal sources met the needs of consumption credit.

3. Sri Lankan Enviornmet of Informal Financial Services

With the introduction of formal financial institutions under the British rule in 1828 to facilitate the needs of the plantation sector informal markets appear to have grown in a small way to cater to the needs of the other sector of the economy. A community of Indian born money lenders emerged to finance the needs of indigenous persons in trade and consumptions. Pawn broking became the common method of finance and laws were enacted to protect pawned article owners and to implement anti usury policies.

The formal financial sector in Sri Lanka constitutes a system encompassing commercial banks, development banks, rural banks, credit societies, savings banks, finance companies, insurance companies, and contractual savings institutions. The opening up of the economy in 1977 paved the way for most of these institutions to expand and develop new products to cater to the growing needs. The exposure of these sector institutions to the practices of formal markets in advanced countries enables them to have advanced methods with sophistication. These developments led to both financial widening and deepening in the country. However, this sector could not cater to the all groups that sought financial facilities of different types due to lack of policy environment with required adjustments to the existing rules and regulations. Consequently, the informal sector has moved in par with the formal sector to cater to the groups which could not benefit from the formal sector institutions.

3.1 Structure of Informal Financial Markets in Sri Lanka

Informal financial transactions in Sri Lanka can be studied under three different categories, which are as follows.

1. Direct money lending includes professional and non professional money lenders, friends, relatives and private pawn brokers
2. Indirect money lending includes incorporate trade, marketing and commission agency and crop mortgage related credit
3. Voluntary credit groups includes single-purpose credit societies, multi-purpose saving and credit societies and Rotating Savings and Credit Societies (ROSCAS) and Accumulating Savings and Credit Associations (ASCAS)

3.1.1 Rural sector informal financial Market

Rural informal financial markets operate with other markets and consist of a wide range of financial transactions linked or tied to land, labor, voluntary credit societies, and informal saving associations such as ROSCAS and ASCAS. Economic activities, mostly agricultural activities, of the rural sector are tied with these financial transactions, as the penetration of formal financial institutions is weak. Though the presence of formal financial transactions in the rural sector has improved in line with the expansion of institutional financial sector with both financial widening and deepening, the informal financial transactions still play a dominant role in the rural sector. The existence a large number of small and landless farmers with irregular and unpredictable income, lack of awareness of facilities available with formal financial institutions, greater procedural requirements and seemingly unfriendly environment associated with formal financial institutions, have contributed to the dominance of informal financial sector.

Popular financing methods in rural Sri Lanka are as follows.

a. Pawning

Pawning is an arrangement where the borrower surrenders a valuable article, mostly jewelleries, as collateral against the borrowed money. The amount lent against such articles is always lower than the market price, so that the borrower has the incentive to service the loan and lender's interests are also secured in the event of a default by the borrower. Two types of Pawn Brokers are in operation: registered pawnbrokers and unregistered pawnbrokers. Unregistered ones are closer to the clients, as their needs are met at any time of the day with easy and simple procedures. Lending conditions and applicable interest rates in the informal pawning transactions can vary from person to person depending on the evaluation of the creditworthiness and the degree of relationship the borrower has with the lender. If borrower defaults, the borrower accepts that the ownership of jewellery is transferred to the lender automatically. However, repayment conditions in most of the cases are very flexible due to cultural practices linked with jewellery. At present, formal financial sector has come with strong competition for pawning but informal pawnbrokers continue to be attractive, possibly due to the flexible terms and conditions they maintain and also the long term association of the rural folk with pawnbrokers.

b. Trade credit

In this system borrowing takes place mostly in goods. Some times services also can be involved. Such transactions could involve either in consumption or investment. Households, that have irregular income sources and also do not have the capacity to purchase their consumer needs in bulk for a few days ahead, tend to purchase their daily requirements from a neighbouring retail store or a boutique. In most cases such purchases on credit are settled fully or partly at different frequencies such as daily, weekly, monthly or irregularly with harvests etc. Sometimes the same boutique owner can lend money in emergency situations, such as a family member falling sick. Similar types of borrowing takes place for production purposes as well. It is more predominant in agriculture activities where farmers borrow seeds, fertilizers, and chemicals etc at different stages of the production process. Repayment of loans could be with the harvest, a common practice, or in cash. Sometimes the lender collects his dues at the initial stage of harvesting, where the borrower has no alternative rather than to oblige.

The interests charged on these types of loans are not clearly identified. Most of the times the interests are hidden in higher prices for items sold to the borrower and lower prices paid to borrower in exchange for their harvest to settle loans. Further, most of the times trade credit becomes a rolling credit, where new borrowing goes to pay previous borrowing.

c. Crop mortgages

This type of credit is common in the rural sector in the country. Lender and the borrower enter in to an agreement, mostly verbal, before the facilities are granted. Borrowed funds used for the production purposes, especially for paddy production, are agreed to be repaid with the harvest or on mortgage of the harvest. Sometimes borrower agrees to pay half in goods from the harvest and balance in cash or pay in full with the harvest. In most occasions lender dictates the terms and conditions and borrower has to oblige due to weak bargaining power.

d. Single purpose credit services

This service, arranged by the group of people jointly , collects a fixed sum of money periodically to accumulate into a fund sufficient to grant loans to members to meet their emergency financial requirements, such as funerals, daughters attaining 'age' and weddings. The most common need of such nature is a funeral. Sometimes there are associations, called death donation societies where members of the society contribute to a relief fund to assist members in such situations. These societies provide single purpose loans too to members at an agreed subsidized rate decided by the society.

e. Direct Lending

Direct money lending bears the following main characteristics but it can differ from one centre to another centre due to various reasons.

1. Little or no collateral is involved
2. No documents or paper work
3. No specific purpose required for loans
4. High flexibility for important loan covenants

Under the indirect money lending, large portion of low-income groups borrow funds mostly for consumption activities. Shopkeepers and boutique owners are mainly involved in these types of fund transfer activities especially with rural sector in the country. Lender will dictate all the terms and conditions of the financial facilities and at the same time borrowers has much respect for the lender. Borrowers are always have much faith in the lender to be fair and just. Rolling over is a common feature in these types of transactions.If the borrower pays the loan in full, he can get a fresh loan again under the same terms and conditions. Most of the lenders keep their clientele for a reasonable period by using same contracts with the borrower. Sometimes some lenders waive off the last interest installment if a fresh loan is obtained with the same conditions. It can be seen that these types of credit arrangements are prevalent among the urban and estate sector.

Voluntary credit groups have also been in the rural sector and organized to certain extent or behave as semi formal financial institutions under cooperative concept. These credit organizations are characterized by unlimited liability, small area of operation and mutual knowledge among members. There is no any provision for dividends or any other return and are like welfare societies.

3.1.2 The Urban sector informal financial market

Urban sector is characterized by relatively more formal economic activities with relatively higher magnitude. Accordingly, the majority of the financial transactions are conducted with formal financial institutions. However, informal financial transactions too prevail to a considerable degree due to various reasons. Urgency of funds, unfamiliarity with formal institutions, lack of collateral, having defaulted with the formal sector, and tax evasions are possible reasons. Nature of business is also an important factor in this regard; people who are involved in illegal economic activities do not turn to formal institutions, as they cannot reveal the actual nature of their business. Using both formal and informal institutions to meet financial needs can also be seen among urban businesses.

Small enterprises tend to look for informal sources of financing at their early stages of business, possibly due to difficulties in meeting the requirements of formal financial institutions, lack of awareness and sense of uncertainty about the repayment of loans regularly.

Several types of informal financial markets can be seen in urban areas especially in metropolitan cities and regional marketing centers such as Colombo (Pettah) Dambulla, Marandagahamula and Meegoda. In these markets large transactions take place on daily basis with the involvement of traders and informal lenders. Informal lenders in these markets have a fairly accurate assessment of the creditworthiness of the borrowers and of ways of recovering their loans. Funds are readily available on request. In the event of a request for funds by a newcomer, it is common to obtain a verbal guarantee from a reliable client at the centre. Usually borrowers are businessmen or merchants engaged in all types of business activities in the metropolitan areas or trusted agents of the merchants. Documentation between lender and borrower generally do not exist. It is a simple, daily transaction where lenders maintain records or borrowers in their own way. All terms and conditions are verbal and exchanges take place based on the long established trust. The amount of the loans can vary from very small amount to millions of rupees. Sometimes, moneylenders use syndication type loans based on the trustworthiness of the borrower. All types of features in conventional syndication loans appear in informal syndication loans too but arranging fee is negligible. It is difficult to find information of the default rates, though such cases could prevail in these markets. Lenders tend to use various tools to recover a loan including physical harassment, especially when a default seems willful. Certain moneylenders maintain close relationships with law enforcement authorities to use their power indirectly to support their activities.

3.1.3 Estate sector informal financial market

Plantation estate sector inherits distinctive characteristics compared to both urban and rural sectors and clients in informal transactions are mostly from estate sector labourers. Their monthly income is only a salary from the estate that is sufficient to maintain a simple life. Therefore some of the estate workers get into activities such as animal husbandry, shop keeping, and some other micro or small-scale industries and they tend to rely on their lender for finance. Because of their living styles, citizenship problems, and work environment, it is difficult for them to link with the formal financial sector.

The common features of informal financial transactions at these market centres could be summarized as follows.

1. No written records of transactions
2. No collaterals or security for loans
3. Very few restrictions on transactions with someone who wishes to be involved
4. Short-term lending
5. Manageable rates to the borrower and different rate structure

3.2 Main characteristics/features of Informal Financial Markets in Sri Lanka

Although there are distinctive characteristics in informal financial transactions across sectors, there are common features as well.

3.2.1 Participants

It can be seen that wide range of participants takes part in the informal financial markets in Sri Lanka. They constitute people such as farmers, shop owners, professional and non-professional moneylenders, businessmen, and institution such as community-based organizations, voluntary credit groups and cooperative societies. Each party has different role in the market. One significant fact that the participation of certain parties in informal markets is an indication of the trust earned by these markets and participation itself generates more trust. This can be seen in the urban informal financial markets than rural financial markets.

3.2.2 Size of lending

The size of the loans granted in informal financial markets follow a somewhat generic pattern, which shows that the size is usually larger in urban sector than in other two sectors. In addition, size of the interest bearing loans are bigger than the interest free loans and small loans may be as smal as Rs. 500/= for street vendors and bigger loan as big as Rs. 5 million or more for organized businessmen in urban and metropolitan centers. However, majority of loans in the informal financial sector is small and spread in a wide range, depending on the economic activities.

3.2.3 Price of the Loans (Interest rates)

Price of the informal financial facilities range from zero interest to more than 100 per cent par annum or in certain cases could be extremely high. The zero rate facilities are mainly provided by friends and relatives and occasionally by voluntary organizations like ROSCAS and ASCAS for very small amounts. Daily basis rates are ranging from 2% to 5% depending on the activity. In most cases moneylenders charge specific amounts for Rs. 1000/= for small-scale borrowers on daily basis or grant loans on discount basis. For example, charging Rs.100/= per Rs.1000/= or releasing only Rs. 900/= for a loan of Rs.1000/=. Furthermore, the interests charged in these methods vary depending on the size of the loan, previous experience and relationship with the borrower, nature of the situation of borrowing and the lenders expected return. In certain cases the effective interest rate is not apparent, as they are charged in different forms.

3.2.4 Approval Procedures

Lender has sole authority of approving facilities for borrowers in the informal financial sector. Borrower does not have any authority to change the terms and conditions of the loan amount, repayment period, interest applicable, and other factors linked to the facility. Due to this reason, some argue that the lender exploits the borrower in an unfair manner and use it as a factor to justify regulating the informal financial sector. But if closely scrutinized, such claims could be seen to be exaggerations to a certain extent, as moneylenders provide an important service in the absence of formal sector facilities. Coexistence of informal money lending with formal lending activities in the economy itself testifies that the society benefits from their service. In certain cases money lenders provide multiple services, such as the link between the city centers and business clients, advisor and also enticer in certain economic activities. The clients receive such services free of charge in most cases.

3.2.5 Collateral/Securities

The informal lending or financial activities are not based on collateral or securities compared to formal sector lending of financial activities. This is the most important factor for survival of this industry all over world today in the presence of the sophisticated formal financial sector. In some countries both sectors work hand in hand. Informal financial sector emphasizes more on goodwill between the two parties than entering in to formal loan agreements. However, some studies revealed that some of the transaction are covered with some securities such as equipment, machinery, consumer durables and immovable assets. But there is no ownership transfer or registering of mortgages by the borrower or lender. In most occasions possession will be changed, but after the repayment borrower will take back the asset. Most of the loans are unsecured in the informal financial sector and this is another reason for the lender to charge higher interest rates for higher risk. Borrower's goodwill thus becomes the main collateral in most part of the country, with the future harvest of the borrower considered as the collateral.

3.2.6 Risk

Loans backed by intangible assets such as goodwill may create a vulnerable situation to the lender and therefore, the associated risk is very high. With the asymmetric information background, lender's selection of the borrower may be questionable. If the selection is poor, loan becomes doubtful and lender has a high risk of collecting his loan funds. But this is not valid for informal financial markets due to symmetric information situation in the market. However, informal moneylenders have diversified their ways of assessment of borrowers through their long experience. Lender knows the borrower well, and his network is capable of gathering most relevant information on the borrower. In other words, informal financial markets tackle this problem very cleverly by using all available sources of information and use credit scoring models very effectively.

Furthermore, the presence of the free rider problems is relatively less in the informal financial market compared to the formal sector. Therefore, most types of risks are mitigated substantially. If any defaults occur due to genuine reasons, he will make rescheduling arrangements with new loans to the borrower. This analysis shows that informal credit is less risky than formal credit most of the lenders provide facilities to known parties.

4. Distribution the Informal Financial Market Between the Formal and Semiformal Financial Sectors

The Consumer Finance and Socioeconomic Surveys conducted by the Central Bank of Sri Lanka (CBSL) at regular intervals have collected vital information relating to financial transactions of the household sector in the country between 1963 and 2004.The following information (Table 4.1) from the report for 2003/04 indicates developments with respect to formal and informal financial transactions over a eriod of around 50 years.

Table 4.1 Distribution of Number of loans by Formal and informal institutions

	Number of Loans %						
	1963	1973	1978/79	1981/82	1986/87	1996/97	2003/04
Formal institutions	7.6	11.5	10.7	9.7	16.6	43.1	45.0
Informal Institutions	92.4	88.5	89.3	90.3	83.4	56.9	55.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Values %						
Formal institutions	n.a	n.a	25.3	38.0	39.8	67.3	61.1
Informal Institutions	n.a	.n. a	74.7	62.0	60.2	32.7	38.9
Total			100.0	100.0	100.0	100	100

Source. CFS 2003/04 Report

Source. CFS 2003/04 Report

Over this period the importance of the informal sector in meeting the financial transactions of the household sector in Sri Lanka has been in a decreasing trend. The two decades of 1980s and 1990s have experienced notable developments in this regard, where the shift from informal sources to formal ones has speeded up in 1980s while the intensity of this move has increased in 1990s. Liberalization of the economy paving the way for more private sector participation and consequent expansion in economic activities at all levels and the availability of facilities could have contributed to the developments in 1980s. Implementations of further liberalizing measures particularly in the financial sector, increased interest in both the private and the public sectors in extending financial facilities to rural areas.. The resulting expansion of micro-finance concept could have accelerated the process that gathered momentum in 1980s.

Chart 4.1 Formal and Informal contribution of Number of Loans (%)

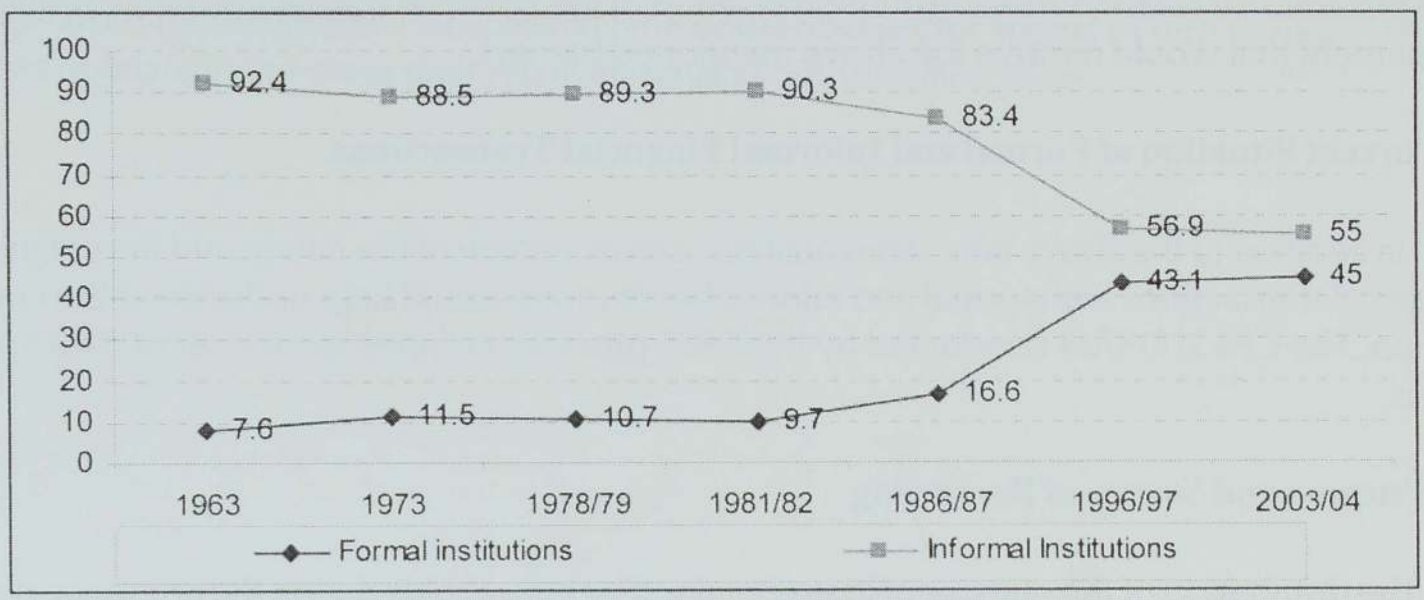
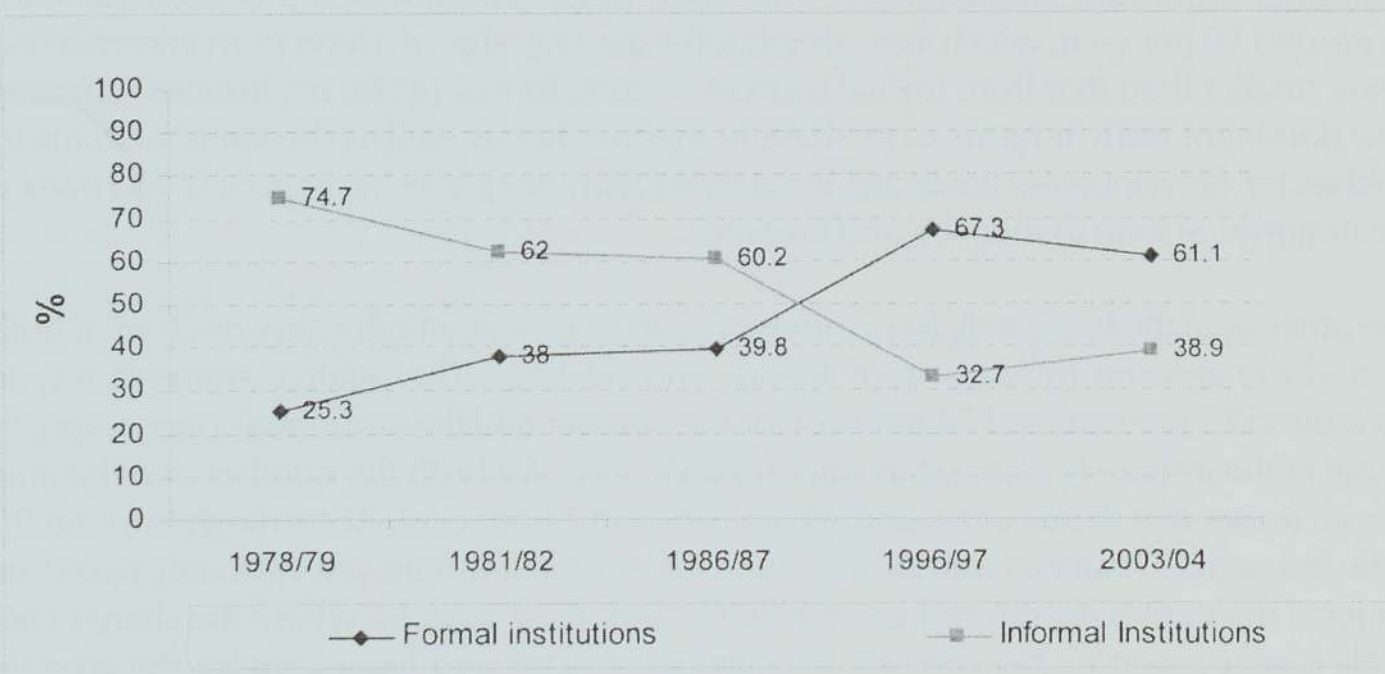


Chart 4.2 Formal and Informal contribution of Value of Loans (%)



However, the developments after late 1990s up to recent times indicate virtually a stagnant situation. The question arises whether the expansion has reached its maximum within the prevailing structural environment encompassing economic, institutional and legal dimensions. The availability of facilities in the formal sector is only one factor that encourages shift of financial transactions from informal institutions to formal and semi-formal ones, especially with respect to borrowing. Ability to meet the documentary and procedural requirements of the formal financial institutions and willingness, which is associated with the awareness and certainty of being able to repay according to the times-frames specified in institutional lending etc., also play an equal, if not greater, role in this regard. If these are the reasons for the observed stand still situation of the shift to the institutional sector, further institutionalization of the financial transactions may require an environment that would remove the above mentioned barriers.

4.1. Current Situation of Formal and Informal Financial Transactions

In addition to the above time series analysis, a cross section of the nature and the magnitude of financial transactions with formal and informal institutions would help understand the current situation. The CFS 2003/04 conducted by the CBSL provides comprehensive set of data for this analysis.

4.1.1 Purpose and Source of Borrowing

The distribution of the number of loans obtained by households during the reference period revealed that around 55 per cent of the loans are from informal institutions, while the balance 45 per cent is from formal institutions. Accordingly there is a tendency among households to turn to the informal sector for their financial needs. Further, the distribution of the amount of loans reveals another important characteristic. The share of the amount of loans from the informal sector is around 40 per cent, which indicates that the average size of a loan from informal sources is relatively smaller than that from formal sources Among formal sector institutions, commercial banks are dominant both in terms of its share in the number as well as the value of loans to the household sector. Development banks and Rural Banks also have played an important role particularly among categories of loan to industry and livestock.

The analysis of the loans only from informal sources reveals a high concentration of both the number and the amount of loans from friends and relatives. The relative share of this single source is around 75 per cent and 74 per cent for the number and the amount of loans respectively. The second highest share is associated with moneylenders for both the number and the amount of loans with respective shares of around 19 per cent and 21 per cent. Accordingly, around 95 per cent of the household financial transactions with informal institutions are with only two sources. The balance 5 per cent is distributed among NGOs and other sources, where the share of NGOs is relatively low at around 2 per cent for the number of loans and 1 per cent for the amount.

Among the two major sources of informal sector loans, friends and relatives have been dominant the dominant source for all purposes of borrowing, while within this category, consumption loans dominate. Convenience of arranging a loan with a fairly low or no interest payments could be the main reasons for this phenomenon. Relatively smaller size of a loan as suggested by the respective shares in the number of loan and amount is also important in this regard. According to the distribution of loans by purpose, the highest number of loans, around 57 per cent, is for consumption purposes. However, the relative share of consumption purposes in terms of the amount is only 18 per cent, which suggest relatively small size loans for this purpose. The average size of a consumption loan from all sources is around Rs. 3,111/=. The average size of a loan varied from Rs. 2,411/= from friends and relatives to Rs. 9,100 /=from commercial banks among specified sources. This range is much narrower within Rs 1,898 from non-specified sources to Rs. 3,397/= from moneylenders. Accordingly the household sector seems to turn to more informal sources of financing to meet their relatively smaller consumption loans.

Table 4.2 The Distribution of the Number and Amount (value) of Loans by Propose and Source 2003/04

Purpose	Source: Formal								Informal				Total
	Commercial Banks	Development Banks	Development Financial Institutions	Rural Banks/Co-operatives	Samurdhi/ Janashakthi	Loan Boards /Thrift Societies	Formal Sector Employers	Finance Companies	NGOs	Money Lenders	Friends and Relatives	Other	
Number of Loans													
Paddy Cultivation	33.3	10.3	1.1	6.9	5.7	9.2	1.1	-		4.6	25.3	2.3	100.0
Other Crops	22.5	7.0	-	4.2	8.5	1.4	-	-	1.4	9.9	38.0	7.0	100.0
Livestock	26.7	13.3	-	20.0	6.7	6.7	6.7	-	20.0	-	-	-	100.0
Industry	28.0	24.0	-	4.0	12.0	4.0	-	4.0	-	-	24.0	-	100.0
Business /Trade	28.9	8.4	1.7	3.8	3.8	1.3	0.4	2.5	0.8	8.4	35.1	5.0	100.0
Housing	29.5	8.6	4.5	5.7	4.1	3.7	4.5	0.8	1.6	8.6	28.3	-	100.0
Consumption	20.1	2.2	0.5	3.6	0.9	1.6	3.0	0.9	0.9	12.1	52.2	1.8	100.0
Ceremonial /Ritual	20.3	1.3	0.3	2.5	0.6	1.6	20.3	0.3	0.6	11.4	37.3	3.5	100.0
Settlement of Dues	32.1	7.0	2.3	7.9	3.3	2.3	0.9	0.5	0.5	14.9	26.5	1.9	100.0
Consumer Durables	20.0	4.2	-	7.4	1.1	2.1	12.6	4.2		9.5	34.7	4.2	100.0
Other	31.5	3.6	-	5.0	1.4	1.4	1.8	0.9		8.6	42.8	3.2	100.0
Total	23.9	4.3	1.0	4.4	2.1	2.1	4.7	1.0	0.9	10.8	42.4	2.4	100.0
Amount of Loans (Values)													
Paddy Cultivation	44.7	10.2	0.4	4.1	5	14.1	1.1	-		3.0	16.3	0.9	100.0
Other Crops	23.6	6.9	-	5.9	11.1	0.5	-	-	0.2	7.1	28.6	16.1	100.0
Livestock	30.5	32.7	-	14.6	0.4	1.5	12.8	-	7.4	-	-	-	100.0
Industry	38.7	9.9	-	3.4	5.2	0.6	-	0.8	-	-	41.3	-	100.0
Business /Trade	43.4	11.6	3.5	0.9	1.0	0.2	0.0	7.1	0.1	4.5	25.4	2.3	100.0
Housing	31.8	7.1	9.1	3.3	1.7	1.7	11.3	1.5	0.9	7.5	24.1	-	100.0
Consumption	28.4	4.2	1.5	3.5	0.6	1.6	3.7	0.9	0.9	13.2	40.5	1.1	100.0
Ceremonial /Ritual	24.4	1.4	0.5	1.7	0.4	4.2	7.1	0.2	0.5	14.5	43.6	1.5	100.0
Settlement of Dues	53.7	3.8	2.3	1.8	1.1	1.8	1.0	0.2	0.7	9.9	20.1	3.7	100.0
Consumer Durables	7.4	8.3	-	14.6	0.3	3.1	11.4	2.6	-	5.7	44.4	2.1	100.0
Other	45.4	10.8	-	1.2	1.8	0.3	1.9	0.3	-	11.3	25.5	1.7	100.0
Total	35.9	7.9	3.3	3.2	1.3	1.7	4.6	2.5	0.5	8.2	29.0	1.8	100.0

Source: CFS 2003/04 Report

4.2.2 Collateral

The data reveals that more than half of the loans are still with no security, a fact that testifies to the existance of informal financial transaction to a greater extent. Presence of asymmetric information and related problems, such as adverse selection in lending and moral hazards subsequent to borrowing, which increase the exposure of the lender to risk of higher defaults, make formai financial institutions to ensure the recovery of loans by backing it with personal guarantees, verbal or documented. This is one important factor that make majority of the households switch to informal sector borrowing as they find it difficult to offer acceptable securities to the formal sector institutions

Table 4.3 Distribution of the Number and Amount of Loans by Collateral

Type of Collateral	Number		Amount	
	1996/97	2003/04	1996/97	2003/04
No Security	57.8	54.5	35.5	37.7
Personal Guarantee	6.7	9.9	10.4	20.8
Immovable Property	1.6	1.2	30.6	9.1
Jewellery/Consumer Durables	31.2	31.0	11.9	20.8
Other	2.7	3.4	11.6	11.6
Total	100.0	100.0	100.0	100.0

Source: CFS 2003/04 Report

Around 58 per cent of the loans taken during the reference period have been with no security or collateral. The situation during the previous survey too is similar with around 55 per cent of loans being with no security. However, the share of the amount of loans with no collateral has been 36 and around 38 per cent respectively in two survey periods. These patterns of the distribution of the shares suggest that the size of loans with no securities has been relatively small. Around 31 per cent of loans during both survey periods have been supported by collateral such as jewellery or consumer durables. However, its share with respect to the amount of loans has almost doubled from 12 per cent during the previous to around 21 per cent during the current survey, indicating an increase in the relative size of a loan in this category. Appreciation of the value of gold and consequent increase in the amount that could be borrowed against jewellery could have contributed to this increase. One important phenomenon with respect to borrowing against collateral is the significantly low share of number of loans against immovable property which is mainly land. One important feature about the land ownership among households in Sri Lanka is that in most cases, clearly identified ownership with documentary support is rare despite their ownership of land according to family norms and traditions. Therefore, informal sector lenders too are reluctant to lend against lands with unclear titles. This is an area where programs to formalize informal financial transactions should take in to consideration. Personal guarantees have been used for around 10 per cent of loans to support around 21 per cent of the amount of loans. It is an improvement both in terms of the number and the magnitude of loans compared to the previous survey.

Chart 4.2

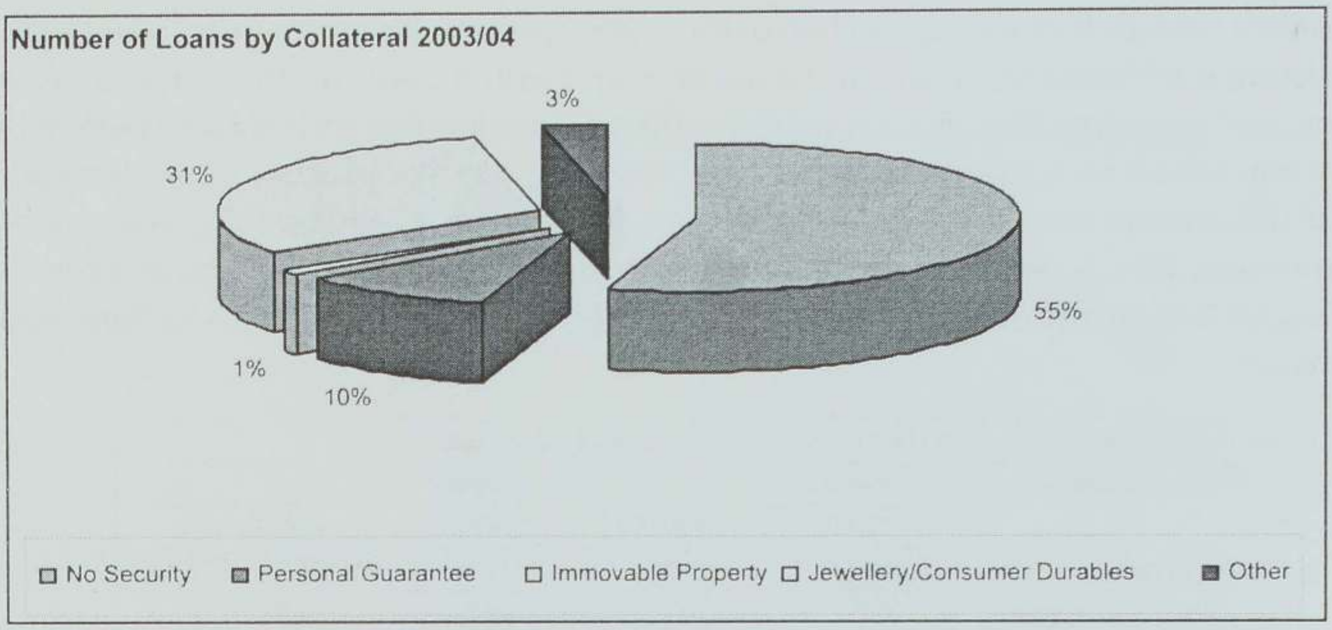
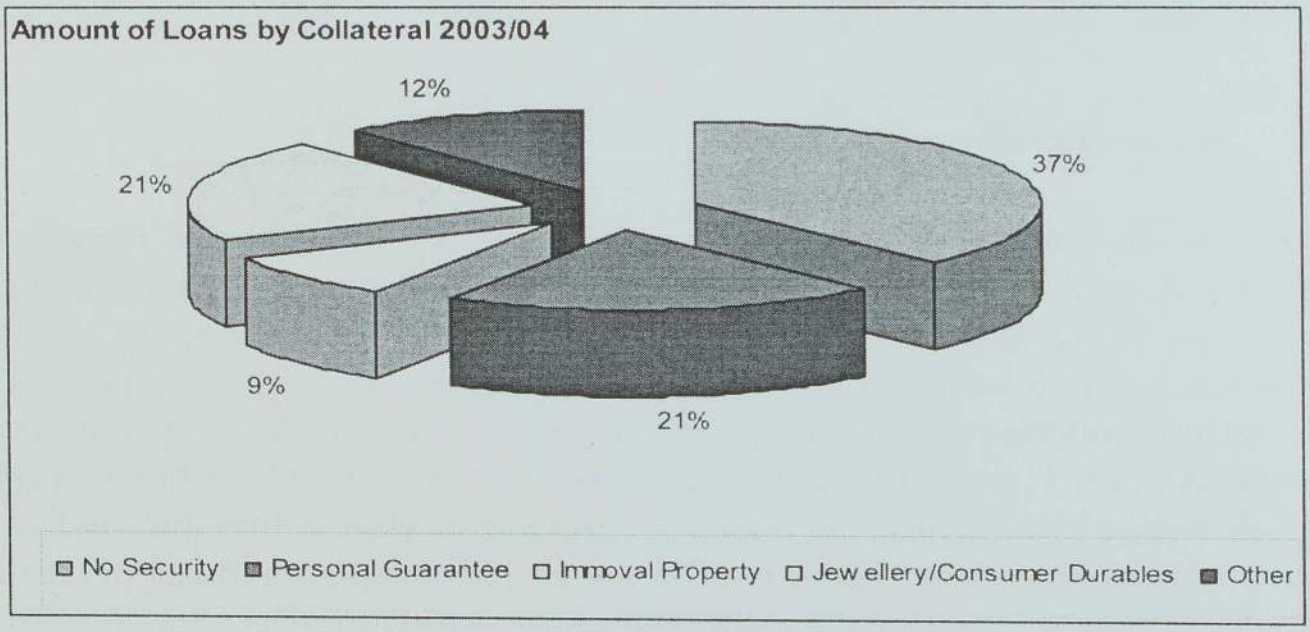


Chart 4.3



5. Factors that influence the activities in the Informal Financial System

The factors that affect the existence and the activities of informal financial transactions can be classified into three areas: (i) Legal and Regulatory factors (ii) Economic and Social factors (iii) poor property rights.

5.1 Legal and Regulatory Factors

Public confidence is the main pillar on which the existence of the financial institutions rest. The government and the agencies that carry out functions to facilitate government activities are responsible for maintaining an effective , credible payment and settlement system. The effectiveness and the efficiency of such a system depend mainly on the financial soundness of institutions that do business by providing various financial services to the society. Hence, governments maintain supervisory and regulatory systems with legal support.. Accordingly, a fair number of acts and regulations relating to financial sectors can be identified. The primary focus of most of those acts and regulations to reduce the exposure of formal institutions to risk of having high defaults has limited their area of operations. This situation has deprived prospective borrowers from access to formal sector institutions. Accordingly, they have left room for informal markets to emerge, due to the demand arising from those who cannot comply with the rules and regulations that govern formal financial institutions and high-level regulation imposed by authorities from time to time.

The Monetary Law Act (MLA) specifies the main functions and responsibilities of the Central Bank of Sri Lanka (CBSL), which is entrusted, with the duty of ensuring price, economic and financial system stability. Under the latter responsibility, the CBSL imposes minimum requirements and guidelines coupled with on -site and off-site supervision to ensure compliance. The Banking Act and Finance Companies Act are examples of regulatory requirements for specific areas. In addition, there are individual institutional acts to govern the operations of individual financial institutions. Bank of Ceylon Act, Peoples' Bank Act and National Savings Bank Act are a few examples. The Securities Exchange Commission (SEC) and Insurance Commission are examples for other types of regulatory bodies in the formal financial sector. In addition, there are large numbers of legislations that successive Governments, since independence, have enacted to secure and safeguard the peoples' interests in different areas of their activities..

5.2 Social and Economic Factors

During the last fifty years, Sri Lanka has maintained a moderate economic growth path to reach the threshold of the lower middle-income country standard, based on the crude measure of per capita income. However, the incidence of poverty is still prevalent across the country, and in certain areas, it has even increased. Data collected by Socio-Economic Surveys revealed that the income disparity has increased with more concentration of wealth, among high-income households. Further, the pattern of economic expansion in the country also indicates high concentration of economic activities in certain areas, particularly in the western province, has denied fair distribution of opportunities for people to involve in economic activities across the country.

Experience in other countries has shown that the availability of opportunities is a key factor that empowers people to generate more income and accumulate assets over time. Higher income and associated accumulation of wealth, with an environment of more opportunities, gradually encourage people to deal with formal sector institutions and adjust their behavior in line with the operations of such institutions. With such an environment activities, behaviours and attitudes change and become advanced and sophisticated. On the contrary, societies that do not have opportunities tend to stay poor and under developed with majority of their activities being primitive, unorganized and informal.

Unequal distribution of opportunities across different regions in the country and poor infrastructure particularly in rural areas, where the majority of the poor live, have kept the poor in poverty, while developed regions have adjusted with increasing globalization. Basically, all economic agents, be they formal advanced units or informal primitive units, are mainly driven by the profit motive. Accordingly, most of the formal sector institutions including financial sector ones have focused their attention on more developed regions while neglecting the needs of other regions. Establishment of state owned financial intermediaries of various types from time to time have failed to address this adequately, since they also have finally been enticed by the profit motive. Further, politically motivated popular schemes to write off loans from the public sector financial intuitions have led to a higher ratio of non performing loans. Bad precedents set by such actions at macro level have made certain development loan schemes utter failures finally depriving even genuine borrowers having access to cheap funds. A large majority of the income earners in the country, particularly in the rural sector and the urban poor, has seasonal or irregular pattern of receiving income. This irregularity is also a constraint for borrowing from the formal sector institutions, which demand regular service of loans. Hence, even creditworthy and genuine borrowers' turn to informal financial sector for their needs. Lack of familiarity, with formal sector environment due to their remoteness geographically, and awareness of the procedures also encourage people to find help from the informal sources. In certain societies borrowing especially for consumption purposes is considered as disgraceful.. That makes them avoid formal financial institutions and secretly find shelter in the informal sector

5.3 Poor Property Rights

Poor property rights are another factor that forces people to turn to the informal sector. As stated earlier, even the poor own immovable properties but have no documentary evidence of title. Hence their inability to borrow from the formal sector, even though they possess necessary skills for productive activity. Thus they are compelled to sell their skills cheaply to other entrepreneurs, who exploit them. The skills of the poor can be used to develop themselves and the economy, if there was a way for them to establish the title to the immovable properties they own

6. The cost and benefits of the formalizing these activities

The available information presented in chapter 3 above reveals that the informal sector financial transactions still dominate the overall financial transactions of households in Sri Lanka. This situation when compared with advanced economies suggests that Sri Lanka has a long way to go in this area. As was mentioned earlier, the relative share of the formal financial transactions is closely associated with the level of economic development and accordingly, the progress in economic development could transform informal financial activities to more formal ones and reduce the share of the informal market in the financial sector. However, direct intervention for this purpose could expedite the process to a certain extent. Providing institutional infrastructure to suit needs of the prospective clientele with an effective awareness program would be an important step in this regard.

Formalization of any activity gives its usage recognition and enables such activities to move parallel with other formal sectors of the economy. Therefore, formalizing the informal sector may be desirable, but it will need a comprehensive programme to meet the multidimensional needs of the poor. Also the growth of informal economy or informal financial market can often be traced to inappropriate, ineffective, misguided, or badly implemented macroeconomic and social policies, often designed and implemented without proper consultation with the actual stakeholders.

There are different views on the normalization of informal financial markets. However, there is general agreement that whatever measures implemented to formalize this sector, they should not be perceived as alien by the people at grass-root level who are the net beneficiaries of such measures. Accordingly, a blend of both the formal and informal characteristics would help a smooth transition of certain informal transactions into a formal environment. In other words, it needs to be a semi-formal environment, which is already there, in association with certain rural sector development programmes in operation.

6.1 Benefits of Financial Deepening

The incidence of relatively high interest rates associated with the informal financial sector is a common phenomenon identified in almost all economic systems. They reflect different types premiums for risk and convenience that the formal sector institutions have failed to provide to the needy sections of the society. If formalization provides acceptable alternatives, the society would benefit by reduced cost of funds, and enable them to utilize relatively higher share of their income for consumption and productive investment.

Further, formalization would provide clear and documented terms and conditions to the client so as to reduce the risk of unexpected terms and conditions under informal transactions. It could provide the legal protections for the less privileged people. Since formalization removes certain barriers that people find when dealing with formal sector institutions, it provides them with the opportunity of selecting institutions of their choice in a competitive environment, so that they can enjoy the benefits of competitive prices. Further, people can enjoy the benefits of non-financial services that are offered by the formal institutions.

In addition to such individual benefits the whole society can reap benefits from a more formal environment due to increased availability of information for effective policy making. Since data collected from established formal institutions is more accurate, it could help more accurate assessments about the performance of the financial sector as well as the entire economy. Accordingly, formalization of informal financial institutions and their operations could create a more efficient financial environment, while enhancing both efficiency and effectiveness of policies for development and poverty reduction.

6.2 Costs of formalizing informal financial markets

Formalization will require the providers of financial services to maintain a given set of standards. This requirement would force some players out of business in which case a certain segment of the market/society on the demand side would lose a service they have been enjoying to meet their needs. Not only suppliers, but also some users of informal services may also be marginalized, if they cannot have formal arrangements to deal with the formalized system. Under formalization process, it is necessary to convert informal financial units into formal ones. In this process of formalization the introduction of new rules and regulations and the establishment of new institutions to facilitate the effective implementation of the process will entail considerable financial cost to the government. Supervision of the operating institutions and their activities to ensure that required rules are observed properly will also bring on added costs to the government.

In addition to such direct and measurable financial costs, the society would encounter both direct and indirect economic costs in the process. If the marginalized segment of the market, to be arbitrarily formalized is relatively large, the economic costs in terms of loss of output and employment opportunities will be considerable. If the arbitrarily formalized institutions do not provide avenues alternative to the informal ones, society will still have to rely on the informal sources for their financial transactions at relatively higher prices compared to the situation before arbitrary formalization, as providers of informal services will have to bear an additional cost to hide their transactions from official scrutiny. Such developments could even lead to social unrest.

Intervention by the government through regulations to formalize informal financial activities could create distorted markets due to the complexity of the causes for the existence of informal markets. Regulation is to protect players in the business. It has a cost but borrowers could gain by lower interest rates and savers also will gain with more certainty and less risk. Designing a policy package to address all related issues in this regard would be an extremely difficult task. The ability, availability, and the willingness are three main factors that encourage people to engage in activities with formal institutions. Direct regulations can do only very little to address those issues. However, facilitating the penetration of formal institutions into needy areas will be more practical. A campaign to increase awareness of the advantages of the benefits that people can accrue through formal sector transactions would complement the facilitating process.

7. The major Findings and Conclusions

Sustainable economic growth and fair distribution of resources and opportunities are prerequisites for quality economic development. Increased investment and commensurate increase in savings to finance that investment have been identified as basic requirements for economic growth. As resources and skills are unequally distributed among different segments of the society, an effective system is required to mobilize resource from surplus units to deficit units. This service is provided by both formal and informal financial institutions in an economy. Country experiences have proved that the relative importance of the share of informal financial transactions is closely associated with the level of economic development and hence varies from economy to economy. In advanced economies the formal sector is very significant, while on the contrary, the informal sector dominates in less developed economies. However, in developing economies too, the formal sector dominates in certain areas, particularly in urban business sector. The characteristics of informal markets are common in most of the countries. Poor institutional infrastructure resulting in lack of facilities, more formal procedures, inability to meet documentary support for borrowing from the formal markets, irregularities in income receipts and associated uncertainty of repayment of loans, lack of awareness, involvements in illegal economic activities, and tax evasion are among the major reasons for people to turn to informal financial market to meet their needs.

Informal financial markets provide a very important service in meeting financial needs of especially less privileged segments of the society who find it inconvenient or uncomfortable in dealing with the procedures in a formal environment with formal financial institutions. As such, informal financial markets provide an array of services to their clientele, but at relatively higher prices.

The available evidence indicates that informal financial markets in Sri Lanka played an important role until early 1970s, which the introduction of open economic policies and deregulation led to an expansion of the formal institutions. This was significant particularly after the introduction of policies to liberalize the financial sector. However, the process has slowed down during the last two decades. Informal financial markets still play a relatively higher role in the economy. Further, such transactions involve fairly small amounts. There are a large number of factors attributable for the existence of informal financial markets. A comparison with advanced economies indicates the Sri Lanka has potential to have more formalized market in the financial sector transactions. Correct policies in this regard could bring about more formal activities into the financial sector for overall benefit to society. However, formalization of informal financial markets should be done after consideration of the impact of such moves on the real stakeholders, which was not the case in the past. However, direct intervention by the government in the formalization process would be difficult and costly in many ways. Provisioning of facilities for formal markets to take over informal market activities could minimize the cost of formalization and deliver benefits to society to achieve Parato improvements.

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(This paper is a section of an article in "The Informal Sector in Sri Lanka" produced by Pathfinder Foundation)

BANKING FOR THE FUTURE: TAKING FINANCIAL INDUSTRY TO THE BOTTOM OF THE PYRAMID

By Manoj Akmeemana

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Adam Smith's Sympathy vs. BOP Reality

Today, in the era of the new economy, switching on to the digitalized audio-visual world will echo so much talk about economic development, poverty eradication and socio-economic inequalities. Philip Kotler vividly elaborated, that the globalized economy is prone to change every nanosecond - becoming highly digitized, inter-connected, more disintermediated, and with convergence of different industries. He so rightly said, "***The future is not ahead of us. It has already happened. Unfortunately it is unequally distributed among companies, industries and nations.***"

Adam Smith, the father of market economies and capitalism, had prophesized;

"***A profitable speculation is presented as a public good because growth will stimulate demand and everywhere diffuse comfort and improvement. No patriot or man of feeling could therefore oppose it. But the notion of this growth, in opposition, for example, to older ideas such as cultivation, is that it is at once undirected and infinitely self - generating in the endless demand for all the useless things in the world.***"

It is doubtable as to how many of the people who advocate and promote a market economy know of the real sense he had quoted above. In this sense, Adam Smith was absolutely right and if he had been here today, he would be astonished to see all the fancies available in a "***throwaway society***"!

The irony is that the digitized world provides innumerous products and luxuries that only a few could afford, irrespective of the real need. The masses on the other hand would not even dare window shop at the modern shopping malls. However, one may argue that without induced demand, there wouldn't be growth to elevate and improve the lives of those who really deserve. ***But is this the reality?***

End of World War II, saw World Bank, various donor nations, aid agencies and national governments fighting for the eradication of poverty. Yet, five decades into the 21st century "Poverty Reduction" has remained a top priority of the United Nations Millennium Development goals. Ironically even the latest report on Human Development titled "Beyond Scarcity, Power, Poverty and the Global Crisis" (of 2006), by UNDP, reports of millions of people who are denied their fundamental human needs to water, education and basic infrastructure.

Table 1
Economic Disparity among Nations 2004

Country Category	GDP		GDP per capita	
	US $ Bn.	PPP US $ Bn.	US $	PPP US $
High Income	32,590.40	30,746.40	33,266.00	31,331.00
Middle Income	7,155.30	20,386.40	2,388.00	6,756.00
Lower Income	1,236.60	5,381.40	538	2,297.00
World	40,850.40	55,976.30	6,588.00	8,833.00

Source: Human Development Report 2006, UNDP

Adam Smith, in the writer's opinion, the most quoted yet the least read economist, in his work the "***Theory of Moral Sentiment***" argued that "***sympathy***" for others (i.e. poor) was the basis of any civilized society. But a society, fueled and motivated by greed to create & accumulate wealth, would not have any sympathy for others that are unseen or unknown. So concerned people in this world of despair, disorder, inequality and definitely uncertainty, are trying to figure out how to eradicate poverty and improve living standards of over 4 billion people earning less than $2 a day!

These are the very people known as the Bottom of the Pyramid (BOP) - the subject matter for the more fortunate bankers to deal with, not on sympathy or philanthropies, but because the very future survival of bankers depends on them.

Figure 1 : The World Economic Pyramid

Annual Per Capita Income*	Tiers	Population in Millions
More Than $ 20,000	1	75 - 100
$ 1,500-$20,000	2 & 3	1,500-1,750

Source: U. N World Development Reports

Many economists have made their own attempts to solve the problem of poverty. Yet the attempts are far behind in success and confined to intellectual debates and interests. In 1974, Schumacher's "Small is beautiful" shed some light on the subject when he proposed methods and technology that are,

- Cheap enough - accessible to virtually anyone (poor)
- Suitable for small scale application
- Compatible with man's need for creativity essential to meet the challenges of modern economy.

But one could argue that in this world, the modern order of business is "***Small is not so beautiful***", since in the eyes of investors, "***being big is not seen as ugly***". Today it is observed many businesses becoming bigger and bigger, through organic growth and mergers & acquisitions. This phenomenon is a reality for all industries - from fast moving consumer goods, manufacturing and industries to financial services.

Being so close to capital (funds), the problems that lie in front of us bankers is to have a new approach to cater to the BOP segment. Instead of adopting a "***sympathetic approach***", a more "***empathetic approach***" is needed to usher a sustainable Win-Win solution for all stake holders, in the business world. Especially the Sri Lankan banking community needs to focus on this market segment since 42% of its population falls under this category. They all have to re-think their traditional strategic approaches, business models and applications "to stay alive" in this globalized business world.

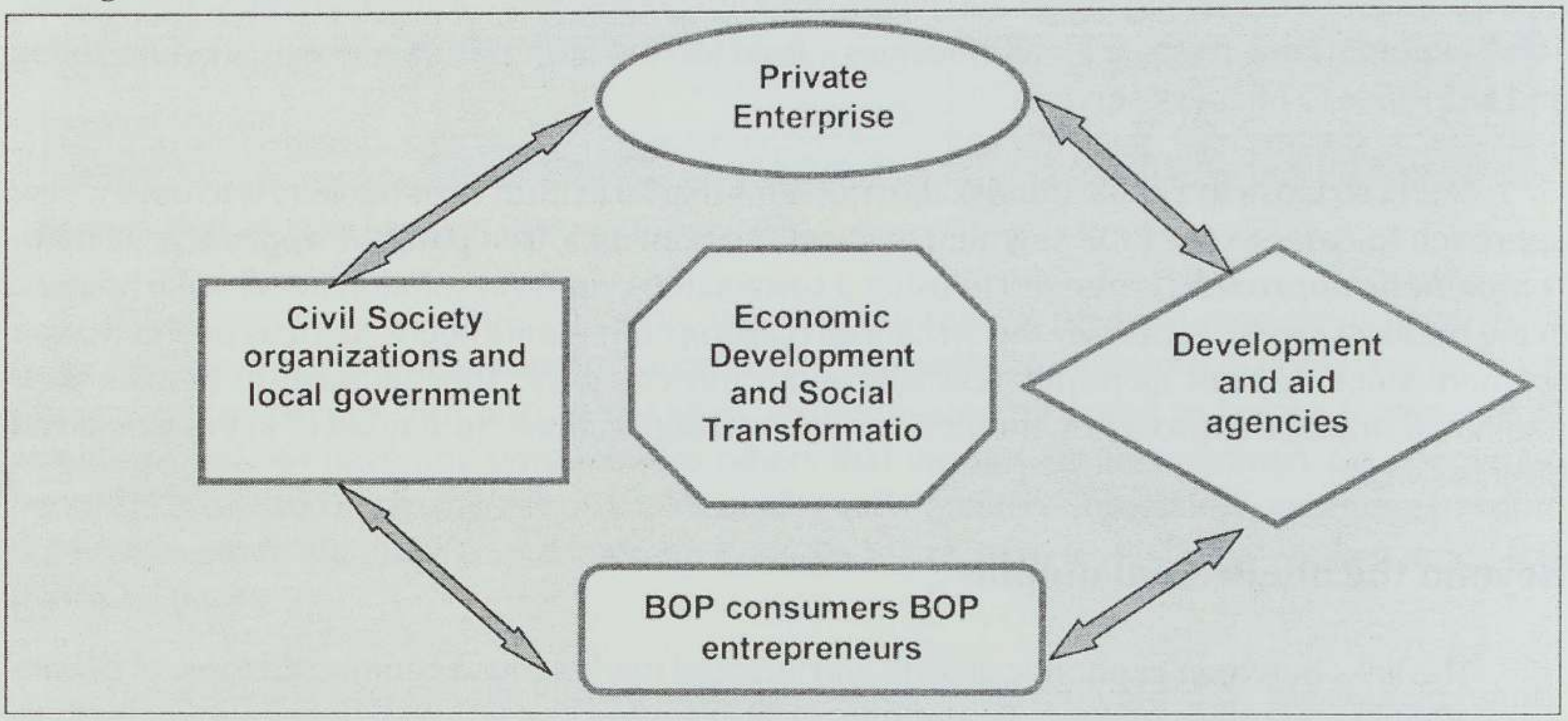
Beyond the intellectual utopias

The links between economic growth and financial markets are a century old topic of debate for academia and policy makers. Schumpeter (1934) argued that financial development leads to economic growth. He observed that financial markets play a dominant role in the growth process channeling funds to the most efficient investors and fostering entrepreneurial innovation. However, J. Robinson (1952) viewed the situation contrary to Schumpeter and argued that financial development passively follows economic growth by responding to the increasing demand for funds due to the economic prosperity. This debate is yet to be settled among economists as well as modern policy makers!

Having said that, in spite of all these interesting intellectual arguments, practical bankers close to capital (funding) as well as people, have experienced what proper financing could do to small businessmen or entrepreneurs. Many bankers have had the joyful experience of contributing to the elevation of a small business or an individual and see them grow into a larger business organization or sometimes into an international business outfit. These practical and dynamic experiences of bankers are much stronger than any empirical debate on economic theory by economists and policy makers. Infact recent empirical studies support the above proposition which suggests that deeper broader and better functioning financial markets can stimulate higher economic growth at macro level (Levine 1997).

However the real challenge is at micro level where business is really happening. Catering to the BOP in a business perspective, appreciating the Risk and Rewards is a challenging task to any industry. In this market economy nothing is "***free***", and sustainable growth and creating shareholder value are essential prerequisites. C. K. Prahalad, observed that success formulas to win the potential market segment of BOP should have "***A better approach to help the poor, an approach that involves partnering with them to innovate and achieve sustainable win – win scenarios where the poor are actively supported and at the same time, the companies providing products and services to them are profitable***"

Figure 2 : Interconnection between economic development and social transformation



Source: The Fortune at the Bottom of the Pyramid, C. K. Prahalad

Prahalad observes that collaboration is more essential in civil society organization and local governments, if this proposition is to be a success. In the Sri Lankan context, this has more meaning and a real value proposition for all NGO'S and INGO'S, in contrast to their current confinement of priorities on areas of civil war, human rights, media freedom and conflict resolution.

This innovative suggestion challenges the civil organizations to build sustainable solutions to the most desperate and voiceless BOP, by taking them for journey as companions, rather than taking them for a ride to achieve various political and other aspirations. This will definitely shift the focus on the root causes rather than symptoms!

Myths and realities of the BOP, A Sri Lankan perspective

Are the poor really poor?

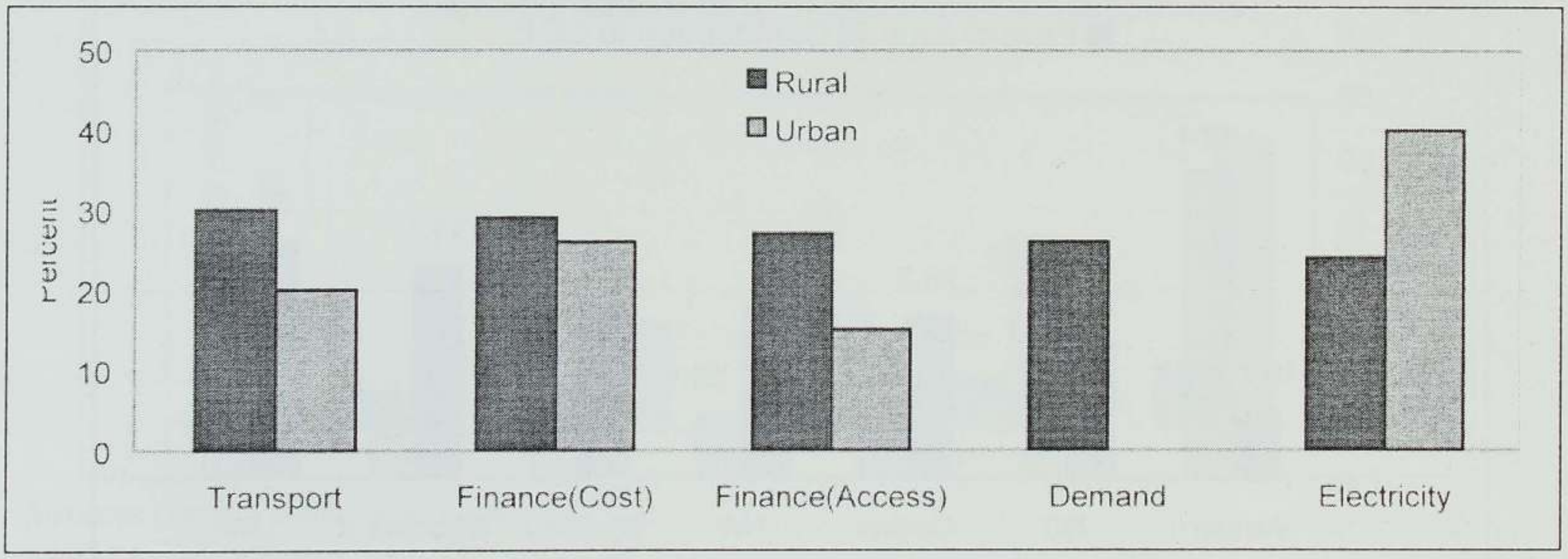
Does the BOP have money and purchasing power? According to Prahalad the dominant assumption is that poor have no purchasing power and therefore do not represent a visible market. Yet he argued that there is more evidence contrary to this myth all over the world. The researchers have revealed that the current income is $3.35 per day in Brazil, $2.11 in China, $1.89 in Ghana and $ 1.56 in India. Yet together they have substantial purchasing power which constitutes to a $ 5 trillion global consumer market!

Population earning less than $ 2 per day in Sri Lankan is 42% and no business can ignore the aggregate demand in them. However, the US Dollar is not a proper measurement of purchasing power in the local context considering the various socio economic realities in the various societies.

There are disparities seen in the same economy in many countries all over the world. Urban and rural disparities are predominant. Sometimes the economic power is concentrated in a single geographical area. Often the BOP being in a high-cost eco-system, even in developing countries, are compelled to pay a premium for everything. Prahalad called it "***Poverty penalty***" which is due to local monopolies, inadequate access, poor distribution and strong traditional intermediation.

The World Bank survey done in 2005, supports the above argument and shows the disparity among rural and urban society in the Sri Lankan economy.

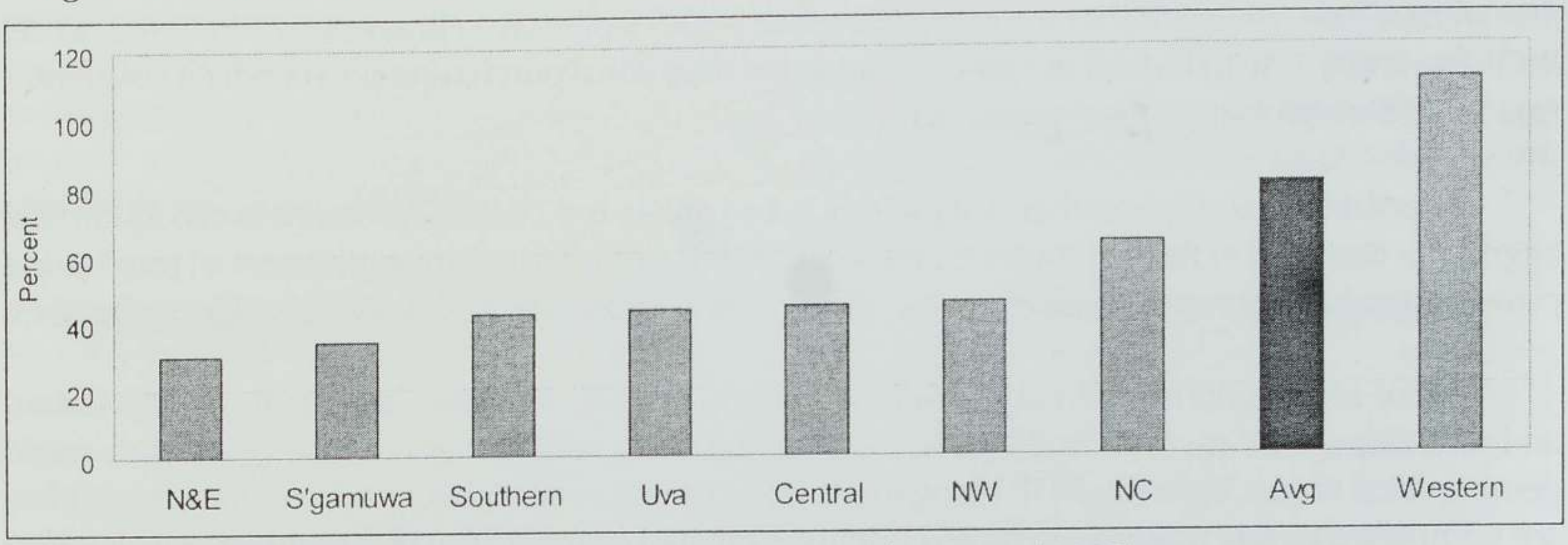
Figure 3 : Ratings for Top Five Constraints Rural Vs. Urban Sri Lanka



Source: Sri Lanka Investment Climate Survey (2004)

Ironically it is the rural society that provides much needed funding to the western province making them less poor and a main contributor to the national economy. Yet it is observed that the poor have to pay more or even a premium for finance as well as other needs!

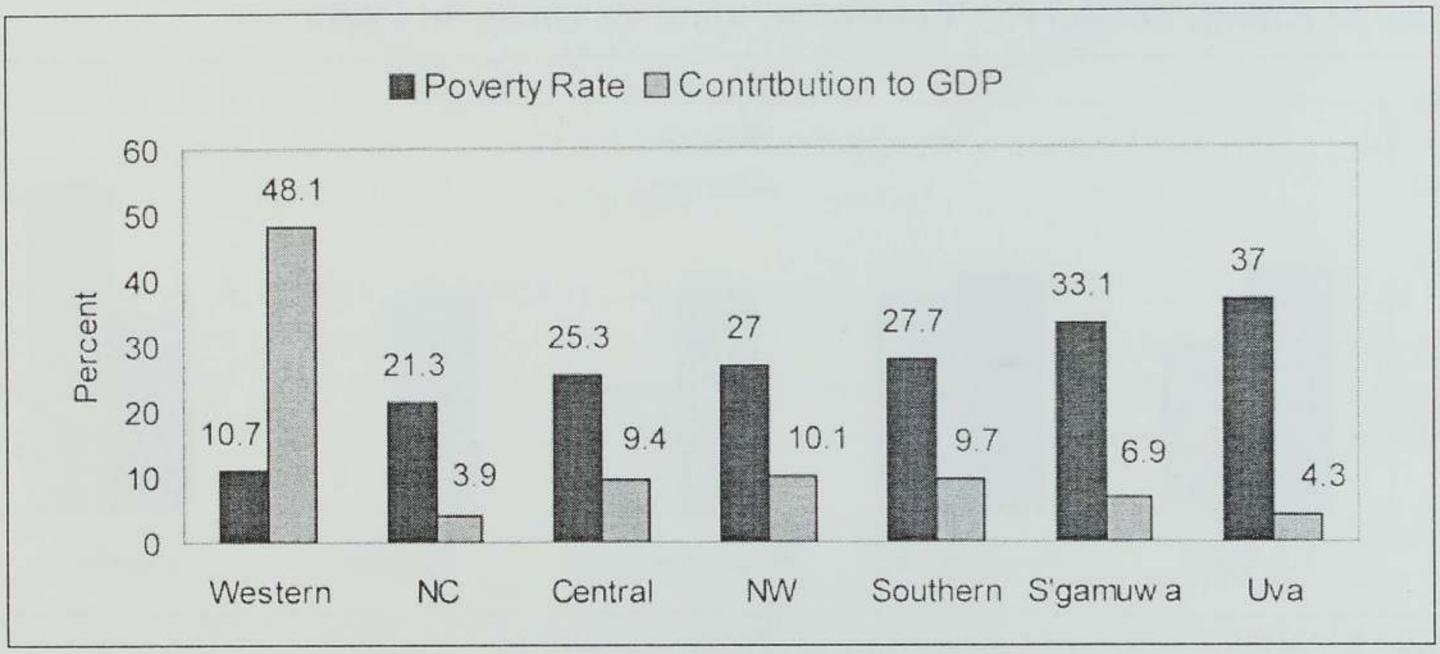
Figure 4 : Commercial Banks - Net saving transfer from Rural to Urban (Percent, 2004)



Source: World Bank report, Improving access to financial services (2005)

The rural sector as well as the poor in western province are using informal, non-institutional sector for financing needs. Many studies have revealed that costs of funds are substantially higher in the informal sector comparative to the formal sector.

Figure 5 : Growth & Poverty Reduction, skewed towards the Western Province (%, 2002)



Source: World Bank report, Improving access to financial services (2005)

Yet the banking sector has so far not been capable of attracting these segments to the formal institutional sector, as a result of the conventional business strategies and models.

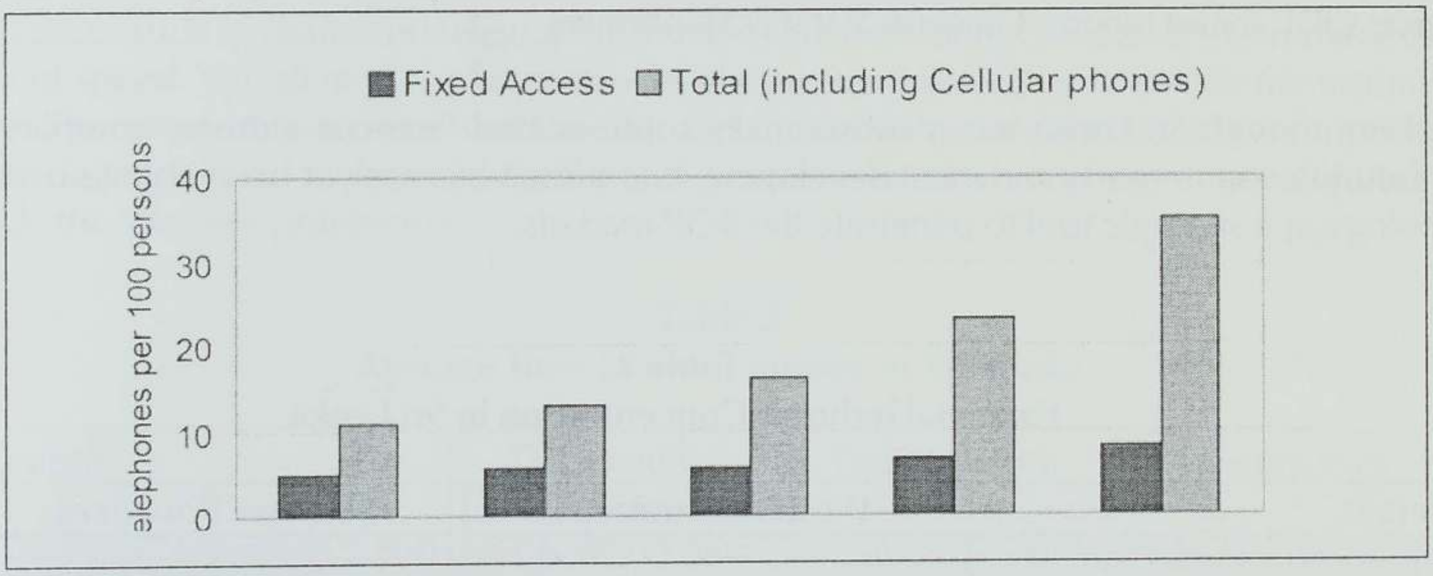
Therefore, traditional financial institutions and especially bankers have failed to penetrate this market, profitably for the shareholder whilst safeguarding the depositor.

Are the Poor averse to New Technology?

Another popular belief is that the poor (BOP) are averse to advanced technology. However, many global, regional as well as local examples indicate that BOP consumers accept and welcome advanced technology. A good example is from our neighboring Indian conglomerate ITC that connected Indian farmers with the market through personal computers in their villages. They called it E-Chopal (It is similar to a Sri Lankan Kopi Kade in the villages). E-Chopal network allowed farmers to access the Chicago wheat prices and make their sales more profitable. Now it is said that this concept has been extended to provide the information on weather conditions, various deceases and remedies for farmers. Indian farmers are now ready to buy their own Personal computers!

In Sri Lankan, Dialog, a major mobile operator generates 80% of its income from outside the western province according to a presentation by its CEO. Dialog utilizes the existing widespread boutiques under a franchise scheme for their mobile re-loading facility. It shows that BOP are connected and networked. It is expected that by 2008 the telecommunication market penetration will increase from 35% to 75% in Sri Lanka.

Figure 6 : Telephone Density

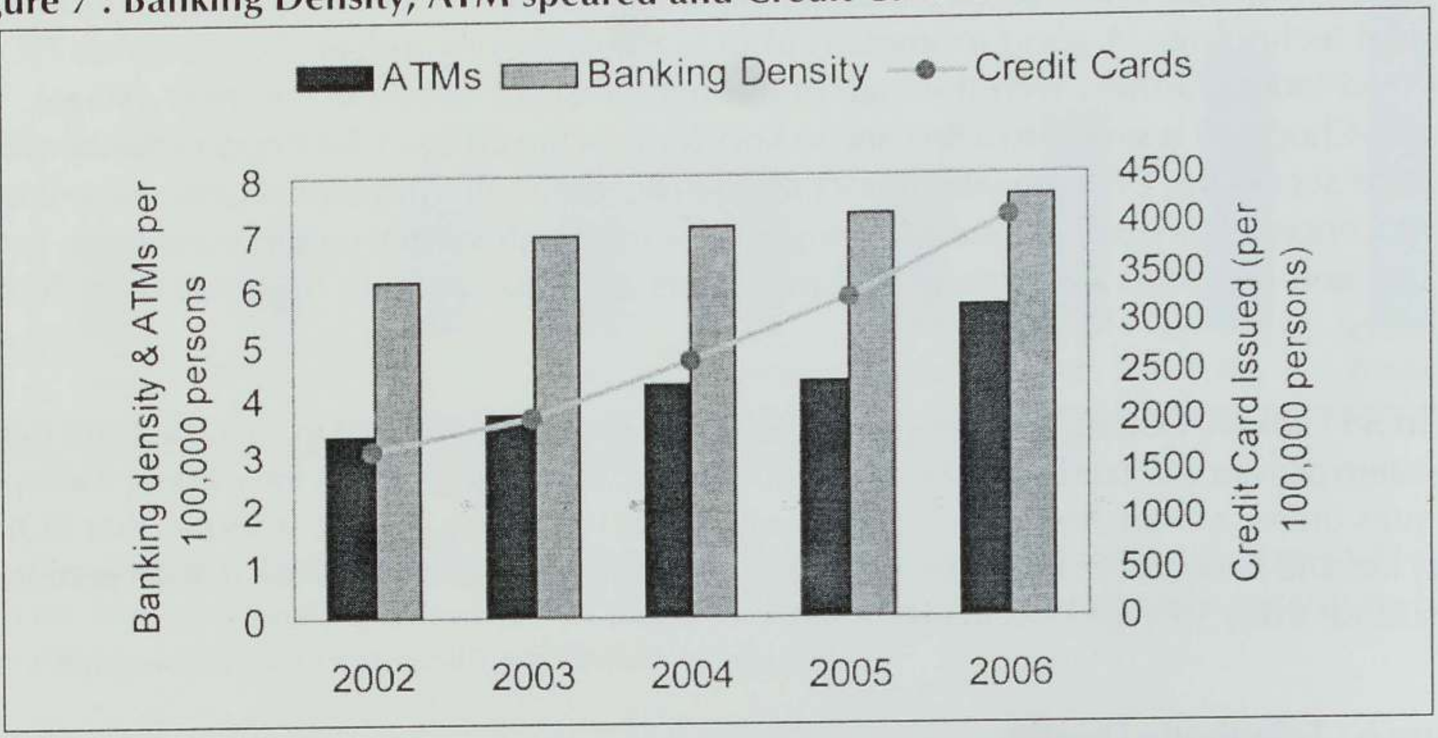


Source: Central Bank of Sri Lanka

It is observed that despite the rapid growth in telecommunication and innovative wireless technology (CDMA), Sri Lankan financial institutions are concentrated more in western province and fiercely competing with each other for the same pie!

The increase in access to banking may mislead one to believe, where the resources are concentrated. The financial industry concentration is a major indicator to judge whether they have substantially penetrated the BOP. It is clear that macro development in the country in the near future will be very remote unless concentrated and focussed attempts are made by policy makers and private sector on the BOP.

Figure 7 : Banking Density, ATM speared and Credit Card Issuance



Source: CBSL annual reports, Census & Statistics Department

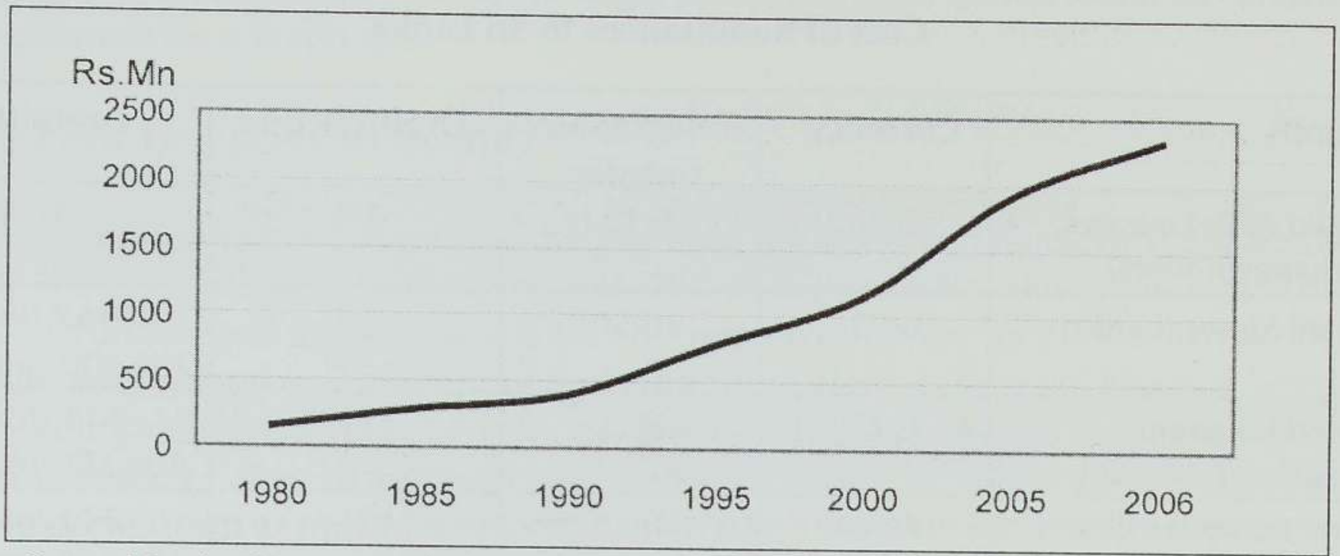
Even though Sri Lanka has a substantially sophisticated financial industry compared to neighbouring counterparts and most developing countries, it has not yet been able to use new technology as a strategic tool to penetrate the BOP markets.

Table 2
Financial industry Concentration in Sri Lanka

Details	Western Province	All Other Provinces
Commercial Bank Branches	598	707
LSB Branches	41	65
NSB Branches	41	66
Financial Companies	18	50
Population	5.3Mn	13.4Mn

Source: Web sites of financial institutions, CBSL annual reports, Census & Statistics Department

Figure 8 : Worker Remittances to Sri Lanka



Source: Central Bank of Sri Lanka

Migrant worker remittances are one of the highest foreign inflows to Sri Lanka, and yet a substantial amount of remittances are routed through informal sources to residents in Sri Lanka due to higher cost, time duration and less accessibility provided by the formal banking sector. Having seen the huge potential in this area some of the local banks and state owned national savings banks have gone for remittance business more aggressively. However traditional mode of remittances such as drafts and telegraphic transfers are inefficient compared to e-remittances, in terms of speed. Yet, all modes of remittances are substantially higher in cost in the institutional sector. Though more and more banks are introducing e-remittances, success of the proposition is largely dependent on wider accessibility and convenience as most of the migrant workers are outside the Western province.

Table 3
Average time to remit money to Sri Lanka

Country	Telegraphic Transfer	Draft/cheque	E-remittance
United Arab Emirates	1-2 days	3*-21 days	10-15 mins.
United States	1-2 days	3*-21 days	10-15 mins.
European Union	1-2 days	3*-21 days	10-15 mins.

Source: Central bank of Sri Lanka (2005)

Table 4
Cost of Remittances to Sri Lanka

Country	Currency	Telegraphic transfer	Draft/cheque	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 remittances)
United Kingdom (banks)	GBP	27.5	22.50	7-11 (for GBP 100-500 remittances
Other European Union (banks)	Euro	10-75	25	7-11(for Euro 100-500 remittances

Source: Central bank of Sri Lanka (2005)

The World Bank Sri Lanka division in its survey in 2005, concludes that "***Like many other Asian countries, electronic networks are unlikely to benefit poor and rural areas in the short and medium term***". This is purely because of the limited ATM density and higher IT related cost of conventional Sri Lankan banking industry.

However, ***the crux of the problem is not the mere cost of technology as World Bank states, but the conventional business model of present bankers that is not able to access the BOP with innovative technologies at affordable costs coupled with the popular myth among most of the banking community and donor agencies & policy makers that the poor are averse to new technology!***

Traditional majestic looking brick and mortar as well as brick and click banks would not be a solution to tap the market simply for three main reasons.

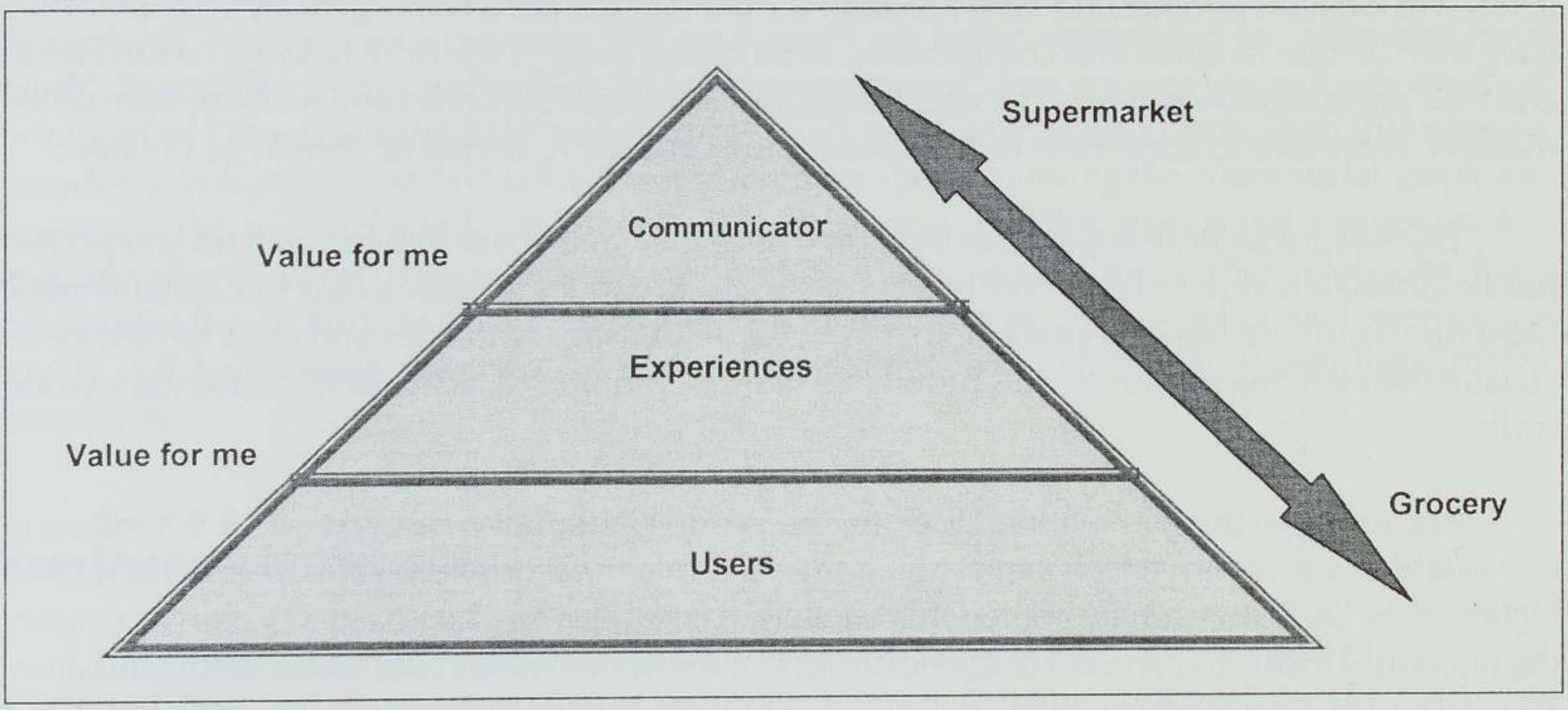
- Investing on infrastructure in remote areas incurs heavy capital costs that burdens on funding, capital adequacy requirements as well as incurs high operational costs,
- Technology used as "frills" and not as a more adoptable and economical distribution mechanism as proposed by Schumacher or more recently by Prahalad,
- BOP markets perceive such majestic looking banking institutions as not being meant for them, and hence drive them towards isolation and the informal sector.

Sri Lankan banks could learn from the less developed financial markets of Latin America and Africa on how effectively and efficiently they have adopted BOP friendly, affordable technologies profitably. A Bolivian financial company, named PRODEM FFP has been able to provide 24 hour high quality financial services to highly illiterate Bolivian rural BOP markets by introducing a smart automated teller machines that recognize finger prints, use color coded touch screen and speak in three different local languages!

Are the Poor receptive to Brand?

Another dominant assumption is that the poor are not brand conscious. But according to research, the poor are very brand conscious and also extremely value conscious. Today it is important to understand that consumers are not "***mere consumers*" *or* "*Users*" of products, ***they have to be understood as experiences and communicators*** (Liyanage). Much is being talked about Branding and consumer behaviours globally, but there are very few researches done on the Sri Lankan consumer. One such researcher, Liyanage argues that, "***although consumption is fast replacing occupation as the chief determinant of one's status in society, the traditional belief and value systems are very much intact and are only changing slowly, rather than radically***".

Figure 9 : The Role of Consumer



Source: The new consumer and implication for retailing, (Uditha Liyanage)

Therefore by consumption of specific products, consumers relate themselves; wanting to experience "***the luxuries***" of the middle and upper societies and communicate something back to the society that they live in order to be recognized in their "***social status***". The BOP specially being in the lower spectrum of the society, are brand conscious and wish to elevate their status in the society through "***experiences***" and as "***communicators***"

Further he argues that the private sector has confined its marketing and communication to the western province's dominant new urban middle class (NUMC) and will have to broaden its scope to understand the much larger spectrum of Sri Lankan consumers. It is observed that many e-based financial solutions introduced by the Sri Lankan banking industry focuses on affluent business executives, and most communications (advertising and publicity) are in English with contents of the message beyond the comprehension of BOP.

Sri Lankan banking industry should understand this reality when serving the BOP. Unfortunately, lack of insight and the many myths on BOP have led to the isolation of the BOP from the formal institutional financial sectors denying the bankers the opportunity of tapping a larger market segment. Introducing products, tested for success in the Western World, would not help capture the BOP, and Sri Lankan bankers need to be more creative in their approach with innovative products that will easily capture the hearts and minds of masses. This cannot be achieved overnight - more research and effort is needed.

Are the Poor Asset-less?

There is no doubt that the poor are "cash" poor, obviously because of their low income levels. Yet 4 billion people who earn less than $ 2 per day are not a homogenous segment. They have their unique features and complexities. In Sri Lanka, most of the BOP belongs to rural areas and their consumption patterns, resource structures and behaviours differentiate them from urban markets. Therefore to access the BOP primarily, the capacity to consume should be created.

The Sri Lankan BOP is not asset-less. They have their asset base in terms of land and estates but unfortunately due to legal constraints, these assets cannot be converted to capital readily. Most rural lands are not acceptable to banks because of issues with titles and are a hindrance as collateral for lending purposes. This problem is almost common to all the BOP consumers world wide.

According to the Heranando De Soto, the World's poor have assets worth $ 9.3 trillion in real estate assets alone, which cannot be converted to capital due to legal barriers and related higher costs. De Soto strongly argued that capitalism failed due to a lacuna in a system to convert the majority's assets to capital. He talked about five mysteries which contribute to this situation. The mystery of missing information; mystery of capital; mystery of legal failures, mystery of political awareness; and mystery of missing lessons from history.

Are the Poor Trustworthy?

It is a wide spread perception that poor are less trustworthy and are not committed to repay what they owe. On the other side of the coin, the poor too do not trust most of the large firms. Therefore "***Matter of trust***" is largely a two sided perception.

In Sri Lanka the perception to a certain extent is real; a farmer considers most of the farming loans as grants. However, this perception was created through the political contexts over the last

6 decades. Private sector firms approaching the BOP market must focus on building trust between them and consumers, and learn to respect the BOP's dignity.

In ICICI Bank the default rate is less than 1% for a consumer base of 200,000 self-help groups', in India. In Bangladesh, the Grameen Bank micro finance scheme is a true success story for Sri Lankan bankers to reflect on, where among 2.5 Mn. consumers the default is less than 1.5%.

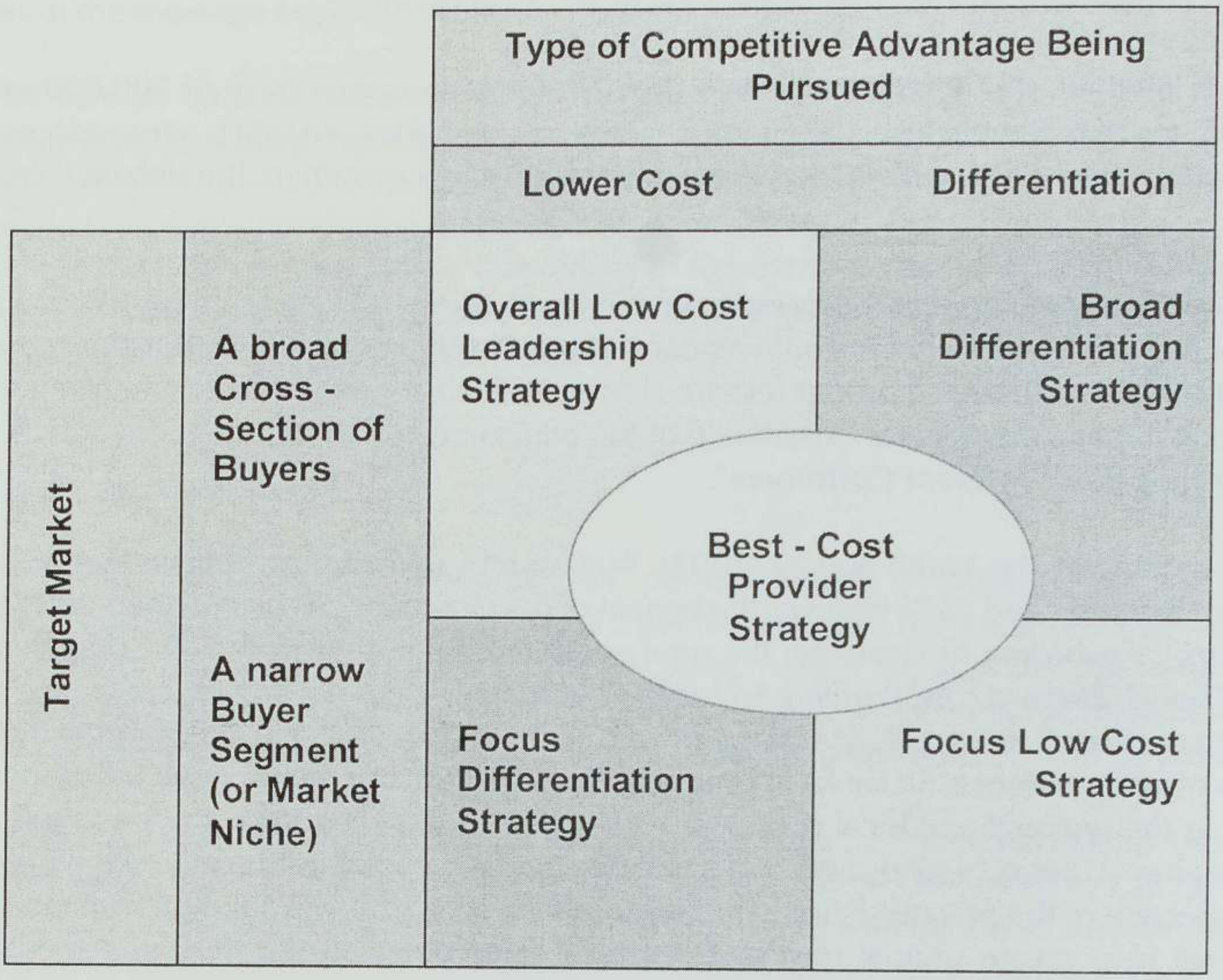
Large firms assume that the default rate among the poor is likely to be higher than that of their much affluent higher income earning consumers. ***But these examples show the contrary to be often true.*** Even though a proper research is not available for the Sri Lankan banking sector's default consumers, the general experience of the banking community is that the default rate is higher among their "***Affluent Customers***".

According to the Youth Survey (2002), 71% of Sri Lankan youth believe that Sri Lankan society is "***not just***" and 75 % believes the benefit of development will be confined to "***Well-to-do sectors***". According to Liyanage, the rural youth are being segmented as "***alienated rural youth***". Though the essay on "***Profiling Sri Lankan consumers***" does not provide concrete empirical judgment of "***Trust***" among BOP and the private sector, it gives a good indication that after six decades of independence, Sri Lanka at large fails to create trust among the wider social spectrum! Lessons in the regional and local context are eye-openers. Building trust is not a simple task - specially after 60 years of suspicions and misunderstanding among both parties. However, from the perspective of the private sector, continuous efforts for a win-win solution with world class quality will help create mutual trust and responsibilities between the BOP and the banking community.

New Domain for Strategy

The word "***Strategy***" originated from the Greek; **Stratëgia,** meaning "***a General***". Strategy is a much talked and conversant concept in modern western management, after 1950's. However, in the Eastern part of the world the concept of strategy had a much wider and deeper meaning - it is "***The way***" in warfare, as considered by Sun Tzu (*"The Art of War"*, 400 B.C.) and Miyamoto Musashi ("The book of five rings", 1600 A.D.), and is thus an old concept. Ancient military acumen and the more recent business arena use the word "strategy" with the vigor and aggression and a sense of competing with each other. The much acclaimed five generic competitive strategies of Michael Porter (1980) too, are presented and discussed in the same manner.

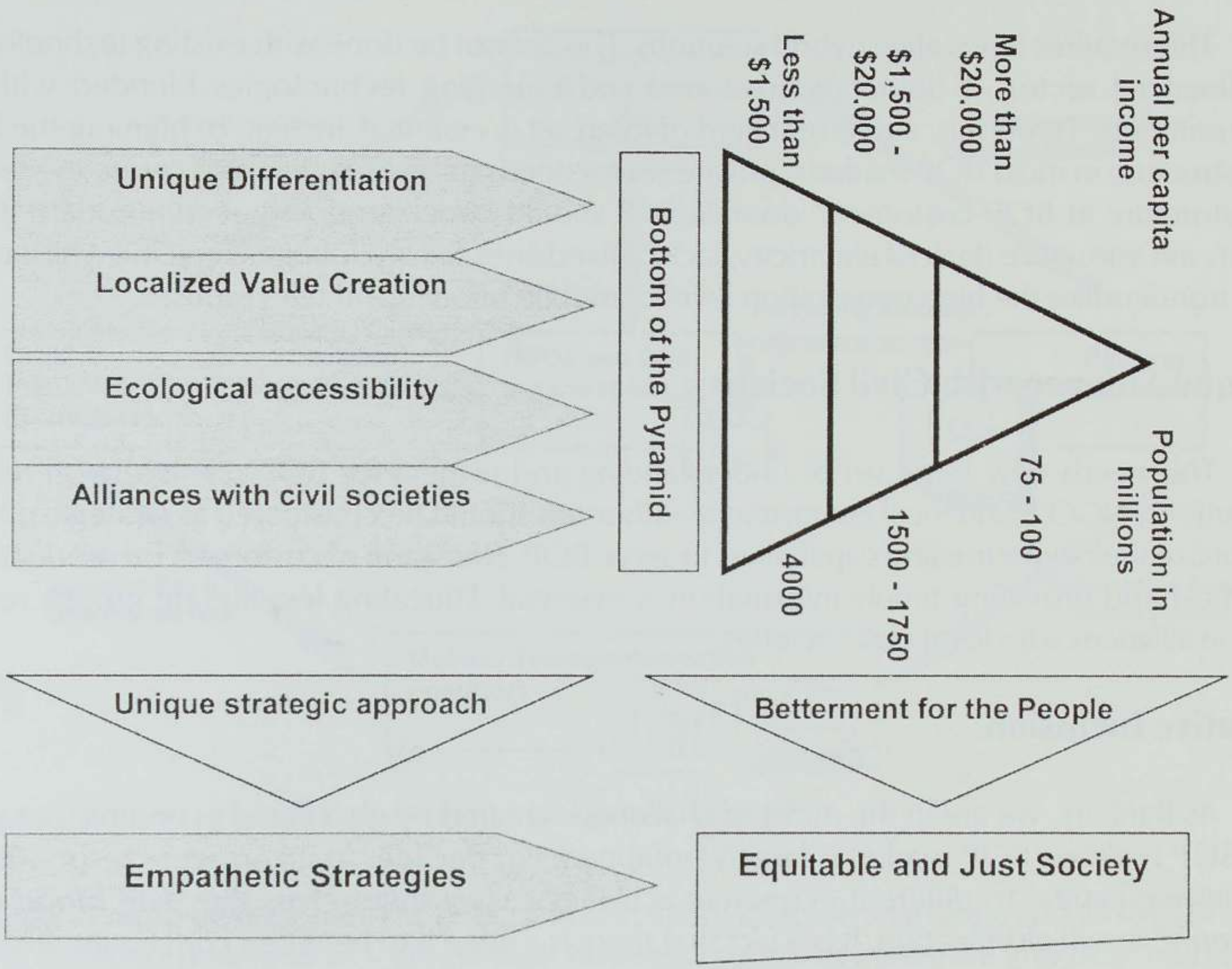
Figure 10 : The Five Generic Competitive Strategies



Source: Michael E. Porter, Competitive Strategy

Having said that, there is no need to re-invent the wheel, but it is essential to approach this subject more "***Empathically***" against "aggression" and with a "***sense of partnering***" than competing with each other to grab the emerging BOP market. We propose a model that considers the BOP to be the "***core, and most important***" part of the emerging market at macro level (in global sense), and as "***the progressive content***" of an economy for transforming poverty driven society to a more equitable and just society in national level.

Figure 11 : Empathetic Approach proposed: Strategies for the Betterment of the People



Source : The Writer's Derived strategic model for the betterment of the people

Unique Differentiation

It is important to understand the uniqueness of the BOP and its purchasing capacity and introduce products. Serving the BOP is not just about lower price or lower cost. Quantum jump in price-performance is essential to tap this market. This requires unconventional product development, brand building and integrated communication strategies which respect the BOP culture and create mutual trust and understanding.

Localized Value Creation

BOP is not a homogeneous market where businesses can adopt a standardized approach like "***Pizza Hut***" and "***Mc Donalds***" franchising strategy. It is essential to consider the local community as customers and localized eco-systems (i.e. boutiques and vendors) as franchising mediums. This will lead to a dynamic cost effective and customer centric approach to help serve the BOP. This will also involve a lot of energy on capacity building and training for local communities.

Ecological Accessibility

This requires innovative hybrid solutions. This cannot be done with existing technologies in the financial sector. It demands advanced and emerging technologies blended with local environments. To do this, a different kind of mind set is essential. Instead of blaming the lack of infrastructure in most BOP markets, private sector needs to be proactive and create the required infrastructure at BOP customers' doorsteps. It should understand and accommodate the low quality infrastructure (lack of electricity, lack of fixed lines or low voltage capacity) whilst milking new frontiers like the high penetration level of mobile phones and televisions.

Unique Alliance with Civil Society

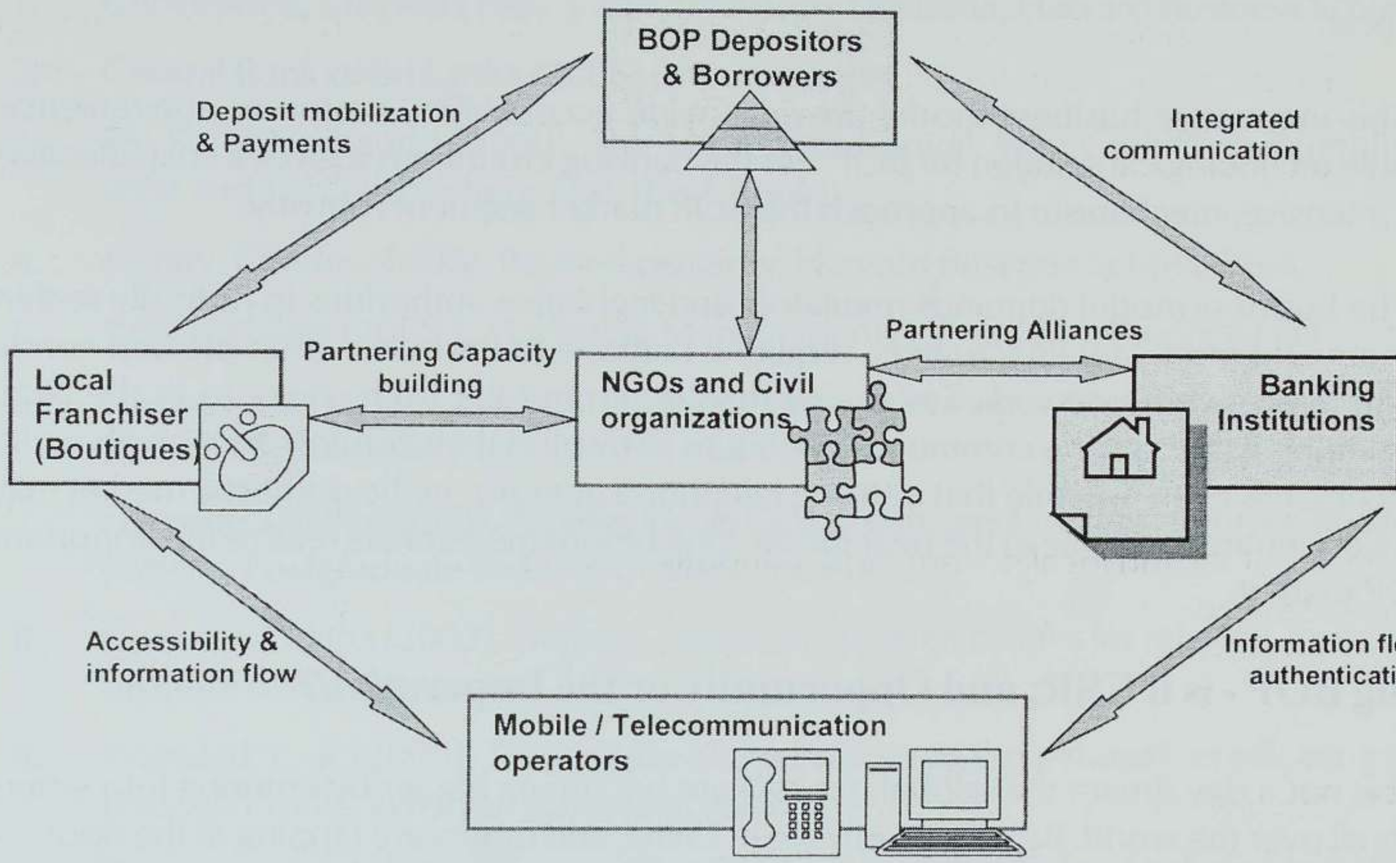
This needs new mind set of understanding and respect for BOP dignity. Local religious institutions, NGO'S and local government authorities should be considered as strategic partners, and utilize their expertise and capabilities to serve BOP. Education of customers on product usage is a must and providing timely information is essential. Educating less literate groups requires unique alliances with local civil societies.

Creative Inclusion

As Bankers, we are in the midst of challenges created by globalized economic paradigms and BOP realities. BOP market is largely untapped. For decades, bankers were responsible for transferring capital to different economic activities calling themselves the "***Life blood of the economy***" in self-glorification. It is a fact that there is a huge gap between conventional banking system and the BOP markets. This Gap cannot be bridged by the conventional approach in the traditional banking system and demands new strategic approaches, new business models and most importantly, a new mind set.

Therefore we propose a new business model to tap the BOP market specially in Sri Lanka which we call the "***Model of Creative Inclusion***". Even though this model is designed to meet the Sri Lankan socio-economic realities, it may be applied to most other developing nations too. However the model does not provide a final judgment nor can it be considered as "***The solution***". It provides only a Platform for Sri Lankan bankers to unleash their full potential.

Figure 12 : Creative Inclusion: Proposed Business Model



Source : The Writer's Derived Business Model for Creative Inclusion

Due to rapid development in Telecommunication, specially in mobile and CDMA phones, banking institutions have to re - create their business models to penetrate into BOP market.

Banking institutions can be operated in major geographical locations in rural areas of the country, build clustering business outlets by franchising the mobilizing of deposits and payments via local boutiques. The much needed connectivity and authentication can be done through telecom operators, where technology can be simple and affordable. Of course proper control mechanisms should be an integral part of this novel approach. Therefore partnering with civil society organizations is a pre-requisite. A simple example for deposit mobilization & payment via this model is explained below.

- Local franchises can be given floor limits to accept deposits as well as for payments. BOP customer could be provided an authenticated number via telecommunication.

- Using the telecommunication, banking accounts can be updated, for both BOP customers and the franchiser.

- Once the flow limit is reached, the franchiser should settle the net-inflow with the bank, and replenish the limit for further transactions.

This type of a model can be applied for micro financing and other lending needs of the BOP. This needs creativity and innovation from the banking institutions as already explained in this article.

This innovative business model provides wide accessibility, customer convenience and affordable technological solution for BOP. For the banking institutions it gives a cost-effective, low capital intensive, mechanism to approach the BOP market segment robustly.

The business model demands regulators and legislative authorities to radically re-think on the century old monetary enactments, requiring courage to introduce a simple and conducive legal and legislative framework. Easier said than done: but the truth stares us in the face. It is plainly simple - if the banking community continues to dwell in their comfort zones with traditional approaches, it is even possible that a strong telephone operator in the domestic market may rob the bankers' entire apple pie in the near future, long before the bankers realize the importance of the BOP market.

Serving BOP - is it CSR; and Opportunity or the Imperative?

It is not a day dream that global bankers are becoming bigger by entering into emerging, markets all over the world. Banking giants are in China, and others are tapping at the doors of our big brother; India. Many global financial giants such as CitiGroup, Lloyds TSB, ABN Amro and Visa International are focusing on the 4 billion gold mine in the BOP, with neither "***Sympathy***" as Adam Smith proposed, nor as a sense of "***Corporate Social Responsibility***", the modern buzzword.

They are focusing on the BOP merely because the existing Markets they operate do not provide leverage to expand market share. Hence they are compelled to think on "***market creation*** as Christensen explained, and "***incubating disruptive innovations***" to serve emerging markets.

In this globalized business world the new rule in the game of survival is to serve BOP markets. ***It is probably more than a "market opportunity" but a "market imperative"***. Therefore Sri Lankan bankers ought to understand the ground realities and demand to be proactive in order to survive, else self-glorifying titles of bankers such as the '***Life Blood of the Economy***" and the "***Engine of the Economic Development***" may become a laughing point for future generations!

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MEASURES TO INCREASE FINANCIAL INCLUSION

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1.0 Background

Financial Inclusion (FI) aims to address financial exclusion - which is the lack of access, faced by the most needy members of our community, to appropriate low-cost, fair and safe financial services from mainstream providers. It is a well known and researched fact that conventional banking has not reached the grassroots in most South Asian developing countries. This is due to a variety of causal factors or barriers such as culture, education (especially financial literacy), gender, income and assets, physical accessibility, lack of status (on the part of most members of the deep rural hinterlands proof of identity), unavailability of technology, and high cost of creating such accessibility. In an era where conventional banking and mode of its delivery are being re-examined FI with respect to conventional banking has to be analysed in the context of the above causal factors and the dynamics of such causal factors, in the changing financial services landscape. Bankers are faced with severe competition to their hitherto jealously guarded businesses such as deposit taking and credit with a diverse set of financial institutions offering the same. Therefore FI makes excellent common sense for bankers and banks to pursue as a survival strategy. Bankers and planners should not lose sight of the fact IF would result in increased market size.

A thought provoking parallel is the mobile communication industry. This industry has not created a digital divide but on the contrary Digital Inclusion (DI). With more and more banks FI has decreased.

1.1 Current scenario on "Financial Inclusion" in Sri Lanka

In most developing countries financial services are available only to a minority. Most often, the underserved population consists of people from the poorer sections of society who have no bank accounts, no access to credit from a formal financial institution or insurance. Based on the Central Bank of Sri Lanka (CBSL) Annual Report of 2004 an approximate 66% of the population is above the age of 18 years. Taking into account all the delivery channels of the banking system excluding finance companies and other financial institutions the penetration of delivery channels across the population, which is eligible to have a bank account stands at a low 0.1%. In the absence of well developed financial systems such people use other informal systems to save monies, obtain credit and insurance and transmit funds between countries and fall prey to unscrupulous middlemen. Although a few local banks, to their credit have valiantly attempted to bridge the gap through mobile banking, such moves have not been fully sustainable in the absence of sophisticated financial systems at the centre. In reality there is widespread FI in Sri Lanka and other developing countries.

Banks by their traditional business models are highly leveraged institutions, which have been afforded to them as a privilege by the Central Banks of the countries in which they operate. This brings in its wake a host of fiduciary obligations on the banks as acceptors of monies of the public in carrying out their business. FI has to be viewed in the context of fiduciary responsibility by all banks. The present fiduciary responsibilities are mainly for safeguarding existing depositors and to mitigate systemic risk which is also highlighted in the CBSL Annual report of 2006.(Chapter 8 Financial Sector Developments and System Stability, Page 119).

The Licensed Commercial Banks (LCBs) have expanded delivery channels in recent times. At present 23 LCBs operate through a network of 1530 branches, 1986 other service outlets, 1127 automated teller machines (ATMs) and 8753 electronic fund transfer facilities at point of sale (EFTPOS). These measures, although heartening, have not significantly increased FI.

Where most sizeable banks cannot access, diverse financial entities such as micro finance institutions have met with success. The Draft Micro Finance Institutions Act (MFI Act) aims to regulate the Cooperative Rural Banks, Thrift and Credit Cooperative Societies, Samurdhi Banking Societies, Sarvodaya Development Finance Centers and several Non-governmental organizations which are involved in deposit taking and micro financing. Non-governmental organizations cannot however accept deposits without the approval of CBSL. The Draft MFI Act seeks to give recognition to all such organizations and license them to accept deposits and provide financial accommodation.

2.0 Generic Causal Factors and Remedial Measures

2.1 Banking Practices

Common, existing banking practices themselves exclude large sections of the population such as the pensioners, self-employed and those who are in the unorganized sector. Such practices are maintenance of minimum balances, various charges, need for personal introductions and rigid documentation. Although the initial objective would have been safety of the depositor's money it is unintentionally creating Financial Exclusion.

Remedial Measures

- Introduce a special category of accounts where minimum balance and withdrawal charges are waived off. The cost could be mitigated, by offering a marginally lower interest rate on such deposits. A steady build up of deposits would soon enable to reach a critical mass, which will offset the costs incurred.

- Documentation should be kept simple and to a minimum with brochures indicating the features of the products in a very basic user friendly manner.

2.2 Financial Literacy

FI cannot take place without Financial Literacy. Financial literacy is the ability to make an informed judgement and effective decisions about the use and management of money. It's an essential skill for functioning in modern society and is becoming increasingly important to the long-term wellbeing of individuals and the community. Banks as well as regulators have failed in this regard.

Remedial Measures

- Holding informal workshops in underserved areas by a person who is acceptable to the community and who speak the same language.
- Officers to help persons with information upon their visits to a bank so that everything is understood. Currently such services are offered only to privilege customers. It is a simple matter of using the same concept to serve another sector of the population.

2.3 Payment Systems

"Payment systems are the backbone of the financial infrastructure of the nation, enhance globalization and act as tools of economic empowerment by Financial Inclusion. There is a need to create payment systems that are efficient, reliable, affordable and of global standard."
Shri M.V.Nair Chairman and Managing Director Union Bank of India

It is a moot point whether the economic empowerment had really occurred and resulted in FI through payment systems as so laudably proclaimed by Mr Nair. Practicing bankers have lamentably little or no involvement with building payment systems at a conceptual level. Their involvement has been at the implementation level where the priority has been that of aligning practices and internal systems with the payment systems. In fact information technology experts have been the sole decision makers at a conceptual level in most financial organisations.

The increased use of payment systems in the retail segment can be achieved by widening their reach and developing practical commercial applications that would directly benefit the users. To widen the reach and awareness, integration of the semi-urban and rural areas into the electronic clearing system is required. Participating institutions like banks have a significant role to play in achieving the objectives.

Simply put the concept of any payment system should replicate with improvements where necessary the intricacies of the settlement and clearing systems of banks. The Central Bank of

Sri Lanka should be saluted for their ground breaking efforts in introducing the Sri Lanka Interbank Payment System (SLIPS), Real Time Gross Settlement System (RTGS) and the Scripless Securities and Settlement System (SSSS) in the years 1994, 2001, and 2003 in this regard. Sri Lanka was leading among the South Asian region countries in this sphere. However these developments have not been able to increase **FI significantly in Sri Lanka.**

In the context of FI it is vital to note that RTGS is for high value transactions and SLIPS is for lower value without the advantage of real time basis transfer. It is imperative then a subsidiary system be implemented to accommodate the low value transactions with the same benefits as far as possible. SLIPS although is intended to cater to the lower value transactions have not exploited its possibilities as a strategy

Remedial Measures

- Developing any system demands a large capital commitment, which could be avoided by banks pooling their resources so that the costs are spread.
- A payment system with a common switch, similar to RTGS, which facilitates real time transfers for small amounts. Ideally this system should have a ceiling amount for transfer in order that high value transactions do not clog the transaction volume.

2.4 Para-banking

Most developing countries have systems to access micro credit and informal saving schemes, which may be costly in the long run. Planners to increase FI cannot ignore the impact of the traditional social order such as moneylenders. In Sri Lanka one very popular form of saving in village and semi urban societies is the Seettu. A group of people is formed and one person (the leader) collects an equal sum of money from everybody in the group. The total amount of the Seettu is specified at the outset and the number of payments each person has to contribute at regular intervals (usually monthly). Therefore the total duration of the Seettu is also known at the outset. The first such collection is credited to the leader. The subsequent collections are distributed in total to each member of the rest of the group so that with the passage of time every member gets the same amount of money. The order in which members receive their contributions is determined by drawing lots where every member is present. Here too number 1 is for the leader and only the rest of the numbers are drawn. The leader's responsibility is to collect all the monies every month and make the payments without fail. Basically the scheme operates on trust. It is also a forced saving as the leader will invariably come to collect the monies that are due to the group from every member during each payment period. The leader and the other members, who receive the lump sum in the initial months, benefit by accessing monies first and enjoying time value of money at no cost.

The method has acquired sophistication and evolved into an auction method through the needs of the members of such Seettu schemes. In principle as explained in the above paragraph the members who draw the latter numbers in the group, through no fault of theirs are disadvantaged by receiving their funds later. In order to circumvent this the leader would facilitate the earlier number holders to offer their tickets on an auction basis to the latter holders who would pay a higher price (receive less) and obtain the earlier tickets. In banking parlance this is discounting which is a normal transaction. It is indeed interesting to observe the manner in which para banking has instilled the principles and practices of banking in an informal way.

Remedial Measures

- Customise banking solutions to work round the existing para banking practices. For example the bank officer could assume the role of the leader and market a group of depositors to deposit fixed amounts on a periodical basis. At the outset a lump sum is paid to the depositor who has been selected by the bank. The balance depositors would be paid at the end of the subsequent periods. There will be an agreement reached into between the bank and the members which will specify the terms of payment and collection in simple easy to understand language. The advantage to the bank is that money flows into the bank and the depositor is **included** (FI has occurred). The depositor has an assurance that his money is absolutely safe which he earlier received by trusting an individual. An attractive rate of interest could be paid and distributed in proportion to the periods the members kept the monies with the group.
- Appoint such leaders as deposit collectors to the bank. Distrust and apparent fear of banks could be mitigated, by channeling the business through such agents at the outset.
- Auction based method could also be offered included in the same contract by discounting the Seettu deposits.

2.5 Accessibility

One of the major causal factors for FI is the lack of accessibility. Delivery of cash and other mode of payments could be addressed to a great degree since the onus is on the banks. Collection although certain persons could be appointed from the regions is not a total solution.

Remedial Measures

- Utilise existing networks spread throughout the country to mobilise and deliver deposits and loans and collect funds such as the postal network, telecommunication network which includes the ever growing mobile communication networks, schools and private chains of stores. In appointing persons to collect funds for the bank a model on the lines of insurance agents and brokers or bank employees could be adopted.

Example

The banks could use an existing widespread network, which has public acceptability and credibility. The agents who will collect the funds and disburse the funds would either be employees belonging to the network, bank employees who are manning desks at such network offices or third parties who would serve for a commission. In the last option the collection and disbursement would have to be through the network to the banks to ensure accountability.

- Mobile banking
  Although hugely popular the potential has not been fully utilized to capture all bankable persons. The mobile banking option should be taken to the far flung villages coupled with other promotions such as mobile communication, consumer durables etcetera to make a total proposition and enable FI.

3.0 Benefits of FI

FI is an important policy goal both from the perspective of realisation of growth opportunities as well as improved risk management for poor households. FI means the ability of every individual to access basic financial services which include savings, loans and insurance in a manner that is reasonably convenient and flexible in terms of access and design and reliable in the sense that the savings are safe and that insurance claims will be paid with certainty. Recognising the importance of FI several policy interventions have been undertaken to address this in the Sri Lankan context. The most important of these include the encouragement of expansion of state-owned banks into rural areas and the creation of specialised rural finance institutions such as the Regional Rural Banks (RRB) and cooperative banks. Despite these well-intentioned efforts, the state of access to finance leaves much to be desired. Design aspects of the financial system architecture are crucial to universalising access. One key requirement is an environment that promotes the emergence of sustainable financial service providers to work in under-served markets.

a) Micro and small enterprises can help them to better integrate into the economy of their countries.
b) Access to financial services also, actively contributes to their human and economic development, to the economic growth of the countries where they live, and to the social safety net that can help protect them against economic shocks.
c) Firms from developed market economy countries are dominant in virtually all main traded service sectors. Their competitive strength is based upon the underlying comparative advantage inherent in developed economies as well as specific factors at the micro-economic level. Out of nine key factors Financial Capacity could be related to FI. In this context access to banking services, credit and insurance are highlighted as important for being competitive.

4.0 The way forward

The way forward lie in the policies at the centre to incentivise those banks who attempt to cater to all sections of the community on an equitable basis including those who are under-privileged. The traditional view in credit, especially in these markets, has been that the originator of loans is also required to manage the implied credit risk of these activities. A separation of the origination and risk warehousing functions, making a case for numerous thinly capitalised local entities that specialise in understanding customer needs and running cost-effective operations which in turn are backed by financial institutions / banks with the ability to diversify risks and raise capital is one measure our neighbour had already looked at. This separation will permit the optimum use of scarce capital in the system without compromising on the scale of outreach. This insight is equally pertinent when thinking about making access to savings universal. This necessitates the legal permission by the regulator to enable partnerships between banks and non-bank entities. The optimum scale of originating entities is an important aspect of design; it must be large enough to afford investments in robust operating systems but contained enough to reap the benefits of local knowledge. Also, in order to encourage entrepreneurial providers to emerge in these markets, they must be able to fully meet the cost of providing services on an ongoing basis. Regulation that takes the form of price caps, for instance, is antithetical to this notion. There are also important regulatory considerations in financial inclusion. We need regulation that is outcome-driven and model neutral. In other words, rather than encourage specific configurations such as, say, cooperative banks, regulation should be focused on encouraging diversity of approaches to deepening access. The outcomes that regulators should care about are, whether access to financial services is universal, whether such access is of a quality that is acceptable (quality is used here to cover aspects such as lender-borrower relationship and features of financial services offered) and whether providers are sustainable and meet certain governance norms. Regulation must not favour, either by way of diluted capital adequacy norms or direct subsidies, one or the other model for reasons beyond these. Finally, the role of the government in financial inclusion is much debated. The biggest contributions lie in creating systemic infrastructure that takes the form of unique identification numbers, payment systems, credit bureau and electronic auction markets that stimulate market activity as a whole as opposed to more interventionist approaches that promote specific institutional types.

4.1 Government incentives

For banks, which formulate strategies to increase FI in the country tax and other such incentives could be given. Already there is a tax benefit allowed for banks, which provide credit to enterprises outside the Western Province. Of major importance would be to channel funds sourced outside the Western Province to be utilized in the areas outside the main province.

4.2 Prudential incentives

Relaxation or reduction in statutory requirements on deposits taken by areas outside Western Province which could effectively increase interest rates on such deposits as well as reduce lending rates.

Continuous monitoring on the part of CBSL to assess the scope, nature and cost of services provided by banks to all sections of the community

In this instance it is important that like in India, in Sri Lanka too transparency be ensured on maintaining minimum balances and charges levied on transactions. Banks should be encouraged to practice differential pricing on categorized sectors such as income earners below a certain threshold level, direct certain state business volumes to banks which provide credit to identified sectors such as farming.

As mentioned banks have to meet several fiduciary obligations in regard to being highly leveraged through public deposits for the greater good of the depositors and systemic resilience. However there needs to be a constant aligning to see if the meeting of such fiduciary responsibilities itself creates FI. It is strongly felt that well established, profitable and soundly managed banks with diverse ownership should be rewarded by less rigorous fiduciary responsibilities.

Although Moral Suasion is an option it is not advised due to the fact that banks should be encouraged to look at FI as a survival strategy rather than in a patronizing way.

4.3 Align banking practices to increase FI

Simple, affordable and accessible products and services

Banks have ventured with gusto into wealth management, private banking so on and so forth. However in this endeavour simplicity, which will no doubt help to create increased FI has been neglected. Banks should be proactive and offer rate comparisons on simply written and designed brochures even though the regulator may not mandate it. The probabilities of increasing FI are high as well as incentivising the targeted segments to choose the mainstream financial sector as opposed to others. What may go to your competitor could very well come to you tomorrow.

4.4 Payment Systems

While electronic online payment systems are indeed a sine qua none for the urban and suburban dweller it is not so for the community outside the metropolis. Smart cards and hand held devices, which will provide access to payment systems at reasonable cost should be explored more. In this the bankers could take a leaf out of the telecommunications industry where the prepaid cards although not cheap have provided access. SMS banking is one innovative mode of banking which could be utilized to strengthen FI through building on its inherent capabilities. The statistics of mobile phone ownership and banks accounts have revealed interesting trends in countries like India where the former exceeds the latter. While one could regret so, its potential should not be ignored as an access tool. Mobile phone usage is another factor that transcends social and economic barriers.

There is an urgent need to ramp up technology based delivery channels particularly in the rural areas. The challenge would be to identify a delivery channel that is not only cost effective but user friendly given the literacy levels of potential users in the rural areas and migrant labour. The introduction of low cost biometric ATMs would go a long way to bridge this gap. Ensuring that the benefits of technology, reaches the unreached is another challenge. It is essential that we think in terms of introduction of a Biometric National Identity Card, which will be utilized for all the needs of the individual and not just the financial needs. If the technology revolution is to fully impact the rural areas, concentration on providing soft infrastructure is a must.

The Blue Book so titled due to United Nations Department of Economic and Social Affairs (UNDESA) and the United Nations Capital Development Fund (UNCDF) being the authors have compiled the results of an intensive study on **"Building Inclusive Financial Sectors for Development"**. This contains information, which pertains to tools the policy makers of developing countries could make use of to increase FI in their countries.

5.0 Developments in FI

Gulbarga has just become the first district in Karnataka and the second in India to be declared 100% financially inclusive by the Reserve Bank of India at a formal function last week (the first being Palakkad in Kerala). With a literacy rate of just 36%, and nine out of 10 Talukas having been classified by the Nanjundappa Committee as most backward, Gulbarga presented an unparalleled challenge for those involved. When the task was taken up in July 2006, the requirement was to open a stupendous 1.85 lakhs of accounts for urban families and 3.97 lakhs of accounts for rural households. It required not only passion for the job, but also very close collaboration between government officials, banks, the RRB functioning in the area and associated NGOs, in identifying the wherewithal and capacity for completion of the job. It was a job well done and is now a good case study for banks and developmental economists faced with the challenges and opportunities of financial inclusion. But what has been done is only the first step. The second, third and the nth relate to inclusive growth and integration with an economy growing at a phenomenal rate of 9%. Mindsets of both the bankers and the banked must be changed. Affordable financial services must include, not only need-based credit, but also insurance services, payment and remittance facilities, and, in due course, financial advise.

Mindset aspects include promoting trust and financial discipline in the rural populace and a revised sense of opportunities amongst bankers. So far, rural operations of commercial banks have not been as commercially lucrative as operations in the more developed urban and metro centres. Their performance in terms of asset quality and composition has not been much better than that of the Regional Rural Banks and Rural Cooperative Banks, all of which had the rural growth mandate, but floundered because of weak technology, low capital bases, inadequate human resources, lack of professional skills and exclusion from reforms.

For commercial banks, hitherto, finance to the rural sector has been of small value and largely by way of dispensing government sponsored schemes, which have had abysmally low recovery percentages. The growth of NGOs, has brought about a radical change in views. Recovery rates of over 90% have made such finance a very acceptable and sought after proposition. Added to this, the new-found interest of corporates in rural India present enticing possibilities, particularly in investment credit. While access to credit is important and vital, other issues of viability, servicing and pricing need to be addressed so as to encourage and expand the outreach that the new model has brought in. In a situation where credit is asset based, i.e., ownership of assets commanding accessibility to credit, equitable distribution of credit is a major challenge. One other major constraint in taking financial services to the unbanked is the transaction costs which are much higher on account of the small ticket size, geographical spread, lack of quality manpower and intense supervision required. While technology can be a mitigator to some extent, I believe cost-effective inclusive growth can be realistically achieved only if we include the existing operators who are in the field, such as the NGOs, local business facilitators and possibly even the money lenders, who have firsthand knowledge of the credit risks and consumption needs of persons, speak the local language and are available dawn to dusk. On the path to inclusive growth, the government can definitely contribute by way of enabling policy and legislative support.

6.0 Conclusion

Banks and the regulators need to build a taskforce which will address issues such as optimisation of payment systems to enhance FI and reduce costs through consolidation measures such as strategic alliances, innovative delivery channels, creation of niche marketing efforts. Initially banks could formulate **Corporate Social Responsibility (CSR)** projects around FI as it is a project which banks could readily give their expertise to. Banks and Central Bank needs to analyse the structure of how payment systems in Sri Lanka have aided Financial Exclusion and develop mechanisms and parallel systems for low value transactions to promote Financial Inclusion. The needs of the community, barriers to FI need to be the focal point in the development of any payment system.

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NEW RULES FOR DOCUMENTARY CREDITS A STEP FORWARD OR A MISSED OPPORTUNITY?

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UCP 600 the latest revision of the Uniform Customs and Practice for Documentary Credits, issued by the International Chamber of Commerce, came into force with effect from 01 July 2007. A leaner set of rules than UCP 500, the new edition contains major changes that letter of credit practitioners will need to know. There are some new provisions, removal of certain existing provisions, modification of some of the existing provisions, re-drafted articles by introducing enhanced clarity and precision of the text aimed at resolving confusion and avoiding different interpretations. This article discusses the new UCP revision, some of the key changes made therein and the issues not addressed or created by the new revision.

1. Background

International trade involves a flow of goods from seller to buyer and at the same time a flow of payment from the buyer to the seller across international borders, in accordance with a contract of sale. The parties in international trade are aware that such payment may be influenced by various issues, such as trust between the commercial parties, their need for finance and, possibly, by governmental trade and exchange control regulations. There are various methods of settling international trade transactions and one of the most common methods of payment, especially in Asia and the Far East, is the Documentary Credit.

The International Chamber of Commerce (ICC) first established in 1919, had as its primary objective facilitating flow of international trade at a time when nationalism and protectionism posed serious threats to the world trading system. It was in that environment that the Uniform Customs and Practice for Documentary Credits (UCP) was first introduced in order to overcome the confusion caused by some countries promoting their own national rules on documentary credit practice.

One of the core tasks of the ICC is to make it easier for companies in different countries to trade with each other, thus contributing to the expansion of international commerce. Since 1933, when the International Chamber of Commerce first published the UCP, the ICC has considered it important to keep the business community abreast of developments and practices that have evolved in this field, and to support efforts to facilitate and standardize international trade practices. The objective, since attained, was to create a set of contractual rules that would establish uniformity in that practice, so that the practitioners would not have to cope with conflicting national regulations.

All embody a basic ICC principle, self-regulation by business. They are devised by experts from the private sector, working in ICC Commissions, who give generously, their time for the benefit of the wider business community. Documentary Credit usage is no exception. The universal acceptance of UCP by practitioners in countries with widely divergent economic and judicial systems is a testament to the rules' success. In a world of fast changing technology and rapidly improving communications periodic revision of ICC rules for trade facilitation is inevitable. It is important that the rules must not only keep pace with new technology, they must also take into account the current legislation, both national and international.

UCP was first published by ICC in 1933. Revised versions were issued in 1951, 1962, 1974, 1983 and 1993. Written virtually to every letter of credit the UCP is accepted worldwide and is the essential ground rules for billions of dollars in international trade transactions every year. They are the most successful private rules for trade ever developed and illustrate the importance ICC attaches to self-regulation.

2. Why use an International Publication?

Adoption of an international publication gives the advantage of using harmonised rules rather than being faced with differing customs having a common understanding of terms, desires, etc. and helps to avoid disputes and, where these arise, leads to much greater predictability in their outcome. Without the international publications, parties might be compelled to resort to the inconvenience and expense of calling expert witnesses as to international usage, with the additional risk of conflicting testimony. With the rules in place, the task of a court is relatively simple. In most cases they are guided accordingly and give effect to the articles/rules as defined.

3. The Revision Process

In 1999 the Task Force report on a possible strategy for future UCP revision considered that it was not yet time for a revision as the number of queries were gradually declining. In 2001 ICC National Committees of several countries believed it was time to establish a time table for a revision of the UCP. In 2002 ICC's Task Force on Documentary Credits recommended that in view of the long lead-time needed to produce a UCP revision, it was time to begin the process and ICC appointed a Drafting Group of nine members to start work on the revision of the current version of the UCP. A Consulting Group was also established with 41 members from 26 countries.

The Drafting Group carried out a methodical survey of ICC Opinions, the DOCDEX dispute resolution decisions, legal cases (e.g. Original docs; Unjustified refusal; Deferred Payment; Fraud) and considered ICC rules since UCP 500: the Uniform Rules for Bank-to-Bank Reimbursements (URR525), International Standby Practice (ISP98), eUCP for possible incorporation. The Drafting Group met on 15 occasions and over 5000 individual comments were received and reviewed. National Committees in 143 countries were requested to vote on a range of issues the likes of continued reference to various terms e.g. 'Negotiation', 'On its face', 'Reasonable time', Discounting of deferred payment undertakings', Relevance of article 30 of UCP 500 (re: Freight Forwarder

Transport documents), preferred versions for 'non-documentary conditions' and degree of review for 'inconsistency' or 'non-conflicting' as shown in UCP 600. It must be stated that from the 143 National Committees only less than 60 of them actively participated in the revision process.

An independent 'professional' review of the wording of the new document was also carried out by a panel of experts, with a legal background, in order to ensure that difficulties if any disputes arise are kept to a minimum.

A review of the opinions by the Banking Commission of the ICC revealed that seven articles in UCP500 accounted for over fifty eight percent of all opinions.

These seven were:

article 9	Liability of Issuing and Confirming Banks
article 13	Standard for Examination of Documents
article 14	Discrepant Documents and Notice
article 21	Unspecified Issuers or Contents of Documents
article 23	Marine/Ocean Bill of lading
article 37	Commercial Invoices
article 48	Transferable Credit

On the other hand 17 articles had either none, or a mere one or two opinions. Therefore it was necessary to closely examine and revise the aforesaid seven articles. They also had to carry out a review of the remaining 42 Articles in UCP 500 as well. Issues not specifically covered in UCP 500 and topics on which there has been cause for banks, companies, the shipping industry or lawyers to write to the ICC for an Opinion, were also considered.

Document checkers are being required to make judgement calls based upon their own interpretation of the document, rather than the support of a clear guideline as to the correct position.

This was a challenge the Drafting Group had to address.

4. ICC Opinions under UCP 500

The Opinions given by the ICC's Commission on Banking Techniques and Practice on the seven articles, which had the largest number of request for Opinions, were in respect of the following issues:

Art. 9. Liability of Issuing and Confirming Banks

The imposition of time limits by Issuing Banks for acceptance or rejection of amendments; Amendments that cross with a presentation; Issues relating to difference between payment, acceptance and negotiation; The legal implications concerning pre-payment of deferred payment undertakings; Retention of Negotiation as a settlement method; Presentation of documents by the beneficiary or his agent direct to Issuing Bank.

Art. 13. Standard for Examination of Documents

Definition of Banking Day; Date for negotiation of documents as opposed to date for presentation of documents; Treatment of documents not called for under the Letter of Credit (LC); Dating of certificates; Language of documents.

Art. 14. Discrepant Documents and Notice

This is the main issue for which the ICC's Banking Commission had been asked to give opinions. Release prior to revision of ICC Policy Paper April 2002 'Discrepant Documents, Waiver and Notice Requirements of a notice of refusal. Single notice of refusal; Liability of an issuing bank after receiving applicant's waiver; Holding documents at disposal

Art. 21. Unspecified Issuers or Contents of Documents

Review of non-transport documents (those not covered by articles 23-29): Dating of documents after the Shipment Date.

Art. 23. Marine/Ocean Bill of Lading

What is deemed to be the Bill of Lading (BL) date?; Port of loading in the LC appearing as the place of receipt on BL and how to make this acceptable under UCP; Issues raised through Position Paper No.4 in relation to carrier name and signing; Emphasise that non-negotiable copies need not be signed, authenticated etc.

Art. 37. Commercial Invoices

Use of a shortened goods description in the Invoice where the credit covers more than one type of goods and only one type shipped; Need for address of applicant or beneficiary to be exactly as per LC and does this include fax, phone, e-mail details?

Art. 48. Transferable Credit

Inclusion of issues covered in ICC Policy Paper October 2002 'Transferable Credits and the UCP 500.'

5. Review of remaining 42 Articles in UCP 500

The Group not only reviewed the remaining 42 articles in UCP 500, they also looked at issues which were not specifically covered in UCP 500. They studied the topics in which there has been cause for banks, companies, the shipping industry or lawyers to write to the ICC for an opinion and areas where it is felt the UCP could be more explicit or encompass additional conditions / criteria. It was observed that document checkers are being required to make judgement calls based upon their own interpretation of the documents. This was not desirable. ICC's aim is to develop the support of a clear guideline as to the correct position to be followed by the document checkers.

6. The Issues

The Drafting Group was of the view that the UCP should not be revised just because it has reached a ten-year cycle of usage. A revision should be made on the basis that a new text will enhance the letter of credit product, enable practitioners to undertake transactions with a set of rules that: The new UCP will be written more clearly (especially to those whose mother tongue is not English); It will encompass current trends and issues and above all, remove the ambiguities that exist today.

7. The Objective

The main objective of the revision is the reduction of unjustified discrepancies by banks, the default position for the majority of standard LC transactions. They also wanted to have transparency and clarity in the new UCP so that it facilitates remedies to reduce queries, and element of interpretation. They also aimed at limiting potential litigation and sought to eradicate poor presentment by beneficiaries by having a clearer understanding of the principles of the UCP. The Group wanted to place the onus on Issuer to be precise in the LC terms

8. The Revision

This revision is the most comprehensive review in the history of UCP. The earlier revisions were all limited to modifying the existing wording and adding new articles to address any new developments pertaining to international trade. In this revision the Drafting Group introduced a logical structure to the rules to enable the practitioners to easily access the appropriate articles. While no draft will satisfy everyone, the Drafting Group gave everyone an opportunity to express their views. All suggestions by the ICC's National Committees were considered, no matter how minor or small. Many UCP 500 articles have been moved or merged with other articles, while others have been deleted. Since decisions are taken by ICC, using a system of voting by the National Committees, some of the desired amendments were not effected due to the lack of a clear majority. Whether this indecisiveness create issues in the future is something left to be seen.

9. UCP 600 – The Structure

The Group wanted the new revision to have a proper structure and the UCP 600 has been therefore structured as follows:

Articles 1-5	: Framework of the UCP 600
Articles 6-10	: Structure of and obligations under documentary credits
Articles 11-18	: Pre-advice; Nomination; Reimbursement; Standard for examination of documents; Discrepant documents, waiver and notice; Originals; Invoice
Articles 19-27	: Transport documents

Article 28	: Insurance documents
Articles 29-37	: Extension; Tolerance; Partial shipment; Instalments; Disclaimers; Force Majeure
Articles 38-39	: Transferable Credits; Assignment

10. UCP 500 / UCP 600

The following UCP 500 provisions are not reflected in UCP600: Article 5: Instructions to Issue / Amend Credits, Article 6: (part) Revocable, Article 8: Revocation, Article 12: Incomplete or Unclear Instructions, Article 38: Other Documents, Content of Articles 2, 6, 9, 10, 20, 21, 22, 30, 31, 33, 35, 36, 46, 47 were either moved or merged On the other hand the following new UCP 600 provisions were not reflected in UCP 500: Article 2: Definitions, Article 3: Interpretations, Article 9: Advising of Credits, Amendments, Article 12: Nomination, Article 15: Complying Presentation, Article 17: Original Documents and Copies

Article 1 of UCP 600: Application of UCP is generally unchanged and despite the intention to remove Standby Letters of Credit from UCP 600 reference is still embedded via vague bracketed wording viz. '(including to the extent to which they may be applicable, any Standby Letters of Credit)'. International Standby Practices ISP98 was formulated specifically to meet the requirements of standby letters of credit and has been in operation for a sufficiently long time and is being widely used. Therefore the continued application of UCP to most articles of which are not applicable to standby letters of credit cannot be justified. It would have been better if the opportunity was used to make standby letters of credit subject to ISP 98 and not UCP 600. If it was considered necessary a provision could have been included in UCP 600 stating that in the event of any standby letter of credit stating that it is subject to UCP 600 the provisions of ISP 98 will apply.

11. The Major Changes

UCP 600 Article 2 - Definitions

Definitions were considered important, thereby not leaving room for different interpretations. Therefore a new article was introduced which included definitions for the following: Advising Bank, Applicant, Banking day, Beneficiary, Honour, Issuing Bank, Nominated Bank, Presentation, Presenter, Complying Presentation, Confirming Bank. The definition for Confirmation (UCP 500 article 9b), and that for Negotiation (ICC Position Paper 2) was also stated in this article. The provision of definitions for common LC language means there is no longer a need to search UCP for applicable definitions. The only exceptions are those definitions applicable to Transferable Credits, which are included in Article 39.

UCP600 Article 3 - Interpretations

New interpretations were introduced such as the following: Singular, Irrevocable. The following interpretations, which were found in various clauses in UCP 500 have all been brought under this article. Therefore: Signed (UCP 500 sub-Article 20 b) m Legalised ..... (UCP 500 sub-

Article 20 d), Branches (UCP 500 Article 2), First Class ..... (UCP 500 sub-Article 20 a), Prompt ..... (UCP 500 sub-Article 46 b, On or about (UCP 500 sub-Article 46 c: now 'calendar' days), To, until ..... (UCP 500 sub-Article 47 a), 'From, after' (UCP 500 sub-Article 47b),First half, second half (UCP 500 sub-Article 47c), Beginning, middle, end (UCP 500 sub-Article 47d)

"On Their Face"

Reference to 'On its Face' has been *deleted in all places except* for in Article 14 "Standard for Examination of Documents" so as to maintain the position that is recognised by courts of the information, page, etc., that the document checker is expected to review. It does not mean, the front as opposed to the back of a document. The term means the *review of a document in line with international standard banking practice and the features of the document itself.*

Article 14a: Standard for Examination of Documents

A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation

Article 14b: Standard for Examination of Documents Reasonable time

Banks shall have a maximum of *five banking days* ('reasonable time not to exceed seven banking days' under UCP 500) following the day of presentation to determine if a presentation is complying. Reasonable time has been a concept not specifically defined within UCP other than the establishment of an outside limit,and not automatically the seven banking day outside limit provided by the UCP 500. There was general agreement to remove the words "reasonable time" from UCP 600 and include a maximum number of days.

However, in article 15 of UCP 600 an issuing or confirming bank when they determine that the presentation is complying, is required to *honour.* Therefore there is a doubt as to whether five banking days is the maximum, since the time taken to determine whether a presentation is complying may be much less than five banking days. This once again brings back the issue of whether there is a definite period for examination of documents.

Another issue is that the negotiating bank, confirming bank and the issuing bank all have a maximum five banking days to examine documents. This means a period of ten or fifteen days will elapse purely for the examination of documents by banks which appears to be far too long. Although some National Committees proposed a more reasonable time of three banking days as a maximum, the majority vote was for five banking days. This is detrimental to developing the Letter of Credit product which the ICC is advocating.

Article 2: ***Concept of Honour***

A new term 'honour' has been introduced in UCP 600 which means:

- to pay at sight if the credit is available by sight payment.
- to incur a deferred payment undertaking and pay at maturity if the credit is

available by deferred payment.

- to accept a bill of exchange ("draft") drawn by the beneficiary and pay at matu rity if the credit is available by acceptance.

All types were placed under one concept: to simplify the rules and avoid repetition throughout UCP, for Bank's obligation under an LC. The basic concept of LC is an instrument of payment – honour is the all-encompassing term for giving of value.

Article 2: Definition of Negotiation

Negotiation continues to be a contentious issue. What does negotiation mean - *different interpretations* exist all over the world. General agreement on the meaning has not been forthcoming. How can it be defined? It has been said that a number of banks fail to understand the meaning of the term 'negotiation' in connection with the availability of a documentary credit, which was clarified by ICC Position Paper No. 2. The term 'negotiation' is defined in UCP 500 as 'the giving of value by the bank authorised to negotiate'. .... the phrase 'giving of value' ... may be interpreted as either 'making immediate payment' or 'undertaking an obligation to make payment'. In my opinion the meaning of negotiation has been very clearly defined. It's just that some of the bigger banks and some of the developed countries are reluctant to advance funds against complying documents and claim reimbursement. Their practice is to pay the beneficiary on receipt of proceeds under their reimbursement claim. In article 2 'Definitions' of UCP 600 it is now defined as follows:

"Negotiation means the *purchase* by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, *by advancing or agreeing to advance funds to the beneficiary*, on or before the banking day on which reimbursement is due to the nominated bank".

This may cause new problems as a new term 'purchase' has been introduced in UCP 600 for which no definition has been provided and it is very unlikely that the banks, which are disregarding the meaning of negotiation, will change their practice. Instead they may try to give different interpretations to it.

Article 6: Availability, Expiry Date and Place for Presentation

This article re-organises article 42 of UCP 500 and re-affirms that a credit is also available with the issuing bank. This will put an end to issuing banks refusing to accept documents submitted by the beneficiary direct and forcing presenters to present documents to the nominated bank.

Article 12: Nomination - Discount of Deferred Payment Undertaking

Nomination of a bank includes *authorising a bank to prepay or purchase* and is included in Article 7. Issuing Bank Undertaking and Article 8. Confirming Bank Undertaking. UCP 600 Article 12- Nomination states 'By nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing *bank authorizes that nominated bank to prepay or purchase* a draft accepted or a deferred payment undertaking incurred by that nominated bank'. This reverses the position in the highly controversial verdict given in Banco Santander / Banque Paribas case. The problems are: whether all the issues have been incorporated, whether there is any conflict with local laws of some countries and who should be responsible for fraud?

Article 13: Bank-to-Bank Reimbursement Arrangements

This article refers to ICC rules for Bank-to Bank Reimbursement. However an opportunity to make the ICC rules which also have been in existence for quite some time and very widely used to be applicable for all Documentary Credits issued subject to UCP 600. It is surprising that ICC does not want to popularise these rules that have been developed with their involvement.

Article 14d: Standard for Examination of Documents

Data in a document, when read in context with the *credit, the document itself and international* standard banking practice, *need not be identical* to, but *must not conflict* with, data in that document, any other stipulated document or the credit.

Article 14j: Standard for Examination of Documents

When the addresses of the beneficiary and the applicant appear in any stipulated document, they *need not be the same as those stated in the credit or in any other stipulated document*, but must be within the *same country* as the respective addresses mentioned in the credit. Contact details (telefax, telephone, email and the like) stated as part of the address of the beneficiary and/ or the applicant *will be disregarded*. The *exception* is when address of applicant is to appear as part of consignee or notify party details on a transport document.

Article 16: Discrepant Documents, Waiver and Notice

A significant change that has been introduced is the additional possibility for holding documents until receipt and acceptance of applicant's waiver without further authorisation of the presenter. Since, a fairly high percentage of documents which are found to be discrepant, are accepted by the applicant, this provision is welcome and provides a more pragmatic solution to a long standing problem..

Articles 19-25: Transport Articles

UCP 500 Article 30 - Transport Documents issued by Freight Forwarders has been removed since a freight forwarder signing as agent of a carrier or as carrier is covered in UCP 600 Article 20 and the content of the other transport articles. It should be noted that UCP has never excluded transport documents because the issuer was a forwarding agent.

Also, reference to carrying vessel propelled by sail only has now been deleted.

Some Carriers in recent times have started on a new practice of making statements on their BL's similar to "Carrier may release the cargo to the consignee without the need to obtain an original BL". Therefore, some National Committees expressed a requirement for wording to the effect that would prevent carriers from attempting to manipulate and desired a definition of a *"Title Document"*. However, it was decided that UCP is not the right forum / document to define a document of title as local conventions and laws also apply. **Disclaimers in bills of lading are also applicable.**

Article 28: Insurance Document and Coverage

Previously UCP 500 Article 34 Insurance Documents; Article 35- Types of Insurance Cover; Article 36- All Risks Insurance Cover must be issued and signed by an insurance company, an underwriter or their agents or their ***proxies.*** Cover notes will not be accepted (previously cover notes issued by brokers only were not acceptable)

The insurance document must indicate that risks are covered at least between the place of taking in charge or shipment, as stated in the credit and the place of discharge or final destination as stated in the credit. Amount of insurance coverage must be at least 110% of the CIF or CIP value of the goods. An important change in the new rules is the provision contained in the article permitting insurance document to contain reference to any exclusion clauses. This can be dangerous if the exclusions have an adverse impact on the usual risks covered by the insurance document for an international trade transaction.

Article 35: Disclaimer on Transmission and Translation

In this article it is stated that if a nominated bank determines that a presentation is complying and forwards the documents to the issuing or confirming bank whether or not the nominated bank has honoured or negotiated, an issuing bank or confirming bank must honour or negotiate or reimburse that nominated bank *even when the documents have been lost in transit between the nominated bank and the issuing bank or confirming bank or between the confirming and the issuing bank.* However, no specific provision has been made emphasizing the liability of the Applicant in such instances to pay the issuing bank, nor for the loss of documents between the issuing bank and the applicant.

Article 38: Transferable Credits

This article has been re-worded for clarity. This is the only article other than article 2 Definitions, which have a definition incorporated. That the issuing bank can be a transferring bank and documents must be presented to the transferring bank are new introductions to this article designed to clarify ICC's position.

12. Issues Not Addressed or Newly Created

Non-banks have been issuing Credits for a number of years and this practice is growing. At the commencement of the revision process it was proposed that the new revision should provide for it using 'Parties' instead of 'Banks', 'Issuer' instead of 'issuing bank', and so on as UCP 500 had no interpretation of bank. During the drafting it was proposed that *'The term bank includes but is not limited to entities traditionally known as a bank or other financial institution.'* However, subsequently this interpretation was removed. *This has not resolved the problem* that the Banking Commission will be faced with when a request for an opinion is submitted on such a case after adoption/implementation of the new rules.

13. Application of UCP 600

With effect from 01 July 2007 banks in Sri Lanka commenced issuing their documentary credits subject to UCP 600 and therefore the commercial parties will also have to conform to the requirements of the new rules.

All Documentary Credits issued and outstanding prior to this date has been issued subject to the earlier revision UCP 500, which will continue to apply even after 01 July 2007. Banks and commercial parties can if they so desire amend the Credit to make it subject to UCP 600 (which must be accepted by the beneficiary). However the better option will be to let those credits remain subject to UCP 500 and in about four months from now a majority of such Credits would have been utilized or expired. By examining the few Credits that remain outstanding, a decision can be taken as to whether they should amend them or let them continue to be subject to UCP 500 until expiry.

Changes were necessary in the SWIFT message formats to accommodate the changes and therefore SWIFT was involved in UCP 600 Drafting Group in order to ensure that the necessary changes are made on time. New mandatory field 40A Applicable Rules with list of codes was introduced allign with UCP 600.Under UCP 500 SWIFT rules stipulated that any Credit sent via SWIFT was considered subject to UCP 500. However, for UCP 600 without providing a new option for UCP 600, a change was made by introducing a new field which was introduced to make the Credit subject to 'latest version' without changing the SWIFT rules, as was the case under UCP 500. Nevertheless, we need to refer back to the SWIFT rules to find out the interpretation of this phrase and it states that the latest version is the version of UCP operative on the day the Credit is issued.

14. Position Papers and ICC Opinions

A number of Opinions had been issued by ICC's Commission on Banking Technique and Practice, on matters referred to them by the National Committees. Furthermore, four Position Papers were also issued by ICC to clarify the provisions in UCP 500. It must be noted that the Opinions expressed were based on specific situations and therefore they will no longer be valid under UCP 600. Similarly the Position Papers will also not be valid under UCP 600.

15. Conclusion

The ICC during the drafting of a new revision decides on each issue put forward by taking a vote from the National Committees. Any proposals to be adopted required a clear majority and if not such proposal was not accepted. Therefore many issues which some National Committees were keen to be included in the new revision had to be excluded. This was evidenced by the fact that there were suggestions for nineteen new articles, however, the number of countries voting for these suggestions did not give rise to an overall majority that would justify such an inclusion. The suggestions included the following:

Transfer by Operation of Law
Participations / Syndications
Corrections / Alterations
Language of Documents
Jurisdiction
Inoperative LCs
Forwarder Type Documents (FCR etc.)
Endorsements
Linkage
Recourse
Good Faith
Revolving Credits

Since most of the messaging relating to Documentary Credits is routed via SWIFT, it was also involved in the drafting and was able to make the necessary modifications in order to accommodate the requirements under the new revision.

International Standard Banking Practice and the eUCP which were documents published by the ICC to clarify the practices under UCP 500 has also been revised to reflect the new requirements under the UCP 600. Please note that the Position Paper issued by the ICC will no longer be applicable under UCP 600. The Opinions issued by ICC's Banking Commission will not be reviewed for applicability to UCP 600 as they have been issued on the basis of facts of particular situations

The local regulations and practices in Sri Lanka will also make life difficult for the Banks in the country. In the Documentary Credits they issue they will not only have to incorporate clauses to meet the regulatory requirements, they will also have to exclude the application of certain articles or sub-articles to conform to the regulations or practices.

The challenge ahead for all practitioners is to use the UCP 600 to work towards creating greater value for the Documentary Credit product, and thereby facilitate global trade making the Credit a preferred payment instrument.

BANKING ON KNOWLEDGE

By Dr.Chintha Dissanayake

Chartered Psychologist

'Employee engagement and customer satisfaction are the proxies for future growth and profitability' - (J.Varley, Group CEO, Barclays Bank)

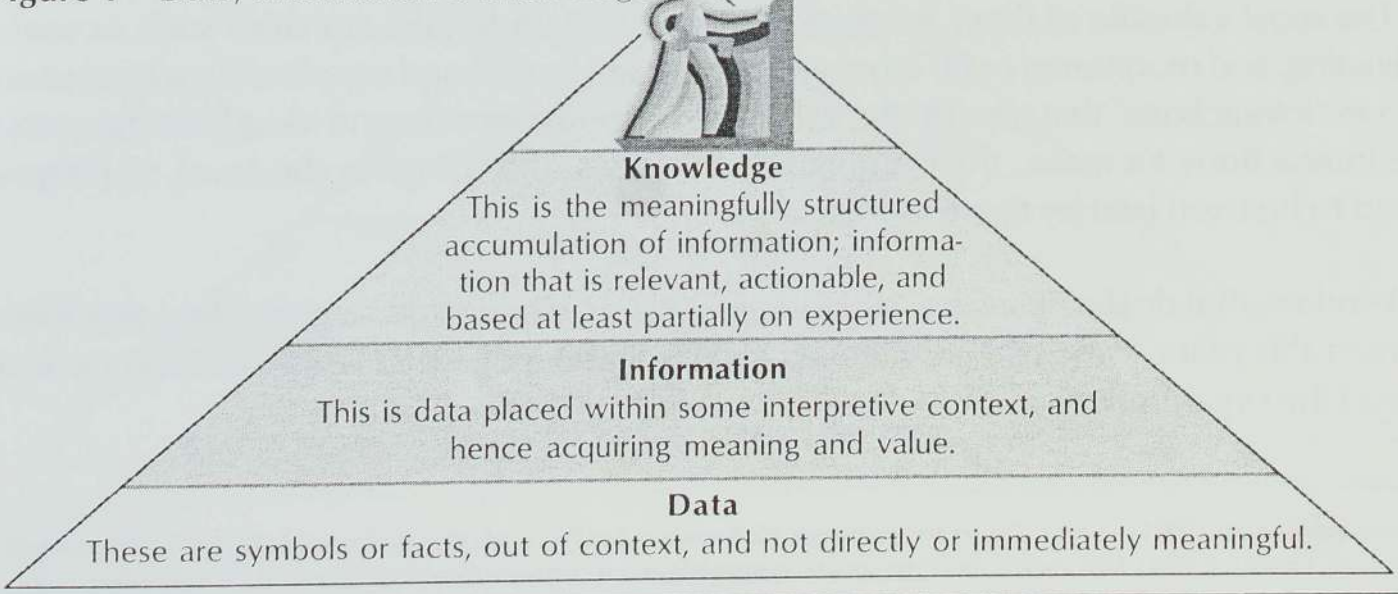
The "Knowledge Worker"[1] a term coined almost half a century ago by Peter Druker, a leading economist, described a new category of employee whose basic means of production was information or the development and use of knowledge in the workplace. Druker went on to predict that these *knowledge* workers will become the life-blood of the future company, and now in the 21st Century this prediction is none truer than in the Financial Industry.

For decades the financial sector, along with others, boosted productivity through re-engineering, automating and outsourcing. However, with rising business volumes and a demand for lower running costs, most advantages gained through these measures were short-lived as competitors caught up with similar technological and process improvements. Today, as companies search for alternate strategies, ones that are high in value and harder to copy, some are engaging the knowledge base of their employees to discover a more enduring competitive advantage.

A Knowledge Economy

The terms *information* and *knowledge* are often used interchangeably, but it is important to draw a distinction between them. (See figure 1 below). Whilst good and timely *information* is vital to any decision making process, it is the *knowledge* that plays a critical role in the quality of the deciscion.

Figure 1 - Data, Information & Knowledge



[1] Peter Druker, *Landmarks of Tomorrow: A Report on the New 'Post-Modern' World* (1959)

In the 20th century, investment in IT departments served companies well by providing employees with the much needed information for business success. However, in today's technologically savvy workplace, with vast quantities of information becoming easily and quickly available to all, the real competitive advantage is in **how** this information is used – ie. the value of the decisions made – and this hinges critically upon the calibre of employee and their *knowledge* in the workplace - an intangible mix of group and individual experiences and thinking.

RESEARCH in brief - The Impact of IT Investment on Productivity

A study of 100 randomly selected companies carried out by the ***London School of Economics*** *revealed that companies get the biggest benefit by combining IT investments with good management.*

Corporations scoring in the bottom quartile of management practices, by deploying more powerful IT resulted in productivity improvements of just 2 percent. However, companies with increased computing power and improved management practices achieved 20 percent higher productivity.

The authors concluded that better management practices could already raise productivity appreciably and boost the impact of IT investments[2].

There is growing evidence that these high-value decision makers are increasing in number and in importance in the modern organization. And unlike in the past, they are not necessarily clustered at the top of the organization – and now includes workers in roles such as managers, sales people, customer service reps and in fact any one whose tasks are anything but routine. Johnson et al[3] point out, 'the potential gains to be made by helping these employees be more effective at what they do and do it cost-effectively are huge – as is the downside of ignoring this trend'.

The most valuable of these workers are those that undertake activities such as searching, coordinating, and monitoring (with other employees, customers and suppliers) in what economists refer to as "interactions" that result in the exchange of goods, services and ideas[4]. As the complexity of the interactions increase, their ambiguity also rises and a higher the level of judgment is required to be exercised by these workers.

Workers that deal with increasing complexity are unique to the organisation that they work in, as over the years, they gain an intense brand of knowledge that is specific and exclusive to them and the organisation.

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2 Bloom & van Reenan (2004) - LSE's Centre for Economic Performance Study - A McKinsey Research When IT lifts productivity Dorgan and Dowdy (2004) http://www.mckinseyquarterly.com/Financial_Services/Banking/When_IT_lifts_productivity.

3 B.Johnson, J.Manyika & L.Yee, (2005) The next revolution in interactions. The McKinsey Quarterly (no.5)

4 Butler *et al*(1997) A revolution in interaction, The McKinsey Quarterly (no 1).

This type of knowledge, also known as ***Tacit knowledge***, or implicit knowledge, is deeply rooted into the organisation's operating practices and culture. And, unlike explicit knowledge (see Figure 2 below), carried out by those workers who undertake more routine interactions, tacit knowledge is much harder to detail, copy, and distribute, and as a result can be harnessed as a sustainable source of competitive advantage. This in turn makes these tacit workers highly valuable to the organisation.

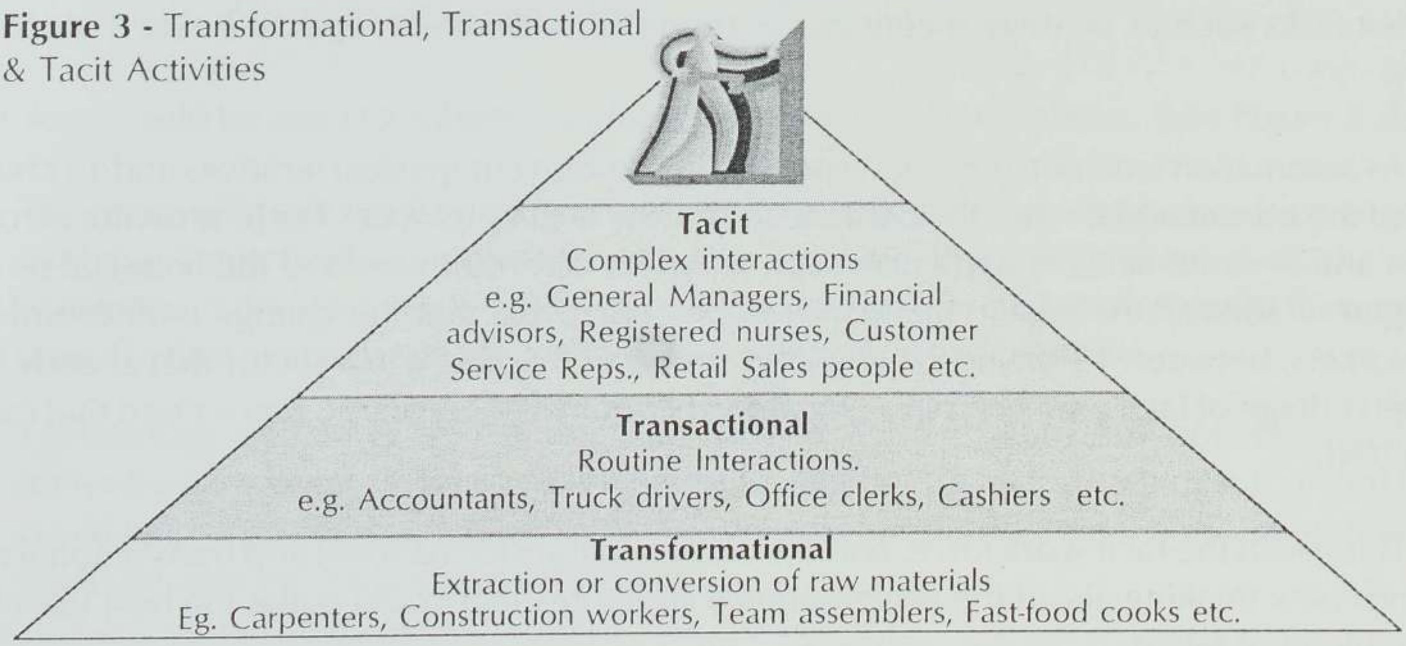
Figure 2 - The difference between Explicit and Tacit Knowledge[5]

Explicit knowledge – This is knowledge that can be formally articulated or encoded; this type of knowledge can be more easily transferred or shared; It can be abstract and removed from direct experience

Tacit knowledge (or Implicit Knowledge) – This is knowledge-in-practice and is developed from direct experience and action. This type of knowledge is highly pragmatic and situation specific, it is subconsciously understood and applied, difficult to articulate and is usually shared through highly interactive conversation and shared experience.

Douglas North (1993 & 1994) described the shift in the nature of economic activity over time. In the 20th century, he highlighted, how most non-agricultural labour involved the extraction of raw materials or their conversion to finished goods (ie. Transformational activities). However, by the turn of the 21st Century, only 15% of US employees, for example, undertook such activities, with the remainder (still in the US) being employed in activities that involved partly (ie. Transactional) or completely interactive (ie. Tacit) tasks[6] .

Figure 3 - Transformational, Transactional & Tacit Activities

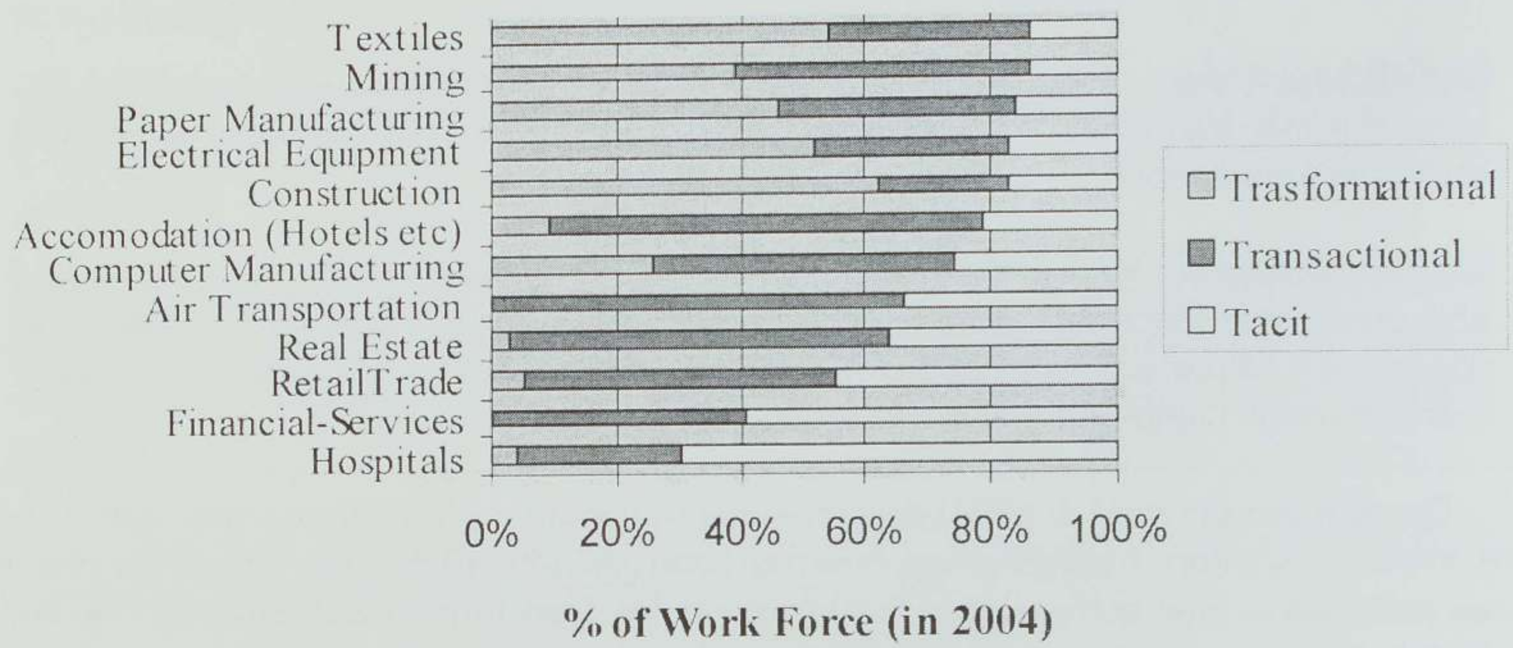


[5] "Knowledge, Groupware, and Internet", Butterworth Heinemann, 2000

[6] Douglass C. North, (1993-1994) "Institutions, Transactions Costs and Productivity in the long run", "Transaction costs Through Time", "Institutions and Productivity in History". – http://econwpa.wustl.edu

Over the years, with significant advances in technology, the more routine interactions (ie *transactional* interactions- see Figure 3 above) have been automated or even eliminated. The automation of these tasks has not been restricted to the more obviously clerical and accounting roles, but also in specialist areas such as IT, auditing and even biochemistry as well as many others[7]. Figure 4, below describes the mix of tasks in a selection of job roles in 2004[8].

Figure 4 - The job Task Mix



Most jobs however, have a mix of activities so that a manager's job would also have elements that are routine, such as completing expense reports or audits for example, as well as more complex tasks such as strategy meetings, for example, with direct reports, being a more tacit activity.

As automation (and outsourcing - especially in Western companies) removes and/or changes many of the transactional roles, the demand for quality tacit employees keeps growing across all sectors and in some fields in particular, such as health care, software and the financial-services (see figure 4 above)[9]. At least in the USA, researchers reveal that the change in distribution of tacit workers, between 1998 and 2004 was in excess of 8%, this is in a sector that already has a high percentage of tacit workers[10]. In a globalised economy, this is once again a trend that cannot be ignored.

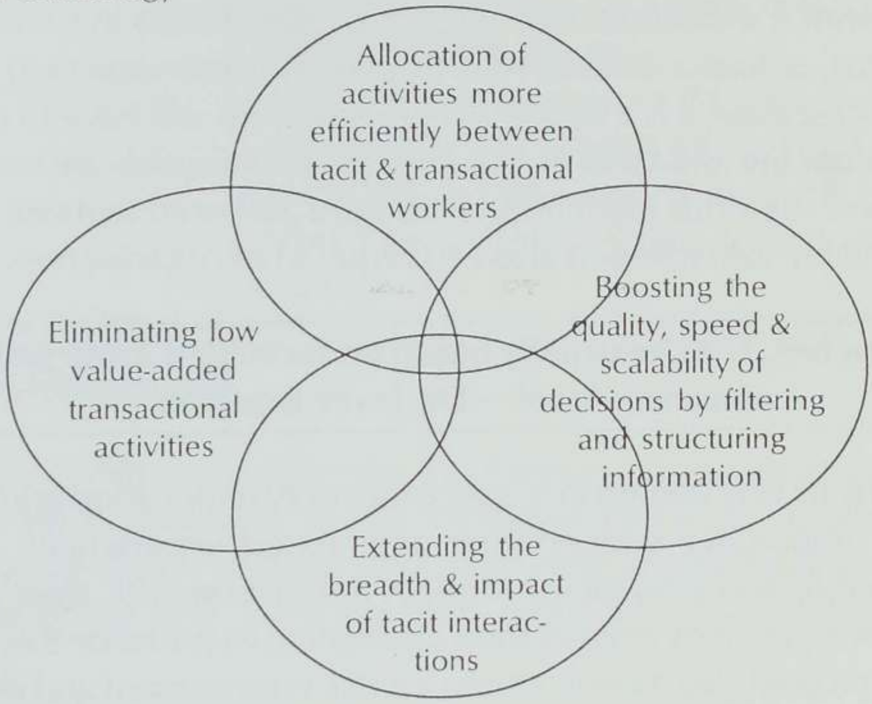
This rise in the tacit work force, and the decline in transformational and transactional roles, demands new thinking about the organisational structures that could make the best use of this shifting blend of talent.

[7] Bradford et al (2005) The next revolution in Interactions. The McKinsey Quarterly (no 4).
[8] B.Johnson, J.Manyika & L.Yee, (2005) The next revolution in interactions. The McKinsey Quarterly (no.5)
[7,8&9] B.Johnson, J.Manyika & L.Yee, (2005) The next revolution in interactions. The McKinsey Quarterly (no.5)
[10] B.Johnson, J.Manyika & L.Yee, (2005) The next revolution in interactions. The McKinsey Quarterly (no.5)

After decades of using technical, procedural and hierarchical methods for managing employees, ones that often treated workers as exchangeable and easily renewable commodities, a move that considers them as a vital company asset, intrinsically linked to their competitive advantage, is indeed a significant shift in thinking for most employers.

Whilst the research and practical knowledge around the management of tacit employees is still in its infancy, there is a compelling band of evidence[11] that strongly insists upon a change in the way we approach performance improvement in the work place. With the great advances being made in technology and its widespread availability today, the new thinking in management recommends its use to boost the work of employees in a number of ways.

Figure 5 - New use of Technology[12]



Technology could be used to enhance and extend the work of tacit labour. (see Figure 5 above)

1. The removal of low value added transactional activities that keep employees from engaging in higher value work is an obvious area. For example, in the high street bank, the use of automatic cheque paying in facilities would free up banking clerks to maximise their contact time in other problem solving and advising activities with customers.

2. Technology can be used for the efficient allocation of activities between tacit and transactional workers. Transaction workers for example, with the help of automated tools, could help customers diagnose and solve general problems, then if no solution is found, could be directed towards a tacit worker.

3. Easier access to high quality & up to date filtered and structured information would save a lot of time for employees who require the information at hand for their decision-making process. Tailored information from data-bases on customer trends, general and personal,

[11]&[12] "The Role of Tacit Knowledge in Group Innovation", Dorothy Leonard and Silvia Sensiper, 1998

would help tacit employees provide a unique service to their clients, for example, in a quick and accurate way.

4. Technology (such as broadband, video-conferencing and collaborative software) can be used to great effect to facilitate the all important communication process between tacit employees, customers and suppliers, to share ideas, interact and collaborate among communities of interest, within and outside of the company.

Technology – no longer a panacea for all

However as stressed throughout this article, technology alone will not be able to enhance productivity in the 21st Century. Procedural techniques, as used in the past for improving productivity, were designed mostly with transformational and transactional roles in mind. Whilst technology helped, even in the past, it had a limited role to play in improving tacit roles. Thus as the importance of tacit roles escalate, it is a reality that organisations will have to change the way they manage their staff to encourage and facilitate this growth. Tacit models are however new territory, but it is clear that any new methods identified, developed and used to make the best use of tacit interactions would be highly valuable and also be unique to its organisation.

'Trust your hunches. They're usually based on facts filed away just below the conscious level' – Dr. Joyce Brothers

Tacit knowledge, by its very definition is 'subconsciously understood and applied' and usually 'shared through highly interactive conversation and shared experience'. Thus creating and exchanging this knowledge and intangibles through interaction with their peers is at the very heart of what these workers do. Any organisation attempting to promote this process of in-house creativity and innovation would also have to create a fertile environment and organisational culture to encourage such growth.

Bryan & Joyce[13] argue that today's big companies are actually ill–equipped to handle their tacit workers, and describes the typical vertically organised hierarchy as one of the most significant barriers to tacit worker productivity. They for example, highlight problems encountered by professionals who, having worked together (horizontally) with peers, must then search for expert knowledge or collaborators (vertically) up the hierarchy, and negotiate for their support. Worse still, they suggest, are those matrix structures where the worker must appease two bosses, each with divergent agendas. Leonard and Sensiper[14], add that in vertically arranged management structures, knowledge and wisdom are assumed to be endowments accrued at the top of the hierarchy. But when managing tacit workers, who are in themselves experts in their respective areas, this basic presumption does not typically hold true. Consequently, different assumptions and strategies must be used to support the productivity of the 21st Century work force.

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[13] L. Bryan & C. Joyce (2005) 'The 21st Century Organization' The McKinsey Quarterly (no.3)

[14] "The Role of Tacit Knowledge in Group Innovation", Dorothy Leonard and Silvia Sensiper, 1998

See Figure 6 below for some of these authors' observations on organisational barriers to the sharing of tacit knowledge[15].

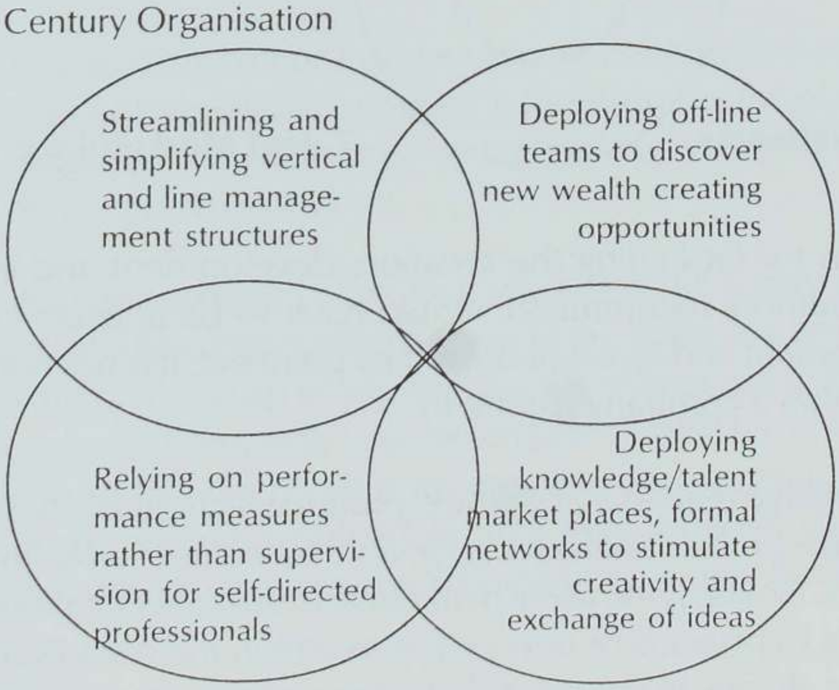
Figure 6 – Organisational Barriers to sharing of tacit knowledge

Organisational Barriers	to Sharing of Tacit Knowledge
Hierarchies	when they implicitly assume wisdom accrues to those with the most impressive organizational titles
Strong preferences for analysis	discouraging employees to offer ideas without "hard facts" to back it up
Penalties for failure	discouraging experimentation
Communication	Strong preferences for a particular type of communication within working groups
Fear of expression	Fear of failing to express the inexpressible when trying to convert tacit knowledge into explicit one
Status	Inequality in status among the participants is a strong in hibitor for tacit knowledge sharing, especially when exacer bated

A new Organisational model

Bryan & Joyce[15], in their writings on the 21st Century organisation, suggests that companies by modifying the vertical structures of the traditional hierarchy to allow different groups of professionals to focus on clearly defined tasks, with clear accountability, can heighten the value of those who collaborate and innovate with peers to create a competitive advantage. (see Figure 7 below)

Figure 7 - The 21st Century Organisation



15 "The Role of Tacit Knowledge in Group Innovation", Dorothy Leonard and Silvia Sensiper, 1998

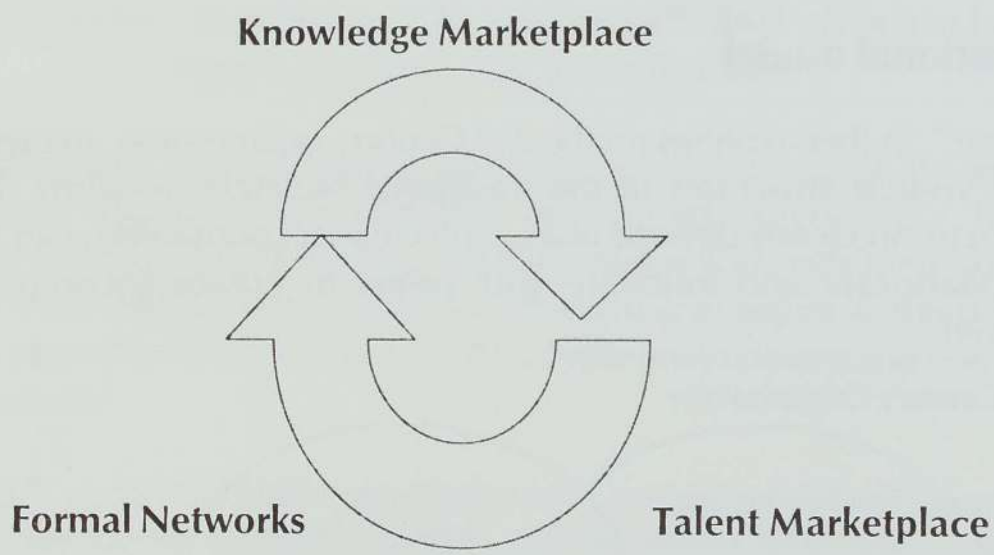
16 L. Bryan & C. Joyce (2005) 'The 21st Century Organization" The McKinsey Quarterly (no.3)

These authors recommend that a company must establish a clearly dominant axis of management and eliminate the matrix and ad hoc organisational structures that often muddle decision-making authority and accountability.

Once the vertical structures have been simplified, they propose that line managers be allowed to limit their attention to meeting near-term earning expectations, whilst having other professionals focusing on the long-term creation of wealth. These authors argue that long-term ideas creation require a different mindset (one that is allowed to wander) to the short-term/ routine day-to-day living mindset. And as such should be allowed their separate operating spaces. They suggest that, once an initiative is ready to be scaled up, they can be placed in the main line structure.

The development of in-house markets and networks, these authors suggest, will help its professionals work horizontally across the whole organisation – 'exchanging knowledge, collaborating and developing communities that create those intangible assets'. The establishment of a knowledge market place, talent market place and formal networks, each mutually supportive of the other, it is suggested, would help companies work horizontally in a very cost effective way.

Figure 8 - Investing in creativity



The above mechanism for facilitating the creation, development and exchange of tacit knowledge, is one that its authors recommend, would have to be actively created within an organisation, with encouragement and investment, as they point out, it is not necessarily a system that would naturally exist within a company (Figure 8).

For example, the knowledge market place would produce high quality 'knowledge objects' as the 'buyers' (other in-house professionals) must be able to access easily, information that is insightful and relevant to them. Similarly, the talent marketplace must offer employees opportunities to seek and offer their talents to projects or new positions within the organisation. There are of course many formal networks already in existence that bring people with similar interests in to the same forum, however, company investment in to them would boost their value by formalising its role within the organisation.

The final set of ideas for the 21st Century organisational model surrounds performance measures. In the old model, supervisory evaluation was the industry norm. However, in managing tacit workers, who are specialists in the areas of their profession, a certain degree of self-direction is recommended. It has been suggested that 'performance metrics, protocols, standards, values and consequence-management systems' would be more effective in managing tacit workers, as such an approach would enable these workers to problem solve using creativity and lateral thinking, in a way that best suits the situation – and bring the best competitive advantage to the company.

Inspired leadership, rather than intrusive management, is the way forward for increasing the productivity of future professionals. These authors suggest that it will become increasingly important to motivate, measure and reward collaborative behaviours in individuals. Workers who are effective at developing the abilities of other talented people or at contributing distinctive knowledge, would be more highly valued in the new organisational model, than those who are equally good at doing their own work but not at developing talent or contributing knowledge.

So, as we race towards the end of the first decade in the 21st Century, it is already becoming clear that we are in need of a different approach to managing the changing face of our modern work-force. As workers become increasingly dissatisfied with outdated management practices, reminiscent more of the Victorian era, it leaves them feeling 'unfulfilled' and 'unappreciated'. Thus the onus has returned to the employer to **select** the best and **develop** and **manage** and **retain** them effectively within the organisation.

Aided by technology, but no longer controlled by it, the management of the knowledge worker, is hugely reliant upon employers appreciating the unique contribution they can and do make to their organisation. At a time when turn over is high, employers must remember that tacit knowledge is protected from competitors only whilst it remains with the organisation, and when key individuals leave, this valuable knowledge is lost to the competition!

In Sri Lanka, as in many other fast developing economies, we have the luxury of learning from the experiences of the older economies in the West. As the playing field equalises, with our expanding knowledge, significantly aided by technology, we must adapt faster and better to the changing forces of the global economy.

The effective management of the tacit worker is still a very new concept to the modern organisation. Many leading organisations, even in the West, are only just realising that they must address this need are on the cusp of exploring ways of harnessing this huge in house energy. It is an energy that all organisations, with talented employees will have, and although we do not as yet have a direct line in to this energy, it is an area that all organisations must seriously consider. Those who are brave enough to invest in their tacit workers stand to gain the 21st Century advantage - one that will surely place the Sri Lankan economy back on the global map.

INTEREST SPREAD AND THE ECONOMIC IMPACT

By Niroshana Seneviratne

Assistant Vice President NDB Group

INTRODUCTION

Undoubtedly, the banking sector plays a pivotal role in the economy, essentially functioning as the market intermediary and the creator of credit. The core banking activity has been to mobilize deposits by paying interest and lending such funds and earn interest. With the liberalization of the interest rates, the banks are given the full autonomy to decide on their deposit and lending rates (interest spread).

Just a snap look reveals that the average saving rate being around 7% and the short term lending rate around 19%, the banks being the market intermediary enjoys a clean margin of 12%. This seems a little high considering the real return of the depositors in an inflationary market scenario. Comparative statistics suggest that the spreads applied by the newly industrialized countries is even less than 2%.

Interest Spreads and Margin

The prevalent practice among banks is to maintain a wide interest margin in order to compensate for cost inefficiencies and to report high profits. As such, banks tended to change lending rates and deposit rates in such a manner that ensures a minimal impact on the interest spread, thus enabling them to achieve higher profits. As a consequence, the interest spread displayed only a marginal decrease (Chart 3.17)

A tendency to maintain a high interest spread is evident, although the interest spread band of the LCBs had narrowed by September 2006 (Chart 3.17). Despite displaying a reducing trend over the last two years, the interest spread of the Sri Lankan banking sector is still considered to be high, at 3.7% by regional standards.

(Financial System Stability Review 2006, Central Bank of Sri Lanka pg 33

The writer attempts to identify the possible reasons for the thicker margins solicited by the banking sector in Sri Lanka and to analyze the possible impact on the economy by the application of the above.

It was not an easy task to find the relevant reliable statistics nevertheless the statistical information does not reflect the real situation as it tend to average results and includes approximations. However, statistics have been used wherever possible to support the views expressed, based on the available minimum information. The views expressed in this article are purely the writer's personal observations.

SPREAD ATRIBUTES

The commercial banks, essentially being market intermediaries, enjoy healthy margins which have been clearly reflected in their financial results for the last few years. Commercial banks have shown a steady growth in their profitability, with a tremendous growth in their respective balance sheets.

A closer look at the profitability of the commercial banks for the year ended 31st December 2006 suggest that, quite a number of banks have exceeded the LKR 1 billion mark in their profits. Probably identifying the growth potential of the sector, under budgetary measures too, various sector specific taxes have been imposed by the government which effectively in toto, well exceeds 60%.

Interest spread, the difference between what a bank earns on its assets and what it pays on its liabilities, of the banking industry has been on the rise for the last few years. A closer look at the available statistics suggest that, the banks have been spreading their margins steadily throughout, indicating probably the stability of the financial sector.

The **Table 1** below indicate the spread between the Average Weighted Deposit Rate (AWDR) and the Weighted Average Prime Lending Rate (WAPLR) from 2004 to 2007 (1st Qtr) which clearly indicate a rising trend. The average spread of 4.86% in 2004 has risen to 11.75% in 2007 (up to 1st Qtr), more than 140% increase.

Table 1
Average Interest Spread

Period	Average Weighted Deposit Rate AWDR	Weighted Average Prime Lending Rate WAPLR	Average Interest Rate Spread
2004	5.31	10.17	4.86
2005	6.24	12.14	5.90
2006	7.60	15.19	7.59
2007*	8.26	20.01	11.75

** Upto March 2007*
Source: Central Bank of Sri Lanka -Bulletin -April 2007

On average, interest bearing deposit rates vary from 5% to 15% p.a., where as average lending rates vary from 13% to 30% p.a in times, even more. The Weighted Average Prime Lending Rate (WAPLR) displayed above is the average lending rate of the banks to its prime (best) customers, in reality, few in number. It suggests that in reality, the banks enjoy even higher margins.

The probable reasons for the thicker margins could be attributable to,

i) Interest Insensitivity of Deposits
ii) Lucid Behavior of Depositors
iii) Market Structure of the Industry
iv) Average Size of the Transaction,
v) Pressure for Profitability
vi) Quality of Lending
vii) Opportunity Cost of Holding Mandatory Reserves
viii) Impact of Tax
ix) Economic and Market Conditions
x) Probably the Inefficiency in the Processes.

i) Interest Insensitivity of Deposits

A closer look at the industry statistics reveals that domestic savings have remained almost unchanged despite the increase in the interest rate spreads by the banks. Interest spreads of the banks have increased to 11.75% in 2007 from 4.86% in 2004. However it seems to have not impacted the domestic savings which suggest that the domestic savings are interest insensitive or interest rate inelastic.

The interest inelasticity of deposit supply to the banks or the interest insensitivity of deposits (bulk of the core deposits) would have been a possible contributing factor for the higher spreads of interests. Theoretically, changes in the T-bill rate are passed on to the deposit and lending rates of the banks. Greater the inelasticity of deposits, the less compelled a bank would be to pass on the increase in T-bill rate to the deposits.

At the time of writing this article (August 2007) the average 3 months treasury bill rate is around 17.25% whereas the three months average deposit rate is around 14%, if the deposits were interest elastic, theoretically the banks would have to pay an interest rate above the T-bill rate to compensate the extra risk the depositor is willing to accept.

It could be argued that the high level of inelastic deposit supply leaves little incentive to the bankers to adopt competitive rates there by not impacting the spreads. It is felt that the emergence of alternate financial intermediaries is essential for lowering the spreads.

In reality, as explained in detail later, the depositors have been receiving negative real returns for the last few years though there has been a noticeable growth in the deposits.

ii) Lucid Behavior of Depositors

Greater the interest spread by the banks, lower the interest rates paid on the deposits. The interest sensitive depositors, mostly the high net worth depositors would read it as a disincentive to save. They would probably withdraw and invest in real assets creating a temporary drop in the bank savings.

However, the person who receives the money in return for the exchange of his assets, would immediately invest them back in the banking system even at lower interest rates, squaring off the position created earlier.

The ultimate end result is the deposits only changing hands, without any impact on the saving base of the banking system.

In a developing economy, the application of so called economic theory that the drop in deposit interest rates, discourage savings, thereby enhance investments, may not fully operational without the other market ingredients such as required infrastructure, incentives, minimum bureaucratic delays, tax concessions etc and the economic growth as a whole.

iii) Market Structure of the Industry

Almost 60% of the commercial banking deposits being well secured with the two state banks, they are at a higher leverage in manipulating the deposit rates. As stated above, the depositors freely attracted to the two state banks having the sovereign backing as merely safe deposits and not as investments. State banks while dominating the market therefore in an advantages position to suppress the deposit rates.

On the other hand, the non performing advances ratio as a percentage of the total advances of the two state banks, on average is well over 10% which invariably results in higher costs, profitability and liquidity related issues. The cost income ratio of the two state banks well exceeds 70% which again results in increased cost of funds.

Even if there is pressure from the government and Central bank, the high cost of funds of the two state banks prevents them from reducing the margins. This would probably help the other banks to capitalize on the margins.

iv) Average Size of the Transactions

It could also be due to the comparative smaller average size of deposits that invariably lead to increased transaction cost. Banking sector in Sri Lanka, in general concentrate in retail banking operations, where, average size of a transaction is small. Sri Lanka being a developing country, though there is a comparatively higher domestic saving rate, major part of it is from the small timers. The disparity in income distribution too suggests that most of the savers save in smaller quantities increasing the volume of transactions leading to high maintenance cost to the banks.

v) Pressure for Profits

It is quite evidenced that the banking sector, specially the private sector is pressed for profits, if not, to enhance shareholder wealth. With the prevailing economic and interest conditions, shareholders expect a comparatively high rate of return on their investments. The financial sector, especially the banking sector has managed to keep upto the expectation of their stake holders.

The average T-bill rate being around 17%, the inflation well exceeding 18%, the shareholders expects a minimum return of at least 20% which the banks may be struggling to fulfill under inflationary economic conditions coupled with an environment not so conducive for investment.

17 August 2007 09:07:34 Lanka Business Online

Sri Lanka banking sector grew 9.5% in first half of 2007: CB

August 17, 2007 (LBO) – Sri Lanka's banking sector assets had expanded 9.5 percent, with loans rising 11.2 percent against deposit growth of 7.6 percent, the Central Bank which regulates the sector said.

"Banking sector has shown a significant expansion during the first half of 2007 reflecting continued expansion in economic activity,".

Performance

Assets had grown by 203 billion rupees. Loans grew by 144 billion rupees outpacing total deposits, which grew by 114 billion.

Banks had earned a pre-tax profit of 26 billion rupees, up 23 from 21 billion last year.

"This profit growth has led to increase the return on assets from 2.2 percent to 2.3 percent," Central Bank said

Number of banks have well exceeded the LKR 1billion mark giving positive signals to the shareholders to demand more. Shareholders, in general, expect positive growth over previous performance and hence the bankers are compelled to keep up to that expectation.

Such pressure for enhanced profits may too have probably contributed to the fatter margins that the banks currently set.

vi) Quality of Lending

The stringent rules on non performing loans (NPL) has a direct impact on the profitability of the banks, both from the provision and write-offs and suspension of interest. In addition to the long practiced specific provision the introduction of the general provision too has burdened the bankers though prudent in application.

Non performing advances while curtailing the credit creating ability of the commercial banks push the banks towards liquidity and cash flow related issue. A loan that was expected to be settled in 2-3 years would not bring in the expected liquidity if the loan becomes NPL leading to liquidity gaps.

The impaired advances portfolio due to NPL, increase the asset risk weight thereby adversely affecting the adequacy of capital.

The bankers are therefore, probably compelled to recover that additional burden on the financials through the enhancement of the interest spread. The end result being the creditworthy borrowers indirectly paying for the defaults of a few.

17 August 2007 09:07:34 Lanka Business Online

Asset Quality

Non-performing loan ratio was around 5.7 percent, with high loan growth. Credit card advances had grown three billion rupees (10 percent) and non-performing loans were around 6 percent. Capital funds had increased by 21 billion (13 percent) giving a better cushion for risks, the Central Bank said.

Prudential Measures

The Central Bank had also implemented prudential measures to reduce risks by imposing a one percent general provision of performing advances to be charged at 0.1 percent per quarter over ten quarters starting in December 2006.

Authorities had increased capital levels by raising risk weights relating to some banking assets. Authorities had increased the risk weights applicable to some banking assets requiring the banks to maintain a higher level of capital and advised banks to curtail lending for consumption.

The Central Bank was also periodically monitoring bank credit delivery at targeted levels in line with monetary policy framework, maximum lending limits of banks to reduce credit concentration risk

vii) Opportunity Cost of Holding Mandatory Reserves

As per the CBSL regulations, 10% of the deposits that have been mobilized as deposits have to be kept with the central bank as Statutory Reserve Requirement (SRR). This balance as per the **Table 2** below is a significant amount for the banking system amounting to LKR 82.2 billion as at end March 2007.

Banks while incurring an interest cost on one hand against the above balance, lose the opportunity of lending them in the market on the other hand resulting in a significant income loss. One can argue that to compensate the lost interest, banks are compelled to keep a reasonably thicker margin of interest.

Table 2
Reserve Position of Commercial Banks

Rs. Millions

Period	Required Reserve (SRR)	Cumulative (SRR)
2004	55,965	391,754
2005	67,328	471,296
2006	79,081	553,569
2007	82,268	575,878

Source: Central Bank of Sri Lanka Bulletin April 07

viii) Impact of Tax

Despite the contribution that the banks make towards the economy, successive governments have used the banks as a means of bridging the fiscal policy gaps through subjecting to excessive taxes.

Banks at present are subjected to Income tax, Value added tax, Withholding tax, Debit tax, Financial Services VAT which in total well exceeds 60%. In addition banks are subjected to stamp duty which too is a main source of government revenue.

The excessive taxes may possibly compel the banks to keep fatter margins.

ix) Economic and Market Conditions

The prevailing economic conditions with high inflation and interest rates have probably compelled the banks to enhance the spreads to keep in line with the demanding pressure from the investors. When the market interest rates are on the rise, expected return of the shareholders too would be relatively high. Both shareholders and long term lenders therefore expects a higher return for their investments

Similarly, in an unsettled economy with political instability, investors generally adopt a "wait and see" attitude, hence, would not part with their funds if not for higher returns to adequately compensate.

Under inflationary conditions, the risk of default by the borrowers to the bank would be on the rise specially the credit card related transactions.

Therefore, the banks would be consciously setting their interest spreads to compensate the possible loss.

x) **System Inefficiencies**

Except for few, most of the banks' cost/income ratios are well over 60% which is comparatively a high proposition. The cost income ratio of two state banks well exceeds 70%. The heavy cost of process duplications, inefficiencies, delays in decision making etc, have contributed towards the swollen operating cost.

Sri Lanka, as a country seems to have the highest number of holidays or non working days which would probably a highest contributor for the rising operating cost. On average during 2007, more than 125 days, (35%) of the time, the banks are closed, during which period the interest accruals and salary accruals continue to work.

A detailed analysis of some of which could probably help reduce the cost tremendously. It is felt that, banks in general, without having a critical look internally, have conveniently passed the burden to the depositors and borrowers through the adjustment of the spread.

COMPARATIVE STATISTICS

Average Interest Spread – Regional Comparison

An attempt to compare the sector statistics with a cross section of the region suggests that we have been maintaining the highest spreads throughout the past few years. The **Table 3** below for selected countries in the South East Asian region for 2006 suggest that countries like Korea and Taiwan being the leading industrial countries in this region, had managed to maintain the interest spreads below a bear minimum of 2%.

Myanmar being an exception giving the highest deposit and lending rates in the region still managed to maintain an average interest spread of 5%. Singapore and Malaysia being leading economies operates with a spread of 4.4% and 2.98% respectively.

The comparative figures for other regions too suggest similar proposition which I feel therefore needs a closer scrutiny.

Table 3
Average Deposit and Lending Rates for 2006

	Deposit Rate	Lending Rate	Interest Spread
Korea	4.47	5.89	1.42
Taiwan	2.06	3.95	1.89
Thailand	4.75	7.50	2.75
Malaysia	3.74	6.72	2.98
Philippines	6.32	9.92	3.60
Singapore	0.89	5.30	4.41
Myanmar	12.00	17.00	5.00
Nepal	2.25	8.00	5.75
Sri Lanka	**7.60**	**15.19**	**7.59**

Source: Central Banks, CEIC and IMF International Financial Statistics, 2006

THEORETICAL PERSPECTIVE

Negative Real Return

Real Return = Nominal Return - Inflation

Negative Return (10.34%) = AWDR 8.26% - 18.6%

Theoretically, the real return from an investment is the nominal return less the inflation rate. The application of the above principle to the depositors indicates a negative real return. The attribution of AWDR and the current inflation rate of 18.6 (As of March 2007 CBSL bulletin) to the above formulae suggest that the depositors receive a negative real return of 10.34%

A simple explanation suggest, at a static inflation rate of 18% and an AWDR of 8.26% that, a Rs.1000 worth of a good would be Rs.1,186 at the end of one year from now, where as a Rs.1000 deposit would grow upto Rs.1082.60 thereby incurring a loss of Rs 103.40.

The **Table 4** below suggests that the average real return of investors for the last four years have been negative. The negative real return has been on the increase over the years. However, it is interesting to note that the total deposits have been on the increase (Refer Table **Table 2**).

It is a clear endorsement of the fact that most of the deposits are interest inelastic.

Table 4
Average Real Rates

Period	(AWDR) Average Nominal Rate	Average Inflation Rate	Average Real Rate
2004	5.31	8.67	(3.36)
2005	6.24	10.85	(4.61)
2006	7.60	16.25	(8.65)
2007	8.26	17.56	(9.30)

Source: Central Bank of Sri Lanka Bulletin April 2007
Source: Central Banks, CEIC and IMF International Financial Statistics, 2007

At this juncture, one could raise the obvious and sensible question "so why do they save?" which I believe is related to the cultural and social upbringing of the depositors. In fact, the current T-bill rate (17.25%) is attractive than the bank deposit rate, still why aren't they invest in T-bills. May be the lack of awareness or ignorance at which expense the banks are benefiting.

The comparative position in the **Table 5** below suggest that Myanmar, Korea and Thailand indicates positive real returns to investors where Sri Lanka leads the list with highest negative return. If not it suggest that something is fundamentally wrong in the interest structure of the banking sector in Sri Lanka.

Table 5
Average Real Return

	Deposit Rate	Inflation Rate	Real Return
Myanmar	12.00	9.30	2.70
Korea	4.47	2.60	1.87
Taiwan	2.06	1.70	0.36
Malaysia	3.74	3.90	(0.16)
Singapore	0.89	1.10	(0.21)
Philippines	6.32	6.70	(0.38)
Thailand	4.75	5.60	(0.85)
Nepal	2.25	7.90	(5.65)
Sri Lanka	**7.60**	**17.70**	**(10.10)**

Source: Central Banks, CEIC and IMF International Financial Statistics, 2006

Risk Return Disparity

In portfolio theory, Capital Asset Pricing Model (CAPM) suggests that risk and return are positively related. The investors expect extra premiums of return for the additional risk that they are willing to take.

In a rising interest rate scenario, the government offering a higher rate, with theoretically zero risk would probably push the risk free return of an investor up. With the increased market volatility, the average market return too would be on the rise where the impact from the market beta would further put upward pressure resulting in higher expected return from similar investments.

$$R_e = R_f + \beta(R_m - R_f) \longrightarrow \text{CAPM}$$

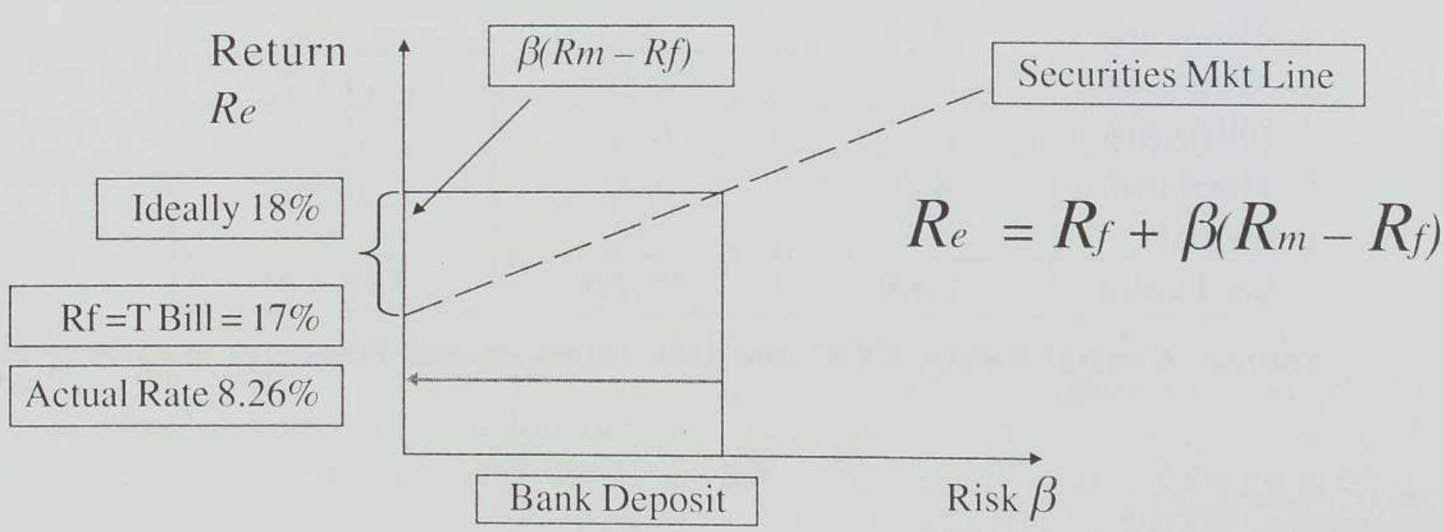
Where R_e is the Expected return or the cost of equity, R_f is the risk free rate of return, R_m is the expected return on the market portfolio, and β is the measure of the responsiveness of the portfolio to the market risk.

The $\beta(R_m - R_f)$ of the above formulae is the additional premium that an investor expects for the additional risk that he undertake.

The risk free return R_f could be attributable to the average T bill rate (17%) as fully backed by government. However, the investment in bank deposit theoretically is more riskier than the sovereignty of the state hence the depositor should be paid an additional premium $\beta(R_m - R_f)$ for the additional risk.

As shown below in the diagram, the risk free return being at 17%, and the bank deposits carry additional risk for which the depositors should be ideally paid an extra premium, say 18%.

However, it is evident from the past statistics that the depositors on average are only paid 8.26% creating a disparity in the interest rate structure, which cannot be explained through fundamental risk return theories.



POSSIBLE IMPACT ON THE ECONOMY

The increase in the interest spread discourages savings and deposits on one hand, and discourages borrowing on the other hand. Either way, it affects the economy adversely.

Excess Units (Depositors)

To keep the spreads thicker, the banks would offer lower interest on deposits discouraging saving and encouraging consumption probably leading to 'demand- pull' inflation. As argued earlier, the impact is not much visible as most of the small time depositors are non interest sensitive. The resultant impact is the discouraged saving (not getting the anticipated growth), as evidenced in **Table 2**.

The savers are now either compelled to spend them on consumption leading to demand pull inflationary impact on the economy, or look for other avenues that would give them an extra premium creating an informal market. Both propositions lead to adverse impact on the economy.

Deficit Units (Borrowers)

On the other hand the banks would push up the lending rates increasing the borrowing cost of the producers probably leading to cost push inflation.

Relatively high borrowing costs would discourage business investment there by suspending or postponing the possible economic trigger activity where the operation of the economic chain, come to an end.

Generally, when the business investment enhance in an economy, increased production and cost effective operation would have a downward pressure on the inflation while activating a chain reaction in the economy. Enhanced production makes way for job opportunities and speedier circulation of money resulting in economic growth.

Disintermediation

The traditional role played by commercial banks in an economy has been essentially, to act as the market intermediary. The commercial banks have been the linking pin of deficit and excess units in the market. Todate, the core banking activity of commercial banks is the mobilizing of deposits and lending them in the market though they provide other services over and over the core activity.

However, it is noted that the bankers are now facing a dilemma of attracting both depositors and borrowers to the banking sector as they (depositors & borrowers) have now taken a different route. Those depositors who are interest sensitive would look for higher interest and route their funds to other non banking institutions both regulated and non regulated.

The banks now seems desperately offering various benefits such as draws with houses and vehicles on offer, travel packages, insurance etc without critically looking at the process fundamentals and adjusting the spreads. The cost of such offers ideally should have been added to the interest cost but may not be rationale as the benefits are offered only to a few selected depositors.

Creating an Informal Market

The most damaging is the informal market created, the money lenders, where the collections and their incomes are unaccounted. The risk being, the market is not regulated, not subjected to taxes etc and the secondary economy created beneath. The traditional regulatory tools available to CBSL such as credit sealing, "moral suasion" etc would have little or no impact as far as these markets are in existence.

There seems to have no statistics of existence of such a market all of us are aware of. In the absence of statistics, the writer is unable to comment on the deposit base of the informal market participants, but it is the gut feeling that a considerable percentage is well secured by the informal players in both in deposit taking and lending.

The informal lending market is hassle free, less documentation (not at all) and prompt. Though the interest is little high the needy borrower serves his purpose with no time. It was also evidenced that the recovery process too of the informal lenders are very prompt as the consequences of non payment probably would be invaluable.

Interest Rates

With the deregulation of the financial market in Sri Lanka, the financials sector, specially, the individual banks are given the autonomy to decide on their lending rates. Banks by widening the spreads have unnaturally set the lending rates at higher levels. The high lending rates in the market probably send a wrong signal to the economy. High borrowing costs may discourage investments, while creating inflationary pressure through heavy production costs. It leads to issues with unemployment and curtail development in the economy.

CONCLUSION

The available Statistics revealed that the spreads have been on the rise in the country and the comparative statistics suggested that ours was in the highest in the region. However one can reason out that the country is agricultural based and yet developing, hence spreads need to be comparatively wider. Of course, as explained above, there are few justifiable reasons for the higher margins solicited by the banking sector.

The economy that is not that conducive for investments with rising inflation rates coupled with unsettled state of the north and east would pressurize the banks for wider spreads. With the government borrowing at 17%, shareholders expects a minimum return of at least 20% which seems not practical if not for widening the interest spreads. Advances to Deposit ratio of the banks possess a sizeable issue for the banks where some of the banks have exceeded their respective cap with excess advances, obviously funded through market borrowings at higher cost.

The possible negative impact on the economy through the wrong signals that it sends to the market is sensitive, if not uncalled-for of a sector vital for the proper conduct of the economy. Specially the process of disintermediation leading to creating a informal market is a sensitive issue which need immediate corrective action.

The writer strongly felt that it is time that as part of the corporate social responsibility, the bankers now get together, probably with representation from the regulator, closely review the interest structure and advocate corrective action for the betterment of the industry and the economy as a whole.

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IMPLEMENTATION OF PILLAR 2 OF BASEL II – THE NEXT CHALLENGE TO THE BANKS AND SUPERVISORS

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1. Introduction

The Basel Committee on Banking Supervision (BCBS) ("Basel Committee"), the international standard-setter in the field of banking supervision issued a revised framework on capital standards for banks in June 2004 titled "International Convergence of Capital Measurement and Capital Standards – a Revised Framework". Popularly known as Basel II, the revised framework is intended to replace the existing capital framework for banks (now known as Basel I), which revealed several drawbacks. The new framework is a landmark regulatory framework offering a newer and comprehensive approach and methodology for financial sector regulatory capital calculation, which recognises the advancements and innovations in banks' businesses, policies and structures and the accompanying financial engineering and innovations. Due to the comprehensiveness and complexity of Basel II, it has taken several years of consultation and quantitative impact studies before finalization.

Under Pillar 1 of Basel II, the computation of the capital ratio has been substantially revised, but what is of greater significance, perhaps is the introduction of two new dimensions in the form of Pillar 2 and Pillar 3. The three pillars complement each other and are mutually reinforcing.

Since the publication of Basel II, banks and regulators over the world have been pre-occupied with various aspects relating to Basel II. Whilst issues such as when to adopt Basel II, which approach/method to use for capital allocation under Pillar 1 have been mostly sorted out, an area that is still under discussion is the application of Pillar 2 of Basel II, the supervisory review process. Being an integral part of Basel II, Pillar 2 poses challenges to the banking industry and the regulators. This article attempts to review the requirements under Pillar 2 of Basel II, and how best the banks and regulators could face the challenges posed under Pillar 2.

2. The Basel Capital Adequacy Framework

Capital is a key component of any prudential supervisory regime to measure the soundness of banks. Banks need to hold capital as a buffer against risk. Capital provides a cushion to absorb losses and acts as a buffer against risk, thus ensuring the safety and soundness of a bank. It also provides a foundation for future growth and is used as a benchmark against which the financial condition of banks can be measured. However, maintaining an optimum level of capital against a prudent level of risk - return is the challenge for the banks.

The 1988 Basel Capital Accord (Basel I), was a milestone in the risk-based approach to regulation and provided a yardstick for the comparison of banking institutions across the world. Though largely accepted and adopted by more than 100 countries, the simple, "broad brush approach" of Basel I made it ineffective in capturing the actual risk of banks and created opportunities for regulatory arbitrage. Its very simplicity rendered Basel I obsolete since it did not factor in the vast strides made by the internationally active banks in the area of risk management. Basel II is the response of the BCBS with regard to lengthy consultation in this regard.

3. Brief Overview of Basel II

As it is commonly known, Basel II comprises of three mutually reinforcing pillars, namely Pillar 1: minimum capital requirements, Pillar 2: supervisory review process and market discipline as Pillar 3.

Pillar 1 – Minimum Capital Requirement:

Pillar 1 relates to the computation of the capital ratio and is the direct replacement of the existing Capital Accord, Basel I. The capital ratio includes an explicit capital charge for credit, market and operational risk. A menu of approaches is available for the computation of the capital charge for each risk.

Pillar 2 – Supervisory Review Process:

Under the second pillar, banks should have their own internal capital assessment processes to capture risks that remained uncovered under the first pillar and thus maintain capital in line with the bank's risk profile and risk management environment. The supervisors are expected to validate the internal capital adequacy assessment process of the banks to ensure that banks have captured all the risks in their business. Where the supervisor assesses that the bank's capital assessment process does not capture all its risks, the supervisor is expected to intervene and recommend early corrective action.

Pillar 2 is also expected to encourage banks to develop and use better risk management techniques including the setting up of a separate risk management function in banks for the prudent management of all material risks.

Pillar 3 – Market Discipline:

The third pillar seeks to enhance disclosure and transparency by strengthening banks' financial reporting system and by encouraging market discipline and allowing the key stakeholders to assess key pieces of information on the scope of application, risk exposures, risk assessment processes and capital adequacy of the institution. Pillar 3 complements and reinforces the first two pillars and infuses market pressures to bring in better risk management techniques and to maintain adequate levels of capital in the banks and enables them to take prudent and more informed decisions in banking.

Blended together, Basel II is not only a risk-based capital framework, but also an entire risk-based supervisory framework, which allows banks to operate in a more prudent manner, leading to the stability of the financial system.

4. The Second Pillar of Basel II

Under Basel II, a bank's *total* capital requirements are ultimately subject not just to Pillar 1, but also to regulatory review under Pillar 2. Risks that are not easily quantifiable under Pillar 1 are addressed in Pillar 2, which seeks to promulgate a comprehensive set of good banking and risk management standards. Further, the effective implementation of Pillar 1 requires the support of Pillar 2. Therefore, greater focus and priority should be placed on Pillar 2 with regard to Basel II implementation.

4.1 The Rationale for Pillar 2

The starting point and the emphasis of Pillar 2 is the bank's internal capital adequacy assessment. Pillar 2 is intended to;

a. Encourage banks to utilize better risk management techniques – the level of risks a bank is exposed to, and the control environment will determine the level of capital required to be maintained by banks

b. Encourage supervisors to enhance risk-based supervision – in order to assess the capital adequacy relative to risks, the supervisor has to enhance the risk-based supervision of banks. Given the nature of supervision adopted by most regulators, which has become increasingly risk-centric, the Pillar 2 process will be an extension and a refinement of the existing supervisory process, rather than a radical change.

c. Focus on internal, not regulatory capital – the supervisor will be evaluating the bank's internal capital adequacy assessment process (ICAAP) that determines the level of capital to be maintained. Thus, all banks are expected to have such an assessment process or ICAAP in place.

d. Ensure that banks have adequate capital to support *all* risks – the bank's internal capital assessment should take into account all the risks facing the banks including those risks not captured under Pillar1 and where the capital is not adequate, supervisor is expected to intervene early to restore capital to the required level. This will foster an active dialogue between the banks and the supervisors regarding the assessment of capital adequacy and risk management standards.

e. Accommodate differences between banks - the level of risks inherent in the bank's operations will determine the level of capital required to be maintained, which will depend on the bank's risk management systems. Thus, the better the risk management systems, the lower the required level of capital.

In describing the second pillar, the Basel Committee proposal states that: "the supervisory review process should not be viewed as a discretionary pillar but, rather, as a critical complement to both the minimum regulatory capital requirement and market discipline." However, other than to prescribe the broad principles for the application of Pillar 2, Basel II does not contain a prescriptive approach to be followed. Thus, it is up to each regulator and the industry to determine, how the requirements under Pillar 2 will be applied.

In order to achieve the objectives under Pillar 2, the Basel Committee has laid down four key principles:

- **Principle 1**: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels (i.e. an internal capital adequacy assessment process or ICAAP).

- **Principle 2**: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the results of this process.

- **Principle 3**: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

- **Principle 4**: Supervisors should intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Accordingly, going forward, the supervisor has a key role to play in validating and reviewing internal capital adequacy assessments of banks whilst intervening at early stages to prevent the deterioration of prudent capital requirements.

4.2 Principle 1: Banks' Own Assessment of Risk and Capital Adequacy

Since Pillar 2 focuses on the bank's internal capital assessment process, the primary responsibility for ensuring that the bank has adequate capital to support all its risks rests with the individual banks. In contrast to Pillar 1, which stipulates how the capital ratio has to be calculated, Pillar 2 focuses on banks' internal process for such an estimation of capital. Accordingly, the level and sophistication of the ICAAP should be tailored to the bank's activities and the risks involved in these activities. The Basel Committee has not recommended a "best practice" with regard to the design and implementation of such a process and is therefore not a "one size fits all" approach. However, some key features that should be included in every bank's capital assessment process have been specified. They are:

i. **Board and Senior Management oversight** – the primary responsibility for establishing a sound capital assessment process lies with the Board and the Senior Management of the bank. They should design policies and procedures to ensure that the bank identifies, measures, monitors and controls all material risks the bank is exposed to. The policies and procedures in this regard should be formerly established through appropriate documentation. It is important that this should be integrated into the management process and decision-making.

ii. **Sound capital assessment** - The ICAAP should also be a systematic and disciplined process that relates capital to the level of risk undertaken by the bank and states capital adequacy goals vis-à-vis risk, considering the bank's strategic focus and business plan. It should also take into account the bank's risk tolerance limits, which should be set by the Board. The ICAAP should be a comprehensive assessment of risks – all material risks faced by the bank should be addressed in the ICAAP. While it may not be possible to measure all risks accurately, a process should be developed to estimate risks.

iii. **Monitoring and reporting** - The ICAAP should be reviewed regularly to take into account the changes in the risk profile and how it affects the capital requirements.

iv. **Internal control review** – As part of the internal control process, the ICAAP should be reviewed and audited by internal and/or external auditors to ensure the integrity of the overall risk management process.

4.3 Principle 2: Supervisory Review Process

The review process by the supervisors would include review and evaluation of the adequacy and reliability of a bank's ICAAP, risk exposure, capital levels and the quality of capital held. The review process emphasizes on bank's risk management and encourages interaction between banks and supervisor to understand the bank's risk management and controls. The outcome of the supervisory review process should not be confined to a capital figure, since capital cannot replace, but only complement good risk management. The review process could involve a combination of the following:

- On-site examinations
- Off-site surveillance
- Discussions with bank management
- Periodic reporting
- Review of work of internal and external auditors

In addition to these traditional methods, both banks and regulators could use forward-looking stress tests to identify possible events or changes in the market conditions that could adversely impact the capital adequacy.

4.4 Principle 3: Capital Above Regulatory Minimum Ratios

Supervisors will typically expect banks to operate above the regulatory minimum level of capital in order to provide a buffer to meet other risks and uncertainties since it may be costly to raise capital when market conditions are unfavourable and to meet fluctuations in the capital ratio occurring in the normal course of business. This buffer is expected to meet uncertainties that affect the banking industry as a whole. Bank-specific uncertainties are to be treated under Pillar 2, which reinforces Pillar 1 by taking into account the risks that are not captured under Pillar 1. However, this process is not intended to lead to automatic capital add-ons, although this could be one of the outcomes of the supervisory review process.

In order to assess that the individual banks are operating with adequate levels of capital, the Basel Committee recommends, among other methods, that supervisors may set "trigger" and "target" ratios or define categories above minimum ratios (e.g.: well capitalsied and adequately capitalised banks) for identifying the level of capitalisation of a bank. Higher capital ratios may be required for outliers.

4.5 Principle 4: Supervisory Intervention

Here, the objective is to identify, as early as possible, *the potential* for serious erosion of the bank's capital position in order to limit risk to depositors and the financial system. This principle involves the use of early warning systems such as trigger ratios as well as preventive and remedial actions. Intervening actions by the supervisor may include a range of options:

- Moral suasion to encourage banks to improve their capital positions
- Intensifying monitoring of the bank
- Improving the bank's ICAAP, risk management, systems and controls
- Requiring the bank to submit a capital restoration plan
- Restrictions on the payment of dividends
- Placing restrictions on bank activities, acquisitions, investments etc.
- Requiring the replacement of senior management and/or the Board of Directors

5. Scope of Pillar 2 Risks

Risks not covered under Pillar 1 are to be catered for under Pillar 2 (figure 1). Three risks, in particular, need to be captured under this pillar, i.e.:

- risks which were not fully captured under Pillar 1 (e.g.: credit concentration risk)
- factors not taken into account by Pillar 1 (e.g.: interest rate risk in the banking book, business and strategic risk); and
- factors external to the bank (e.g.: business cycle effects).

Figure 1

Banking Risks Addressed under Pillar 1 and Pillar 2

Banking Risks	Pillar 1 Risks	Pillar 2 Risks
Credit risk	• Counterparty default risk • Transaction risk (e.g.: through recognition of CRM)	• Credit concentration risk • Portfolio risk (aggressive expansion/deterioration in asset quality etc) • Residual risk (from use of CRM/securitisation etc.)
Market risk	Trading risk arising from adverse movements in interest rates, FX security and commodity prices	Residual risk (e.g.: vulnerability under stress and scenario tests)
Interest rate risk	Interest rate risk in the trading book	Interest rate risk in the banking book
Liquidity risk		• Funding (cash) liquidity risk • Asset (market) liquidity risk
Operational risk (including legal risk)	Risk of loss resulting from inadequate or failed internal processes, people and systems/from external events	Residual operational risk (e.g.: risk of loss resulting from low-frequency, high impact events)
Strategic risk		Risk due to: • bad/imprudent or improperly implemented business decisions or strategies • lack of response to external changes (industry, economic or IT)
Reputation risk		Risk due to contagion, negative publicity or susceptibility to market rumours

6. The Internal Capital Adequacy Assessment Process (ICAAP) in Banks

The ICAAP is a comprehensive process that a bank should put in place for identifying and measuring the risks in its business and for assessing how much capital is needed to support such risks. The fundamental elements of a sound ICAAP are discussed in subsection 4.1

The ICAAP should capture all material risks of the bank. While Basel II does not detail the composition of a ICAAP, each bank is expected to establish the ICAAP to fit its own circumstances and needs, based on the risk profile and level of sophistication of its operations. The ICAAP should be a risk-based process and should form an integral part of the management process and decision making culture of a bank. It should be subject to sensitivity analysis and stress testing with regard to the key assumptions on which the ICAAP is based. Stress testing is discussed in detail under section 8.

7. Specific Risks to be Addressed Under Pillar 2

7.1 Credit Concentration Risk

A risk concentration is any single exposure or group of exposures with the potential to produce losses large enough (relative to a bank's capital, total assets or overall risk level) to threaten a bank's health or ability to maintain and sustain its core operations due to an erosion of capital and customer confidence. Risk concentrations are arguably the single most important cause of major problems in banks. Such concentrations are not addressed in Pillar 1.

Credit Risk concentrations include:

- Large exposures
- Credit exposures to parties connected to the bank
- Credit exposures to counterparties in the same economic sector or geographic region
- Credit exposures to counterparties whose financial performance is dependent on the same activity ('group' borrowers)
- Indirect credit exposures arising from a bank's credit risk mitigation activities (e.g.: exposure to a single collateral type)

Banks should have internal systems/policies and controls to identify, measure, monitor and control concentrations, including stress tests in its ICAAP.

7.2 Interest Rate Risk in the Banking Book

While interest rate risk in the trading book is covered under market risk in Pillar 1, interest rate risk in the banking book is a risk explicitly covered under Pillar 2. Interest rate risk is the exposure of a bank's financial condition to adverse movements in interest rates. Although interest rate risk is part of the business of banking, excessive interest rate risk can pose a significant threat to the bank's earnings and capital. To facilitate supervisors' monitoring of interest rate risk exposure, banks will have to provide the results of their internal measurement systems, expressed in terms of a standardized interest rate shock. If supervisors determine that a bank is not holding capital commensurate with the level of interest rate risk, they should require the bank to reduce its risk, to hold a specific additional amount of capital, or a combination of the two remedies.

In an environment where banks are faced with deposit raising challenges, some having shifted to money market borrowing to fund their asset base, the interest rate risk exposure of the banks has become significant. Another aspect of interest rate risk is the maturity mismatch that the banks are typically exposed to in their deposit and lending portfolios. Whilst current accounts are considered on-demand deposits, savings and fixed deposits have certain accepted maturity terms. On the other hand, most of the asset book of a commercial bank is typically short term (less than one year, mostly maturing in less than 3 months). Managing these maturity mismatches in a volatile environment with low long-term rate curves as compared to high short-term interest curve is another challenge. Some banks have moved to behavioralising[1] of their loan and deposit portfolio to better manage this risk.

7.3 Operational Risk

Gross income, used in the Basic Indicator and Standardised Approaches for operational risk, is only a proxy for the scale of operational risk exposure of a bank and can, is some cases (e.g.: for banks with low profitability) underestimate the need for capital for operational risk. Supervisors are expected to consider whether the capital requirement generated by the Pillar 1 calculation gives a consistent picture of a bank's operational risk based on the guidelines issued by the Basel Committee[2].

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1 Certain assets and liabilities behave in a different way from that which their contractual maturity would suggest. These products require behaviouralisation to ensure that the risk inherent in the product is correctly recorded. Behaviouralisation may be defined as the method for measuring interest rate risk for products where this risk is different from that indicated by the product's maturity or re-pricing. The proper capture of the interest rate risk run should enable it to be managed more efficiently.

2 Sound Practices for the Management and Supervision of Operational Risk, BCBS, February 2003

8. Stress-testing under the Supervisory Review Process

Stress testing plays a key role in the assessment of capital adequacy under Pillar 2. Stress testing is a generic term for the various techniques (quantitative and/or qualitative) used by banks to gauge their vulnerability to exceptional but plausible events. As defined by the Bank for International Settlements (BIS)[3], stress testing is a risk management technique used to evaluate the potential effects on an institution's financial condition of a specific event and/or movement in a set of financial variables. The level of complexity of stress testing is expected to vary with the size and level of sophistication of institutions. It is important for institutions to embed stress testing into their risk management framework. In that respect, stress testing should form part of the bank's risk management and the assessment of capital adequacy.

8.1 Types of Stress Testing

There are a number of categorisations and concepts currently used by the market or the supervisors. In the context of the ICAAP, stress testing could generally fall within the two following categories: scenario tests and sensitivity analyses.

Sensitivity analyses are generally less complex to carry out since they assess the impact on an institution's financial condition of a move in one particular risk driver, the source of the shock not being identified, whereas scenario tests tend to consider the impact of simultaneous moves in a number of risk drivers, the stress event being well defined. For instance, a typical sensitivity analysis would be to assess the impact on an institution's profitability, should interest rates fall sharply in one day. In contrast, a scenario test would consider the impact of, for instance, a 'Black Monday' like event on an institution's profit and loss account. Such a scenario takes into account a combination of changes in different risk drivers being affected by the stress event chosen by the institution.

8.2 Uses of Stress Testing

In practice, stress testing is a valuable risk management technique whose potential applications are quite varied within each individual institution. In the context of internal capital assessment under Pillar 2, institutions should consider stress testing for the following purposes:

- As a diagnostic tool to improve the understanding of the institution's risk profile.
- As a forward looking tool within the ICAAP:
- Earnings are a part of an institution's overall capital planning and are the first line of defense to absorb losses. Therefore, institutions should consider, in the context oftheir ICAAP, assessing how their earnings are affected by stress situations.

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3 Committee of the global financial system, January 2005: Stress testing by large financial institutions: survey results and practice

- Stress testing may be used to assess the adequacy of internal capital. For example, this can be relevant for smaller institutions that may want to tackle their ICAAP through a series of very simple relevant stress tests to inform their view of the adequacy of their internal capital,
- For institutions using internal capital models, stress testing could be used to supplement statistical methodologies (such as VaR). Stress testing helps form an alterna tive view where paucity of historical data limits the predictive power of such mod els.
- Institutions should use stress testing as one tool to assess the risks in a forward-looking manner. It will then be possible for institutions to compare the outcome of those stress tests against their business plan and take the necessary measures in the light of these results.

Some examples of scenarios for stress testing are:

- How an economic downturn would affect the bank's capital and earnings
- The effect of a global recession, occurring once in a 25 year period
- Country failure where the bank has a major presence or exposure
- How changes in the credit quality of a major counterparty would affect the capital and earnings
- The impact of a liquidity crisis on profits
- The effect of a health hazard such as Pandemic Avian influenza, bird flu
- A financial crisis in the region (eg: Asian financial crisis)
- Crisis in a particular industry (e.g.: garment industry, tourism sector etc.)

Stress testing enables a bank to build up a medium/long term capital plan, including mitigating actions approved by the bank's Board and senior management. This would be a key input in analysing the appropriate levels of capital required and provides a buffer in excess of the minimum regulatory capital requirements.

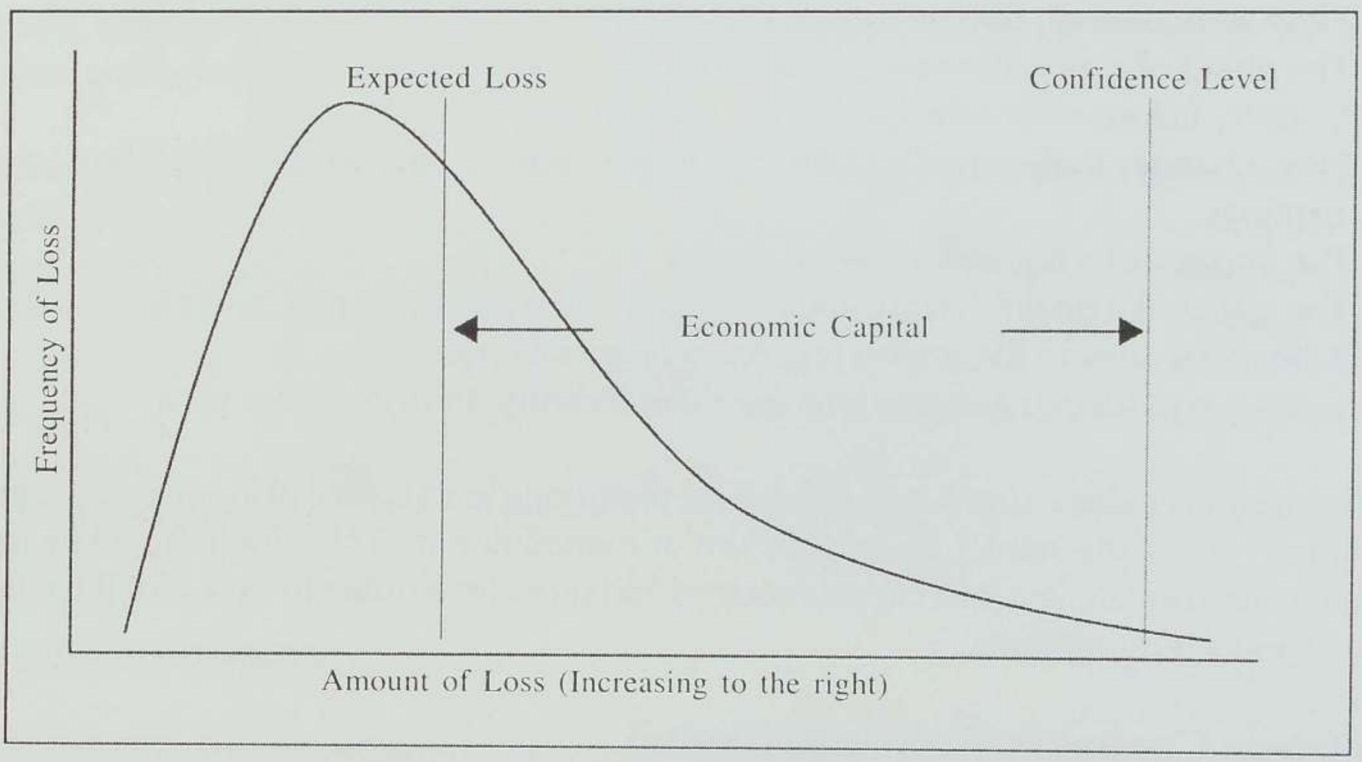
9. Regulatory Capital vs. Economic Capital

The focus on the internal capital assessment of banks under Pillar 2 has highlighted the distinction between economic capital and regulatory capital.

The regulatory capital refers to specific categories of equity (and other capital elements permitted by the regulator) used to meet capital regulations.

Economic capital, on the other hand, could be defined as the amount of risk capital. It is a single measure, which captures *unexpected* losses or reduction in value or income from a portfolio of business in a financial institution. The risk arises from the unexpected nature of the losses as distinct from the *expected* losses which are considered part of doing business and are covered by reserves and income. Economic capital covers all unexpected events except for catastrophic ones for which it is impossible to hold capital. Typically this is calculated by determining the amount of capital that the firm needs to ensure that its realistic balance sheet stays solvent, over a certain time period, with a pre-specified probability (generally between 99.96 and 99.98 percent) equivalent to the insolvency rate expected for a AA rating.

The concept of economic capital differs from regulatory capital in the sense that regulatory capital is the mandatory capital the regulators require to be maintained while economic capital is the best estimate of required capital that financial institutions use internally to manage their own risk and to allocate the cost of maintaining regulatory capital among different units within the organization. Large international banks have been using economic capital models for over 10 years for assessing their internal capital needs. Model results are expressed as a level of capital expressed in monetary units, necessary to support specific risks assumed. Since economic capital is based on a probabilistic assessment of potential future losses it is a potentially more forward-looking measure of capital adequacy than traditional accounting measures.



It is expected from the Financial Institutions that they hold risk capital of an amount equal to at least the economic capital, which can be above the minimum stipulated regulatory capital requirements.

10. Challenges in Implementing Pillar 2

Given the vast scope of Pillar 2, the challenges posed to the banks and the regulators in its effective implementation are enormous. The primary responsibility under Basel II for developing a comprehensive ICAAP that captures all material risks rests with the banks, which would be assessed by the supervisor. Even under the existing Capital Accord, Basel I, banks are expected to operate above the minimum regulatory capital. Under Pillar 2 of Basel II, this becomes a formal requirement. In adopting the advanced capital estimation methods under the advanced approaches for Pillar 1, the criteria under Pillar 2 become a factor for supervisory validation of the internal measurement methods. The main issues that would arise with regard to implementation from a bank's perspective are;

10.1 Challenges from a Bank's Perspective

- Supervisory guidance for ICAAP - Many banks currently do not have formal and well-developed ICAAPs for assessing capital adequacy. They need clear and comprehensive guidance from supervisors on how to formulate and implement a "sound" ICAAP that would meet supervisory requirements whilst suiting their own operational areas.

- Taking into account the comprehensiveness the ICAAP has to guarantee, and its planning function, it is obvious that the requirements will be best met by implementing an economic capital model. Such a mathematical model relates the capital of a bank to the risks it takes within its business activities taking into account diversification effects between risk types. Only very large, International Banks will have the resources to establish such an advanced system for the allocation of capital. As such, it is envisaged that most banks in Sri Lanka will need more time to develop their capital planning and assessment capabilities, though they may not be complex as large international banks with diverse business operations in different geographical areas.

- Quantification of certain specific risks such as reputation risk and strategic risk – there are no standards set by the industry or Basel Committee currently available for the measurement of such risk. The Basel Committee expects the industry to develop measurement methods. Until such time, banks will have to use estimates.

- The state of readiness of the bank's risk management systems. The establishment of a central risk management function would facilitate prudent risk management.

- Banks also need to consider how to make ICAAP an integral part of their management process and decision-making culture, and not view it as another regulatory tool.

- Supervisory transparency and accountability – Banks would generally expect sufficient transparency in the way the supervisors exercise their discretion under Pillar 2. Further, Pillar 2 will inevitably increase supervisory scrutiny over banks. Concerns with regard to whether the supervisory review process will translate into interference with the way a bank conducts its business could also arise.

10.2 Challenges in Implementing Pillar 2 – Supervisor's Perspective

- Considering the expanded role of the supervisor with regard to Pillar 2 implementation, and the absence of an established framework, the major challenge for the supervisor would be with regard to supervisory resources. Specifically, issues such as standards for a sound ICAAP, which could be applied to banks of different sizes and risk, profile, the extent of reliance placed on such ICAAPs to measure capital requirements pose tremendous challenges. Of particular significance is the building up of industry support for the supervisory review process. Thus, the development of objective assessment criteria for application of Pillar 2 becomes imperative.

- Given that banks will not be making use of sophisticated models for risk management and capital assessment while using the standardised (simple) approaches under Pillar 1, the supervisors may have to develop a mechanism such as a template for the identification of elements unlikely to be adequately catered for by the standard models, and requiring review under Pillar 2.

- Supervisory transparency - The supervisor also has to develop criteria that will be used in Pillar 2 assessments, including target and trigger ratios, which should be made publicly available. If capital requirements are set above the minimum for an individual bank, supervisor should explain the risk characteristics specific to the bank as well as remedial action proposed. Particular considerations would be determining the imposition of capital add-ons - whether a supervisory model should be developed and the scope, i.e. all banks or only "outlier" banks.

- Use of stress tests: should supervisors impose industry-wide standard stress test scenarios or permit individual banks to use their own scenarios.

- Building an effective dialogue with the individual banks is a key requirement under Pillar 2. However, blending the Pillar 2 requirements with the existing supervisory framework should not be a major challenge since most supervisors adopt a risk-based approach to supervision.

- Legal and regulatory impediments - the regulators should have the legal powers to exercise supervisory judgment and enforce capital add-ons where it is warranted.

- Cross-border application of Pillar 2; Enhancing the scope of cross-border communication with regard to application of Pillar 2 for international banking groups in order to reduce duplication of supervisory efforts needs to be considered. This requires harmonizing the divergent supervisory approaches of different regulators. A pragmatic approach to mutual recognition under home - host regulatory co-operation would be an important factor here.

11. Conclusion

Under the Basel II Capital Adequacy Framework, a bank's ultimate capital requirements are subject not only to the minimum capital requirements under Pillar 1, but also to regulatory discretion under Pillar 2. However, it is not intended to require formal capital add-ons across the board.

The three pillars, together, are intended to achieve a level of capital commensurate with a bank's overall risk profile. Along with the supporting Pillars 1 and 3, Pillar 2 of Basel II provides an impetus for banks to improve their ability to manage all material risks that a bank is exposed to and also provide the incentive for improving the risk management systems. Given the scope and coverage of Pillar 2 requirements, it could be envisaged that Pillar 2 will lead to a gradual evolution of capital management practices among banks. Thus, not only the international banks using economic capital models, but the smaller banks too will have to develop their capability in assessing internal capital requiements.

Pillar 2 will also help the banks to develop their business strategies and better risk-adjust pricing (measuring return on capital). Going forward, Return on Risk Adjusted Capital (RAROC) would be the norm for pricing as compared to Return on Capital (ROC). The use of stress testing under different scenarios will provide a more forward looking estimate of capital requirements and open out senior management thinking to possible risks that banks are exposed to.

The implementation of Pillar 2 will require much effort from the banking industry as well as pose great challenges to the regulators. Since the regulatory approach to supervision adopted by most regulators, including the Central Bank of Sri Lanka is risk-based, it is expected that Pillar 2 would be an extension and a refinement of the existing regulatory approach and not an entirely new endeavour.

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ROLE OF CUSTOMER RELATIONSHIP MANAGEMENT IN CUSTOMER LOYALTY AND RETENTION IN THE MODERN BANKING ENVIRONMENT

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1.0 Introduction

Customer Relationship Management is the overall process of building and maintaining profitable customer relationships by delivering superior customer value and satisfaction (Kotler & Armstrong 2006).

Customer Relationship Management (CRM) has been defined narrowly as a customer data management system, until very recently. According to this definition, CRM was involved in maintaining detailed information about the individual customer and managing the customer 'touch points,' such as purchase and sales force contacts, service and support calls, Web site visits, satisfaction surveys, credit and payment interactions or every contact between the customer and the Company. However, more recently, CRM has taken on a broader meaning and considered as the most important concept of modern marketing. Two leading Professors on Marketing, Kotler and Armstrong (2006) states that, CRM builds and maintains profitable customer relationships by delivering superior customer value and satisfaction. 'Customer satisfaction' is the feeling a customer experiences when the customer's expectations are met (Chaston, 1993), whilst loyalty is shown when a customer repeatedly turns to the same provider to buy a product or service. Horstmann, (1998) a researcher on customer satisfaction and loyalty in the service industry, argues that there is a strong relationship between customer satisfaction and loyalty. Customer satisfaction influences loyalty; the higher the level of customer satisfaction, the higher the level of loyalty. Therefore, it is interesting to discuss and important for the Banks to note, how CRM can facilitate customer loyalty and retention in the modern banking environment.

During the past two decades, the environment within which the banks operate has changed rapidly due to many reasons. Globalization, technology revolution, fast developing communication modes and financial liberalization have facilitated this change, intensifying the competition in the Banking Industry. As a result, the array of financial products and services have been broadened. Many efficient delivery and processing channels, innovative products and services have been developed, enhancing access to finance through the above facilities. To recall a few: introduction of Automated Teller Machines (ATMs), Electronic Fund transfer facilities at the Point Of Sale (EFTPOS), Electronic Banking facilities such as Internet Banking and Telephone Banking, Debit card, Credit card and Traveller's card facilities are notable features which increased wide accessibility to banking services in the industry. These rapid changes in the environment have compelled the banks to compete with each other for the same market share, introducing unique products and services through effective Customer Relationship Marketing, to obtain a competitive edge in the market.

In addition to the above changes in the banking environment, the customer aspect too have changed during the recent past. The volume of banking customers have increased over the last two decades, with a wide range of tastes and preferences. Customers have become more knowledgeable, sophisticated, assertive and highly demanding, Majority of them are less loyal, and more inclined to switch to a competitor at the slightest dissatisfaction with their regular banker. Customers in the modern banking environment expect flexibility in hours of operation, greater convenience, customization in products and services, user friendly IT facilities, transparency in transactions, wider accessibility, control and secured operations, personalized, friendly service etc. The number of financial institutions too have increased in the environment, competing to attract new customers with aggressive marketing. strategies. With the increased number of banks to choose from, customers now demand better quality, more customized products and services from the banks. In this customer-centric business environment, attracting and retaining the customers in the long-run has become a key challenge for the banks. This has led to a shift in the business focus in the modern banking environment from ' transactional marketing' to 'relationship marketing'. As a result, the customer is at the centre of all business activities. Banks have to position their staff to attend to the needs of the customers in a highly customized and responsive manner, introducing Customer Relationship Managers, each designated as the prime contact for an assigned group of customers. They act proactively and offer customized products and services, in a timely manner. The objective of banks introducing customer relationship management is to build and maintain profitable customer relationships by delivering superior customer value and satisfaction, in order to enhance customer loyalty and retention.

However, attracting and retaining customers is not an easy task in the present ,highly competitive business environment. The role of Customer Relationship Management in customer loyalty and retention in the modern banking environment, based on the marketing concepts and research findings, will now be discussed in detail..

2.0 Customer Value and Customer Satisfaction

According to Kotler & Armstrong (2006), Customer buys from the firm that offers the highest 'Customer Perceived Value' or the customer's evaluation of the difference between the total benefits and the total costs of a marketing offer, relative to those of competing offers. Customers often act on perceived values because they do not judge product values and costs accurately or objectively. Customer satisfaction depends on the product's perceived performance, relative to a buyer's expectation.

According to the Product's perceived performance, the customer satisfaction levels are of three types : If the

1. Performance is short of customer expectations, the customer is considered to be "dissatisfied";
2. Performance matches the customer expectations, the customer is considered to be "satisfied" and
3. Performance exceeds customer expectations, the customer is considered to be "highly satisfied" or "delighted".

A business cannot function without its customers. The financial losses and loss in reputation can be damaging for its image, when losing customers. Therefore, smart firms aim to delight customers by promising only what they can deliver and at the end, delivering more than what they promise. Highly satisfied customers or delighted customers make repeat purchases and tell others about their positive experience with the firm. Customer-centric firms go out of the way to make their valued customers delighted. The key is to match the customer expectations with the company performance. As the marketing scholars have stated, although the firms seek to deliver high customer satisfaction relative to their competitors, they do not attempt to maximize customer satisfaction, since it affects the firms' profitability in the long-run. The purpose of marketing is to generate customer value profitably. Therefore, striking a balance is important in generating customer value and satisfaction in the customer relationship management process. It will be useful to mention the highlights of the following marketing research to emphasize the above point. The findings will be very useful to the banks in the modern environment to design their customer relationship management strategies.

Marketing research has proved that with higher customer satisfaction, the level of loyalty of the customer increases. A customer that is "very satisfied" is six times more likely to repurchase a product than a customer that is "satisfied" (Matzler & Hinterhuber, 1998) However, it is important not to exceed the satisfaction level too much, since if it happens, the customers' expectations will be even higher the next time. As indicated in the Figure I below, this will result in an upward moving spiral, where the risk of service failure increases. Therefore, it is important to increased the satisfaction level of customer by small steps, to avoid the risk of dissatisfied customers in the future (Gronroos, 2000). The shape of the relationship between satisfied customers and loyal customers is a curve-like relationship and the scholars, Hart and Johnson in Gronroos (2000) discussed this through "the Zone of indifference" (Figure 1).

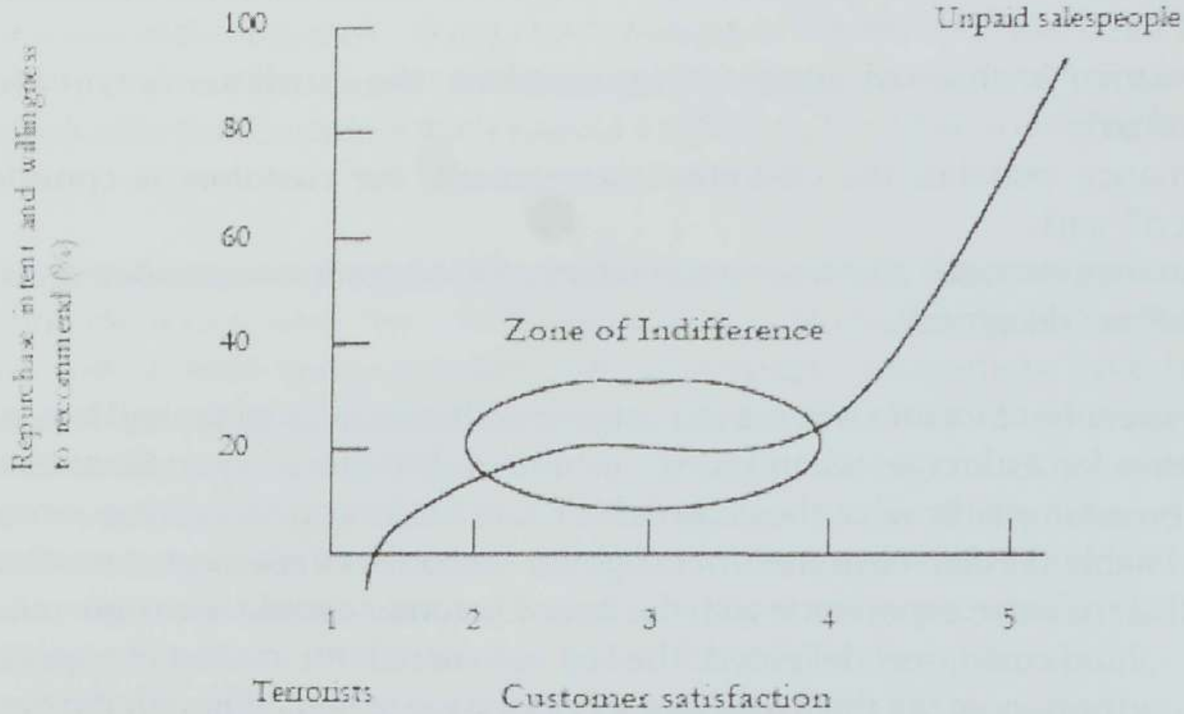

Figure 1 - Zone of Indifference (Gronroos, 2000)

The curve indicates the customer relationship, ranging from completely dissatisfied customers to very satisfied customers. The large, slowly increasing slope is called the *"zone of indifference"*, where customers are merely *"satisfied"* and who do not tend to be loyal customers, with a high retention rate. By offering superior service and value-added products, firms can make the customers leave this zone of indifference and become loyal through driving them towards being *"very satisfied"*. The customers in this area not only become loyal through repeat purchases, but also willingly spread positive comments by word-of-mouth about the firm. But dissatisfied customers try to scare away potential customers by bad-mouthing the company (Gronroos, 2000).

3.0 Customer Relationship Levels and Tools

The knowledge on different types of customer relationship levels and tools will be very useful to Banks, as much as to the other firms, in order to offer high quality customer relationship services. Kotler & Armstrong (2006) state that, companies can build customer relationships at many different levels; basic relationships, full partnerships, frequency marketing or club marketing relationships, depending on the nature of the target market. A firm may seek to develop basic relationships with many low-margin customers, at one extreme. In this situation, the firm may not call on them to get to know them personally, but creates relationships through brand-building advertising, sales promotions or through its web site.

At the other extreme, in markets with few customers and high margins, firms will create full partnerships with these high net-worth clients. For example, from the international market, P&G customer teams work closely with Wal-Mart, Safeway, and other large retailers, building long-term, full partnerships to sell their products. Further, Boeing partners with American airlines, Delta and other airlines in designing airplanes that fully satisfy their requirements. In between the above two extreme CRM levels, other levels of customer relationships are possible.

In the modern marketing environment, many established companies are developing customer loyalty and retention plans under their CRM programs. Beyond offering consistently high value and satisfaction, the companies use specific marketing tools to develop stronger bonds with their customers. The frequency marketing programs offered by the companies, that reward customers who buy frequently or in large quantities are examples for such marketing tools. The frequent-flier programs offered by airlines, room upgrades to frequent guests by hotels, patronage discounts to "VIP" customers by supermarkets and mobile phone companies are few examples of these marketing tools the companies use to develop stronger bonds with their customers.

Further, some companies sponsor club marketing programs that offer special discounts and facilities to members and create member communities in their respective industries. Companies add structural ties as well as financial and social benefits, to build customer relationships in this regards. Banks could use the above knowledge on customer relationship levels and tools to strengthen their CRM processes, to face the challenges in the modern banking environment.

4.0 Changing Nature of Customer Relationships

Many notable changes are occurring in the ways in which firms are relating to their customers in the marketing world. Since these changes are very important to the banks to face the challenges in the modern environment, how the nature of customer relationships have changed will be discussed next. In the past, firms focused on mass marketing to all customers, keeping a distance and selling in a standardized way to any customer who comes along. But today's companies are no longer building relationships with each and every customer. Instead, they are building more direct and long-lasting relationships with more carefully selected, fewer, more profitable customers. Firms are finding new ways to deliver more value to customers, and also beginning to assess the value of customers to the firm, called *selective relationship management*. Many firms use the customer profitability analysis to select the profitable or target winning customers for pampering, and to weed out non-profitable customers.

Once the profitable customers are identified, firms create unique, attractive offers and special handling to capture these clients and build their tust and loyalty. Many banks too follow this process to identify profitable customers from their vast databases and to cut out losing ones. The customer values are calculated based on factors such as an account's average balance, account activity, services usage, profitability to the bank and other variables. Banks use such customer information to identify high net-worth clients and offer them customize, personalize products and services. This in turn facilitates customer satisfaction and loyalty which leads to retention in the long run. However, this sorting-out process, has many risks since the future profits are hard to predict. But most banks believe that the benefits outweigh the risks. For example, imposing a charge for the bank account balances below the minimum level, will help the banks to identify their unprofitable, money-losing customers. Further, the marginal customers will become profitable customers by boosting their account balances, high enough to avoid the charge.

As discussed above, Companies as well as banks are being more selective about which customers they choose to serve and they also serve the chosen customers in a deeper, more long-lasting manner. In the present environment, the firms/banks are going beyond designing strategies to attract new customers and create transactions with them. Customer Relationship Management is used today to retain current customers and build profitable, long-term relationships with them.

Marketing scholars have identified 'Marketing' as the science and art of finding, retaining, and growing profitable customer relationships. In the present environment, more emphasis is made on growing customer loyalty and retention, specially with the profitable customers. In the past , the emphasis was on market growth with a large supply of new customers. In the modern environment, banks face new marketing realities and changing demographics. Highly demanding customers, more sophisticated competitors, over capacity in the industry mean that there are fewer customers to sought after. In this scenario, many banks are aiming at the same stock of highly profitable customers. As a result, the cost of attracting new customers is rising. Marketing research reveals that, on average, it costs five to ten times as much to attract a new customer as it does to keep a current customer satisfied. Given these new realities, banks now go all out to keep their profitable customers. Creating customer value and building strong customer relationships, are key strategies to retain profitable customers. Major changes are occurring in the modern banking environment to bring more value to customers. Effective *Customer Relationship Management* and *Partner Relationship Management* play a major role in this task.

Kotler & Armstrong (2006) defines Partner Relationship Management as working closely with partners on other company departments and outside the company, to jointly bring greater value to customers. The traditional thinking that marketing is done only by marketing, sales, and customer care units has been changed now. According to the modern thinking, marketing has no sole ownership of customer interactions, but every functional area can interact with customers, especially electronically. "Every employee must be customer focused" is the new thinking in the business world and the firms are linking all departments in the cause of creating customer value. Many successful companies in the global arena, such as Procter & Gamble, Hewlett-Packard form cross-functional teams, rather than assigning only sales and marketing people to customers to attend to their needs.

Similar changes are occurring in how companies connect with the firms outside their companies, such as suppliers, channel partners, even competitors etc. Most of the companies today are networked companies, relying heavily on partnerships with other firms. Today's companies have realized that to be effective they need strategic partners. Therefore, in the modern competitive marketing environment, strategic alliances are blooming across almost all industries and services.

Examples from the international arena, Dell computers partners with Microsoft and Intel to provide customized e-business solutions and Volkswagen is working jointly with Archer Daniel Midland to develop biodiesel fuel, to add value to their customer services. In the local banking environment, many leading commercial banks partner with telephone companies such as, Dialog GSM and Mobitel, to enhance value of their customer services. The most recent example in the local banking environment is the NDB-Dialog mobile commerce network, termed "eZPay". Dialog Telekom and NDB Bank in August, 2007 unveiled eZ Pay, South Asia's first mCommerce (mobile commerce) initiative, a service that enables the consumer to carry out a variety of electronic, commercial transactions through its mobile phone, anywhere within the Dialog GSM network coverage (The Sunday Times, August 19, 2007). Therefore, the knowledge of changing nature of customer relationships are of key value to the banks, to be competitive and to enhance their market share in the industry.

5.0 Creating Customer Loyalty and Retention through CRM

How to create loyal customers and retain them in the banking industry ? This is a major challenge to the banks in the modern business environment. The following discussion on research findings will be valuable to the Banks, to manage profitable customer relationships, in order to maintain customer loyalty and retention. As Kotler and Armstrong (2006) explain, the marketing process involve building customer relationships by creating and delivering superior customer value and then capturing the value in return, in the form of current and future sales, market share, and profits. Companies create highly satisfied customers or delighted customers, who stay loyal and buy more in the long-run, by creating superior customer value. Marketing research has shown that, good customer relationship management creates customer delight and in turn, delighted customers become loyal and remain with the company, giving positive referrals of word-of-mouth to the others about the company and its products. Studies have revealed that even a slight drop from complete customer satisfaction can create a huge drop in customer loyalty, resulting in losing customers. Further, companies are realizing that losing a customer means, losing a customer lifetime value or the entire stream of purchases and services that the customer would make over a lifetime of patronage. Therefore, the aim of customer relationship management of companies is to create customer delight and not customer satisfaction ! (Reicheld etal 2003). The importance of the role of Customer relationship management in the present, competitive business environment is highlighted by the above research findings.

Further, it is important to note that, companies should build right relationships with the right customers, at the right time. This is key to manage the total combined customer lifetime values of their customers, or the customer equity of the company. Customers should be viewed as assets that need to be managed and maximized. Research has shown that all customers are not good investments, even the loyal customers can be unprofitable and some disloyal customers can be profitable. How to identify the profitable customers ? Is it the consistent big spenders the company has to acquire, ignoring the erratic small spenders or the erratic big spenders to be retained and lose the consistent small spenders ? It is often unclear whether, who should be acquired and at what cost. Therefore, it is vital for the banks to understand this situation and build the right relationships with their customers.

As the writers, Relnartz W. and V. Kumar (2003) have stated in the article, "The Management of Customer Loyalty" in the Harvard Business Review of July 2002, the companies should classify customers according to their potential profitability and manage their relationships accordingly. Further, customers are classified in to four relationship groups, according to their potential profitability and projected loyalty. It has been noted that each of the groups require a different type of relationship management strategy to maintain these customer groups..

As indicated in Figure 2 below, customers are grouped as (1) True friends (2) Strangers (3) Butterflies and (4) Barnacles, indicating their fit between company's offerings and customer's needs, and the level of profit potential.

Figure 2 - Customer Relationship Groups

Potential Profitability		Short-term customers	Long-term customers
	High Probability	**Butterflies** Good fit between company's offerings and customers needs; high profit potential	**True friends** Good fit between company's offerings and customers needs; highest profit potential
	Low Probability	**Strangers** Little fit between company's offerings and the customers needs; lowest profit potential	**Barnacles** Limited fit between company's offerings and customers needs; low profit potential

Projected Loyalty

Source : Adapted from "The Management of Customer Loyalty" by Werner Relnartz and V. Kumar, HBR July 2002, p.93

"True friends" are the most profitable and loyal customer group, with a strong fit between the customer's needs and the company's offerings. To delight these customers and nurture, retain, and grow them, the company needs to make continuous relationship investments.

"Strangers" are with lowest profit potential, little projected loyalty and a little fit between the company' s offerings and customer's needs. The relationship management strategy for this group of customers is 'do not invest anything in them'.

"Butterflies" are with high profit potential, but low projected loyalty. There is a good fit between the company's offerings and the customers' needs. However, the benefit from this group of customers are like butterflies, they come and go, short-term. Companies should enjoy the butterflies for the moment, effort to convert them to loyal customers rarely successful. The relationship management strategy to be adopted with them is, the firms should use their marketing promotions to attract them, create satisfying and profitable transactions and then stop investing in them until the next time around.

"Barnacles" are not very profitable, but highly loyal. There is only a limited fit between the company's offerings and the customer's needs. For example, Bank customers with small accounts that bank regularly, but do not generate enough returns to cover the cost of maintaining their accounts. They create drag, like the barnacles on the hull of a ship and are the most problematic customers. The relationship management strategy to be adopted to this group of customers is the for company to try to improve their profitability by selling them more, increasing their fees/charges etc. However, the relationship should be stopped if they cannot be made profitable.

The key learning point of the above study to the Banking Industry : Different types of customers require different relationship management strategies and the goal is to build the right relationship with the right customers at the right time.

6.0 Relationship Quality and Performance of the Customer Relationship Manager

According to the results of a recent marketing research conducted in Sweden on "Customer Loyalty and Satisfaction : A study of Swedbank's small corporate clients in Gothenburg (Dec 2002)", the relationship quality and the performance of the customer relationship manager are vital for the growth and survival of the Bank.

How customers perceive a company is very much impacted by how they are approached and treated by front-line and support-employees at different encounters with the Company. As Chaston (1993) found out, some customers are reluctant to approach their banks for discussions of financial needs, because they have experience of bad relationship quality in a less welcoming atmosphere. Personal relationship with the bank is the factor of most importance for the clients at an abstract level, and the need for personal relationship increases proportionally, with the complexity of a situation. (Ivarsson (2005).

The impact of the Relationship Manager's way of managing the relationship is found to be a key factor in success of the relationship with the client. Therefore, ability of the Relationship Manager to understand the client, finding solutions, treating them as important clients and the performance of the bank's staff in day-to-day activities, leads to changes in the level of satisfaction. Change of the Relationship Manager, or several changes over a short period of time, with no previous insight about the customer's business, is seen to yield dissatisfied customers, who might instead switch to other banks, if this turnover is not handled in a positive manner. Satisfied customers will be less likely to switch banks and more likely to stay loyal to, and give positive referrals about the Bank. (Madill et al., 2002). The other factors that affect the relationship of customers with the bank is the competency level of the Relationship Manager. For example, how much communication there is with the client, Relationship Manager's knowledge in the subject matter, the level of flexibility involved, changes and conflicts and the level of solidarity in the relationship etc. Research by Ivarsson (2005) too highlighted the issue of competencies of the Relationship Manager, but he calls it instrumental nearness and includes both the Relationship Manager's economic knowledge and his/her authority to negotiate on behalf of the Bank and provide the customer with quick information regarding his financial needs.. It is important to change banks' Corporate Policies and Procedures which would make them more flexible in handling their relationships with the clients.

7.0 Conclusion

Therefore, in conclusion, the Customer Relationship Management (CRM) is a strategic area in the banking industry, where the Customer Relationship Manager plays a key role in customer loyalty and retention in the modern banking environment. Information and research findings revealed in this article may be helpful to the banks to meet the challenges in the modern banking environment.

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MARKET MAKER'S LEGAL RISK UNENFORCEABILITY OF FINANCIAL DERIVATIVES CONTRACT

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1. Introduction

Financial derivatives have been sometimes classified as financial weapons of mass destruction, which carry latent and potentially lethal dangers for the economic system. Prophesy of Sir Julian Hodge the famous Welsh scholar and banker stated "at some time in the future financial derivatives could bring the world's financial system to its knees." In spite of the doomsday remarks made by many on the financial derivatives, the world of finance is kept mesmerized by the capabilities and powers of the financial derivatives.

Sri Lanka is no exception. In recent years the handful of derivative deals struck in Sri Lanka obtained a place in the headlines of the financial mass media. Yet, the derivatives remain an elusive area in the field of banking in Sri Lanka, partly due to the lack of knowledge in this area and mainly due to the risks inherent in the financial derivatives. Legal risk is just one of risks inherent in a financial derivative. Albeit in the presence of a sound and tested legal system but in the absence of a statutory legal infrastructure and the required maturity in the markets can the Sri Lankan legal system support the emerging derivatives market in Sri Lanka?

There have been many a writing and discussion among the Sri Lankan financial and legal intelligentsia on the subject of legal risk inherent in financial derivatives. However the forgoing work attempts to discuss the most common legal risks with a particular emphasis on the risk of invalidation and counterparty termination of the derivatives contract.

2. Common Legal Risks

The legal risk is the risk that the counterparty's performance obligations are legally unenforceable, through:

- a counterparty lacking the power to enter into derivatives transactions (ultra vires)
- transactions breaching regulatory prohibitions (such as gaming and wagering legislation)
- the legal documentation being inadequate or unenforceable in cross-border transactions
- the netting provisions being ineffective under bankruptcy or insolvency laws.
- the counterparty repudiation or refusal to perform on the common law grounds

In the on-exchange market, clearing houses bear all legal risks (other than ultra vires risk, which is borne by the contracting brokers) for all registered transactions. In the OTC (over the counter) market, legal risk can be reduced through use of Master Agreements (which would address most of contract law issues), effective netting rules, methods to deal with the ultra vires problem, and appropriate exemptions from the gaming and wagering legislation.

Whilst the legal risk is given an analysis in the following text it should be recognised that all these risks are not confined to the derivatives market. Also, they should be dealt with to the greatest degree possible by internal market mechanisms and private and self-regulation without restricting the market activities. However, where necessary, these controls should be supported by various regulatory structures, in particular:

- Appropriate clearing or other contract protection arrangements for all on-exchange derivatives markets
- Risk disclosure, "know your client", "client suitability" and other protections for retail end-users, and
- Legislation to uphold private netting arrangements and introduction of sui generis (unique in its characteristics) or specialised legal regimes.

3. Ultra Vires- (Beyond the Power)

Some entities may be restricted in dealing in derivatives by their charters of incorporation. The enforceability of any derivatives transactions into which they enter could be jeopardised by their lack of power to act as contracting parties. Theoretically, this ultra vires problem can apply to any financial market instrument. However, in practice, it is more likely for trusts (trust deeds) or incorporated bodies (Memorandum and Articles of Association) to place restrictions on derivatives transactions.

The ultra vires risk is unique to counterparties in the OTC derivatives market. In exchange derivatives markets with novation (act of replacing an obligation to perform with a new obligation bearing the features of the same) clearing, this risk is borne by the contracting brokers.

3.1. Ultra Vires in Incorporated Bodies

Almost all of world's most significant financial entities are incorporated bodies. Unless the charters of incorporation permit it, the obligations undertaken by the entity may not be enforceable in law. However in Sri Lanka under the Companies Act, No. 7 of 2007, the doctrine of ultra vires has been abolished for the companies incorporated under the act.

3.2. Ultra Vires in Trusts

Some of the worlds largest fund managers are trusts. Also the trustees are personally liable for the misuse of the trust fund. There are several problems concerning the capacity of some trustees to enter into these transactions as the trustee may lack authority to enter into all or some derivatives transactions under the instrument setting up the trust.

3.3. Ultra Vires in Life Insurance Companies

The ultra vires problem may also apply to life insurance companies. OTC derivatives counterparty to an insurance company should obtain evidence that the derivatives transaction is for the purposes of the business of the insurance company's statutory fund. This is necessary to ensure that the fund is available to meet the life company's liabilities under that transaction.

3.4. Ultra Vires in Other entities

The ultra vires doctrine may affect other entities such as friendly societies, building societies and government entities.

There are several regulatory policy suggestions in formulating laws for dealing with the conflicting interests of OTC derivatives market participants with respect to the doctrine of ultra vires.

Also it should be reiterated that any form of regulation should encourage smooth market functionality and wherever possible the markets should be self regulated.

4. Suggested Regulatory Policies

a) The validity of any OTC derivatives transaction and its enforceability against entity assets cannot be challenged on the basis of lack of capacity.

b) Unless a trust deed provides expressly to the contrary:

- The trustee is presumed to have authority to enter into any OTC derivatives transaction
- The exercise of that authority is taken to constitute a proper exercise of power by the trustee [unless the counterparty has actual knowledge to the contrary]
- The trustee has an unqualified right of indemnification out of the trust fund in respect of any transaction falling within the presumption.

c) Law would provide that any entity that has a prohibition, or restriction, on its capacity to enter into derivatives should identify itself in a public register. There would be a presumption in law that any entity not on that register has full power to enter into OTC derivatives contracts.

d) Law would leave it to the contracting parties to deal with this matter through their own arrangements.

However even in the absence of clear-cut laws, the derivatives market is moving ahead. The banks in Sri Lanka seem to out do each other by executing derivative deals, which are announced through headline banners. Often the "Treasurer" of the end user counterparty usually executes most of the derivatives transactions. It is always possible for the end user to claim that the "Treasurer" carried out the transaction without proper authority.

As a precaution the bank must always take care to obtain the updated evidence as to the authorized representatives who are expressly authorized to transact on behalf of the end user counterparties. This evidence should be executed under the seal of the corporate as per the charter of incorporation of the end user counterparty.

5. Illegality of Derivative Contracts Due to Gaming and Wagering Legislation

The primary purpose of gaming and wagering legislation is to regulate various forms of gambling and betting. However the performance of a derivative contract depends on the occurrence of a future event and a party to the contract may not have any interest in the underlying subject matter of the contract. Thus, this legislation could also affect the validity of some derivatives transactions.

- On-exchange Markets:- Currently, all transactions on futures exchanges and option contracts on securities exchanges are exempt from gaming and wagering legislation.

- OTC Markets:- Doubts have been expressed from time to time as to whether financial contracts such as currency and interest rate swaps may be invalidated by gaming and betting laws.

It is useful to examine the legislative exemptions given to financial derivatives in jurisdictions where there are active derivative markets.

- United Kingdom

The Financial Services and Markets Act of 2000 (FSMA) governs the financial derivatives market. Under section 412 of FSMA Gaming and wagering legislation does not apply to transactions regulated by the FSMA with certain provisos.

- USA

State anti-wagering and bucketshop laws do not apply to contracts traded on futures exchanges. The securities legislation specifically exempts options traded in accordance with the rules of a self-regulatory organisation from State gaming, wagering and bucketshop laws.[1] The State laws may, however, apply to OTC derivatives.

[1] Securities Exchange Act s 28(a).

- Sri Lanka

Sir Lanka has been a follower of the English laws and precedents. Although the English system evolved to develop distinctions between games of chance and game of skill and to make exemptions on certain financial transactions, the Sri Lankan system has not.

According to the eminent Sri Lankan jurist Professor C G Weeramantri quote " some such statutory provision would be a welcome sign to our law on the matter" unquote - of gaming and wagering.[2] However it is interesting to note that the transactions resembling the features of financial derivatives has been subjected to judicial review in Sri Lanka as early as 1939. Two leading cases are Erahim Lebbe Marrikar v. Arulappa Pillai (1939 16 CLW 25 PC) and Bartlet & Co v. Lebbe Marikar (1941 NLR 225 PC at 228).

In a commodity forward contract, the mere fact that one party performs the contract by paying the difference between the contract price and the market price on the due date does not make the contract a wagering contract.[3] But there must be sufficient proof that it was a term of the arrangement between the parties that commodity purchased or sold was not to be delivered under the forward contract but that the contracts were to result merely in the payment of the difference.[4]

It was held that in order to establish the existence of a bet it is necessary to prove "that the contractual documents are a cloak and neither party intended them to have any effective legal operation"[5]. However a derivative contract if proved to have been executed for legitimate commercial purposes will undoubtedly be allowed to operate by the law.

6. Sovereign Immunity (Particularly for Cross-Border Transactions)

There is always the risk that a defaulting party to a cross-border derivatives transaction may take defence under sovereign immunity. This issue has to be addressed through international conventions and multilateral trade agreements. However, any counterparty that successfully claims this defence and the jurisdiction that allows this defence will have to face the serious consequence of market isolation.

Furthermore, a large fraction of derivatives volume (positions) is in the inter-dealer market (Who cannot afford to face market isolation) and non-financial end-users account for only a small fraction of transactions.[6]

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[2] Law of Contracts – Vol 1 – pp 391 C G Weeramantri

[3] Law of Contracts – Vol 1 – pp 395- C G Weeramantri

[4] Erahim Lebbe Marrikar v. Arulappa Pillai (1939) 16 CLW 25 PC

[5] Bartlet & Co v. Lebbe Marikar (1941) NLR 225 PC at 228

[6] The Bank for International Settlements in its survey of OTC derivatives market activity (BIS, 2003) estimated total market value of gross OTC interest rate derivatives positions at USD 4,328 billion in 2003- H2 (interest rate derivatives account for 62 percent of all derivatives by market value). Of these, USD 1,872 billion (43 percent) were inter-dealer positions and only USD 687 billion (16 percent) were with non financial customers. www.bis.org

7. Harmonizing Sri Lankan Laws with Different Jurisdictions

While cross-jurisdictional disparities remain in the legal treatment for most contracts (Specially with respect to netting), there is widespread consistency in the treatment of derivative contracts in many jurisdictions. This argument has been made by regulators and industry groups[7] and has been cited by legislatures when legislation has been passed. Any reform of laws in Sri Lanka must take into account comparable overseas laws and practices, including the nature and functions of derivatives regulation in other major jurisdictions, in particular the UK and the USA.

This international legal harmonization is required in the following areas.

- Contract protection controls
- Prudential regulation of OTC market-makers
- Risk disclosure
- "Know your client" requirements
- Protecting clients' assets
- Record-keeping
- Discretionary accounts
- Derivatives activity disclosure
- Marking derivatives to market
- Supervisory disclosure, and
- Global regulatory and information-sharing arrangements

8. Unenforceability of Netting & Close Out Rights

Close-out and netting consist of two separate but related rights, often combined into a single contract.

- *Close-out:* The right of a counter party to unilaterally terminate contracts under certain specified conditions.
- *Netting:* The right to offset amounts due at termination of individual contracts between the same counterparties when determining the final obligation.

In the U.S., as in most countries with well-developed securities markets, derivative securities enjoy special protections under insolvency resolution laws. Most creditors are "stayed" from enforcing their rights while a firm is in bankruptcy. However, many derivatives contracts are exempt from these stays.

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[7] International Swap and Derivatives Association (ISDA), a trade group that coordinates industry documentation practices and lobbies for legislative changes to support the enforceability of those contracts.

Furthermore, derivatives enjoy netting and close-out privileges, which are not always available to most other creditors. By combining two offsetting contracts under the same master agreement the counter party would have to manage only the net position.

In the U.S. and some other jurisdictions, the governing contracts typically contain terms stipulating the actions to be taken in the event of default[8]. In other jurisdictions, such as the UK, a common law netting right exists. In Sri Lanka it was established by the case De Costa V Bank of Ceylon[9], that law concerning the "Ordinary course of banking business" should be English Common Law and not Roman Dutch Law. If the counterparty to a derivate transaction is a bank, it could be argued that the transaction fall within ambit of "the ordinary course of banking business".

The ordinary banking activities and practices has not been clearly defined. The eminent banking law scholar Dr Wickrema Weerasooria[10] has stressed the need to have a clear list of practices and activities that fall under the ambit of banking business. Any future compilation of such a list should definitely include financial derivative transactions as a banking business.

9. Can Derivatives Contracts be Classified as Insurance Contracts?

Insurance contracts other than life policies are contracts of indemnity (contact shall limit value to the loss), whereas the financial derivatives are not always contracts of indemnity. Also derivatives differ from insurance in that derivatives do not require one party to suffer an actual loss for payment to be made.

An equivalent to the 'Insurable interest' which is the fundamental ingredient of a contract of insurance that means the insured must have interest in the subject matter of the contract, does not appear in a financial derivatives contract (Except in credit derivative contracts). In contrast to insurance contracts, counterparty to a derivatives contract (Except in credit derivative contracts) may not have any interest in the underlying asset and can enter into the derivative contract in pursuance of the profit.

Concepts found in insurance contracts such as "contribution" (in case of many insurers: apportion liability amongst them) and "subrogation" (Insured cannot make a profit from his loss and that for any profit he does make he is accountable to in equity to his insurer), are not found in derivatives contracts.

However a concept similar to the **Uberrimae Fidei** (Utmost good faith) has been imposed on the derivative markets by the regulators under the risk disclosure regulations. The risks associated with the derivatives have to be disclosed specially to the retail participants under these rules. *In*

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[8] A recent example is the acceleration of some $4 billion of Enron's debt following its downgrade by rating agencies. The firm could not meet the resulting demand for immediate payment of principal and was forced to file for bankruptcy.

[9] (1969) 72 NLR 457

[10] APB-Progressive Banker and the Law-13th Anniversary Convention- pp35

these circumstances, it is difficult to interpret a derivatives contract as a contract of insurance. Thus the financial derivatives contracts are exempt from common law obligations and regulatory scope of insurance contracts.

10. Other Laws

Other statutory and common law rules may apply to OTC derivatives market activities. In some instances, OTC market participants may be liable for misrepresentation, negligence or misleading or deceptive conduct in their dealings with clients or counterparties:

10.1. In Contract Law

In contract law the factors invalidating a contract are error or mistake, misrepresentation, duress, undue influence and illegality (Illegality has been addressed above). The most probable grounds that counterparty chooses to challenge a derivative contract or refuses to perform the obligations under the derivative contract would be mistake or misrepresentation[11].

Misrepresentation

Misrepresentation is false statement of fact made by one party to another party and has the effect of inducing that party to enter into the contract. This may be used as grounds to invalidate the Contract.

Mistake

A mistake is an incorrect understanding by one or more parties to a contract and this may be used as grounds to invalidate the contract.

Duress and Undue Influence

Duress is the "threat of harm made to compel a person to do something against his or her will or judgment.This means the compulsion under which person acts through fear of personal suffering. The concept of 'economic duress' is also used to vitiate contracts.

Undue influence is an equitable doctrine that involves one person taking advantage of a position of power over another person.

10.2. A Case Study - Proctor and Gamble v. Bankers Trust

Facts: *On May 8, 1996, Judge John Feikens issued an order stripping from Procter & Gamble several legal grounds for recovery in its case against Bankers Trust Co. and BT Securities in federal court in Cincinnati, Ohio. In fact, in this ruling Judge Feikens enhanced considerably the strength of P&G's case by* ***finding that a legal requirement exists that the dealer disclose material information even if there is no fiduciary duty****.*

[11] Proctor and Gamble v. Bankers Trust – This matter was settled out of court

Judge Feikens noted in his Opinion that "BT claims that P&G owes it over $200 million." With a trial date fast approaching, Bankers Trust agreed to settle this claim by receiving the sum of $35 million. These terms, overwhelmingly favorable to P&G, presumably reflect the well-advised parties' views as to the relative merits of the case. As such, the settlement can be viewed as recognition of the correctness from the outset of Procter & Gamble's challenge of these trades.

The Opinion is helpful in that it is the first written holding by a judge in the United States to address the broad range of legal issues challenging the enforceability of swap and swap-related transactions. However, as a juditial precedent, the Opinion has several significant limitations.

- **The Opinion is not binding in any other case** - this Opinion by a single U.S. district judge is not legally binding. In the future other courts will be free to accept or reject Judge Feikens's reasoning.
- **The decision was not legally tested** - these legal conclusions were not tested on appeal.
- **The choice of substantive law is questionable**-Judge Feikens looked to the contractual choice of New York law in the International Swaps and Derivatives Association (ISDA) agreement and, over P&G's objection, then applied New York substantive law to decide the validity of these non-contractual claims. Another court elsewhere, applying its own state's conflict of laws principles, could well limit the ISDA contractual choice of law only to contractual claims.
- **Bankers Trust owed no fiduciary duty to P&G** - After quoting case authority to the effect that in New York no fiduciary relationship can exist where the two parties were acting and contracting at arm's length or between parties to a business relationship, the court noted that "P&G and BT were in a business relationship"-and therefore no fiduciary duty was owed by BT to P&G.
- **But Bankers Trust owed a duty to disclose material information to P&G** -Judge Feikens found that under New York law the agreement between the parties contained an implied covenant of good faith and fair dealing which, in turn, imposed a duty on Bankers Trust to disclose material information.

10.3. Mitigation of Common Contract Law Risks

The common law risks can be mitigated by the full disclosure of the nature of the transaction and requesting the customer (end user counterparty) to obtain independent advise as to the nature of the risk that is undertaken. Any adviser who gives advice in the course of a fiduciary relationship has a duty of care commensurate with that relationship. Where the relationship between the adviser and client is contractual, a term may be implied that the adviser will use the skill and diligence, which a reasonably competent and careful adviser would exercise.

It should be highlighted that at present Sri Lankan banks are in the practice of requesting customers to obtain independent professional opinions in respect of voluntary waiver of common law rights. This is evident in the waiver of common law rights of the guarantors.

A similar approach could be adopted by the banks, in respect of customers who deal in derivative transactions. Thus the banks should in addition to the master agreement, request from the end user counter party;

- a risk disclosure statement read agreed and signed by the independent advisor and an authorized representative of the end user counterparty
- a waiver of common law rights (such as *lesio enormis* - undue enrichment) read agreed and signed by the independent counsel and an authorized representative of the end user counterparty.

11. Special Legislation

In limited circumstances, intermediaries (Brokers) may also have a common law duty to advise their clients of particular features of derivatives transactions or material changes to these derivatives transactions that may affect the client's financial position or obligations.[12]

11.1. Protections Offered to End User Counterparties by Regulators in Overseas Markets

Risk disclosure: All overseas jurisdictions have risk disclosure requirements for on-exchange derivative transactions. Australia has risk disclosure requirements for futures contracts and some securities. Australia, Canada and the US apply risk disclosure requirements to all participants whereas the UK requirements only apply to the least sophisticated clients.

Suitability requirements: The UK and Canada have a "know your client" rule, which includes a positive obligation to seek information from a client. In the UK, this rule only applies to transactions for the least sophisticated clients. Australia and the US have suitability requirements for securities, but not for futures or derivatives.

Most of these regulations award following protections to the investor:

Private customers have the following protections:

- exchange-trading requirement (no contingent liability transactions except currency risk hedges to be off-exchange)
- suitability requirements
- risk disclosure
- charges disclosure
- advertising controls

[12] *Oabate Pty Ltd v Nichols Commodities Pty Ltd* (November 1983, Supreme Court of NSW). The nature and extent of this duty should be determined by the circumstances of each case. Relevant factors would include:
- the volatility of the market for the commodity in question
- the client's trading experience

- transaction reporting obligations
- confirmation notes, difference accounts and valuations requirements
- communications controls (not misleading and presented fairly)
- Client funds segregation requirements.

Non-private customers have the following protections:

- suitability requirements (discretionary transactions)
- advertising controls
- transaction reporting obligations
- confirmation notes and difference accounts and valuations
- communications controls (not misleading)
- client funds segregation requirements (some non-private customers).

Non-customers (market counterparties) have more limited protections, namely:

- advertising controls
- transaction reporting obligations
- communications controls (not misleading)
- client funds segregation requirements

The protection against unsolicited calls applies to various "private investors". Compensation fund claims are limited to eligible investors (excluding professional investors and business investors). All firms must comply with the financial supervision requirements.

12. Appropriateness of the Counterparty and the Suitability Test

A bank acting as a derivatives dealer should implement measures in order to assure that its counterparties (end users) have the legal and regulatory authority to engage in the contemplated activities and that the terms of any contract governing the bank's derivatives activities with a user (counterparty) are legally sound. A bank acting as a dealer should also maintain documentation in the file that indicates if a user requested a transaction that a bank believed was inappropriate for that user given its level of financial sophistication. Although there is currently no legal bar against executing a derivatives transaction for any user, given the risks of liability, the bank should retain documentation that details the individuals involved in the discussions (both bank and user).

Banks should consider obtaining an opinion of counsel in the jurisdiction of any foreign counterparties to support bilateral netting agreements for purpose of calculating credit exposure for transactions with such counterparties. The legal status of netting for the users in some foreign countries is uncertain, and banks should obtain legal assurance that netting agreements will be valid in the event of default or bankruptcy.

12.1. Suitability and Appropriateness Policy

The objective of this policy is to protect the bank against the credit, reputation and litigation risks that may arise from a user's inadequate understanding of the nature and risks of the derivatives transaction. *(As stated in Reserve Bank of India Circular on Draft comprehensive Guidelines on Derivatives)*[13]

Before undertaking a derivative transaction with or selling a structured derivative product to a user, a bank should:

a) document how the pricing has been done and how periodic valuations will be done. In the case of structured products, this document should contain a dissection of the product into its generic components to demonstrate its permissibility, on the one hand, and to explain its price and periodic valuation principles, on the other. This document should be shared with the user concerned.

b) analyse the expected impact of the proposed derivatives transaction on the user;

c) ascertain whether a users has the appropriate authority to enter into derivative transactions and whether there are any limitations on the use of specific types of derivatives in terms of the board memorandum/policy of the former, level at which derivative transactions are approved, the involvement of senior management in decision-making and monitoring derivatives activity undertaken by it,,

d) identify whether the proposed transaction is consistent with the user's policies and procedures with respect to derivatives transactions, as they are known to the bank,

e) ensure that the terms of the contract are clear and assess whether the user is capable of understanding the terms of the contract and of fulfilling its obligations under the contract,

f) inform the customer of its opinion, where the bank considers that a proposed derivatives transaction is inappropriate for a customer. If the customer nonetheless wishes to proceed, the bank should document its analysis and its discussions with the customer in its files to lessen the chances of litigation in case the transaction proves unprofitable to the customer. The approval for such transactions should be escalated to next higher level of authority at the bank as well as the user,

g) ensure the terms of the contract are properly documented, disclosing the inherent risks in the proposed transaction to the customer in the form of a Risk Disclosure Statement which should include a detailed scenario analysis (both positive and negative) and payouts in quantitative terms under different combination of underlying market variables such as interest rates and currency rates, etc., assumptions made for the scenario analysis and obtaining a written acknowledgement from the counterparty for having read and understood the Risk Disclosure Statement.

[13] http://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=457

h) guard against the possibility of any misunderstandings. All significant communications between the bank and user should be in writing or recorded in meeting notes.

i) ensure to undertake transactions at prevailing market rates and to avoid transactions that could result in acceleration/deferment of gains or losses,

j) should establish internal procedures for handling customer disputes and complaints. They should be investigated thoroughly and handled fairly and promptly. Senior Management and the Compliance Department/Officer should be informed of all customer disputes and complaints at a regular interval.

It may also be noted that in cases where a bank is dealing with a user directly or through another bank with the latter as an intermediary, it must still ensure a 'Customer Appropriateness and Suitability' review of the intermediary bank as also the end user. The forward contracts are in use for long time and are well understood by the market participants. Nevertheless, even for plain forward contracts, it is advisable that banks, in their own interest, may explain to the customer, the risk implications of the product.

13. Master Agreements

Globally recognized International Swaps and Derivatives Association (ISDA) and other Master Agreements are extensively used in the OTC derivatives market. These Master Agreements were originally developed in the USA and Europe in response to concerns about the enforceability of contractual netting arrangements, and to harmonise and expedite the documentation process in OTC markets. Master Agreements are continually evolving for existing and new derivatives products.

The extensive use of International Swaps and Derivatives Association (ISDA) agreement has made its place in the derivatives market as the standard documentation.

Lawyers who advise Sri Lanka's financial market participants are quite familiar with the ISDA Documentation. However a proper judicial test has not taken place in Sri Lanka.

14. Conclusion

The threat of invalidation of the contract may even come from the regulator. The board and senior management should make sure that all necessary regulatory approvals have been obtained, that adequate operational procedures and risk control systems are in place. Such derivative activities should be consistent with a bank's overall risk management policy and business plan. Even if a bank intends to invest in derivatives of a type and in a manner that does not require a formal application to its regulators, new types of derivative activities that present potential legal or business issues should be discussed with the appropriate regulators before implementation.

Also banks must continue to be vigilant as regulatory and legal standards in this area continue to evolve.

This article is a mere attempt taken at discussing the most common legal issues that a banker might encounter in enforcing a derivatives contract. The law of contract is a vast area of law: hence this is not an exhaustive and comprehensive text analyzing all legal aspects of financial derivatives.

BANKING INDUSTRY IS TOTTERING - STORMS OF CHANGE

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Glaciers are melting, the water levels of oceans are rising, earth plates are moving frequently, resulting in tsunamis and earthquakes. Landslides and floods are becoming frequent natural disasters. Weather patterns are changing. Africa is dying with HIV Aids. Asia is threatened by Bird flu, Europe is threatened by Mad Cow disease. Al Qaeda and several terrorist groups are threatening world peace. Russia and China, old communist allies, have joined hands for military exercises; is it a preparation for another cold war? Globalization pushes products and services to a position of Low Price - High Quality without geographical barriers. Key to Industry survival or growth is global communication which has a traffic volume worse than traffic on highly congested roads during peak hours. Everything is unpredictable, volatile, very fast, non-stop and sometimes disastrous.

The History:

The modern banking history began in Lombard Street where the traders and business community entrusted their excess money to respectable, honest, trustworthy merchants for safe custody and return. Then these merchants recognized the time gap between deposit and withdrawal of money and began to lend a part of it. The whole business of banking was based on mutual understanding, trust, moral values etc. and it was a psychological bond among depositors, lenders and borrowers.

Marketing orientation of Banking Industry

The history of the paradigm shift in marketing orientation of the banking industry was begun in the latter part of the 20th Century. The scenario was clearly illustrated by the famous marketing guru, Phillip Kottler in his famous book – Marketing Management.

"Years ago; bankers had little understanding or regard for marketing. Bankers did not have to make a case for checking accounts, savings, loans or safe deposit boxes. The Bank building was created in the image of a GREEK TEMPLE, calculated to impress the public with a bank's importance and solidity. The Interior was austere and the Tellers rarely smile. One lending officer arranged his office so that a prospective borrower would sit across from his massive desk on a lower chair. The office window was located behind the officer's back, and the sun would pour in on the helpless client, who tried to explain why he/she needed a loan. This was the Bank's posture before the Age of Marketing.

Marketing should be in a friendly atmosphere. The Banks learned that attracting people to a Bank is easy; converting them into loyal customers is hard. The Banks began to formulate programmes to please the customers. Bankers learned to smile. The bars were removed from the tellers' windows. The Bank interior was redesigned to produce a warm friendly atmosphere. Even the outside Greek-temple architecture was changed. Competitors quickly launched similar programmes of friendliness training and decor improvement. Soon all banks were so friendly that friendliness lost its decisiveness as a factor in bank choice

Segment and innovate: Clearly they began to look alike. They are forced to find a new basis for competition. They began to realize that no bank can offer all products and be the best bank for all the customers. A bank must examine its opportunities and "take a position" in the Market. Positioning goes beyond image making banks which seek to cultivate an image in the customer's mind as a large friendly or efficient bank.

Marketing is advertising, sales promotion and publicity, marketing into bank not in the form of the Marketing concept but in the form of advertising and promotion. Banks were facing increased competition for savings. Few Banks started to do heavy advertising sales promotion. They offered umbrellas, radios and other "Come-ons" and attract new customer accounts. Their competitors were forced to adopt the same measures and escurried out to hire advertising agencies, sales promotion experts.

The process of marketing orientation of banking industry has moved to the areas of publicity, advertising, market intelligence and research, marketing information systems etc developing sub-branches of financial service marketing within the main subject of Marketing.

Someone can raise a simple question. Is it the starting point of storms heading towards the banking industry?

The banking industry has experienced a paradigm shift in the latter part of the 20th century which would not be discussed at length in this paper. However the following is the reality:-

1. Entry of rapid development of computer hardware, software with communication and networking to the industry is dominating the industry today.

2. Moving away from Core banking and entering into other areas of financial markets, capital markets, and formation of subsidiary companies and entering into different areas of non financial services.

3. Globalization of industry through global regulatory frameworks.

For a service organization like a bank it is necessary to understand and believe that the "customer is always right". The customer is always right even though he/she is wrong. The customer is always right if he/she thinks that he/she is right. It is the job of the bank personnel to convince the customer about the rules and the regulations relating to a particular service or situation.

Bankers will be required to educate themselves on customer counselling in the new environment. The bank that is able to provide maximum satisfaction to the majority of customers will be the ultimate winner in the growing and competitive financial markets. In the new millennium, it adds another role to bankers: "Customer advising and customer counselling".

Now storms are blowing in from all directions tottering the Banking Industry. Stormy winds are everywhere trapping the banking industry in a maze; how can it find its way back ?

Planned changes to unplanned change management

Change simply means the alteration of the status quo. Even in a most stable organization change is necessary just to maintain the present status. Accordingly, management must continuously monitor the outside environment and be sufficiently innovative and creative to find new and better ways of utilization of organizational and industry resources so that the customer needs are competitively met and customer problems are adequately solved. The term of customer includes both internal customer and the external customer and the stake holders. The change is the demand by external forces and internal forces. External forces are usually generated by the external environment and can be classified broadly in the following manner.

1. Remote external environment (global as well as domestic)

   Remote external environment consists of Economic, Political, Mega trends in Customer / Consumer Behaviour, Legal and Regulatory, Social and Cultural, Demographic, Technological and Natural environment. Individuals and institutions cannot influence these variables. Even an industry in a particular country cannot influence them because they are valid globally and that is why these environmental forces are remote and not variable.

2. Operational external environment

   It consists of customers of a particular institution / organization, suppliers, labour market, government and competitors. Usually individuals and organizations can influence to some extent subject to given strengths and weaknesses of that organization.

Internal Environment

This includes a large number of strengths and weaknesses of a particular organization, covering many areas.

In the banking industry, it covers the image of the bank, quality of the staff, financial strength (liquidity, capital, adequacy, profitability, assets base etc.) level of product and service differentiation and innovativeness as well as strategic management competencies, technology productivity level of the staff, quality of machinery and equipment, convenience of locations, refurbishment level of premises, good governance, accounting standards, level of non performing advances and provisioning etc.

The internal environment can be controlled by the management.

Naturally those environmental forces continuously demand changes in the particular industry or institution. The management's solution is to introduce planned changes and development interventions. Kirk Lewis has given a simple model explaining the process.

Desire to Change

↓

Unfreeze

↓

Change

↓

Refreeze

Organization development aspect requires intervention in key major areas.

Structural Intervention

↓

Technological Intervention

↓

HR Intervention

↓

Strategic Intervention

↓

Physical Intervention

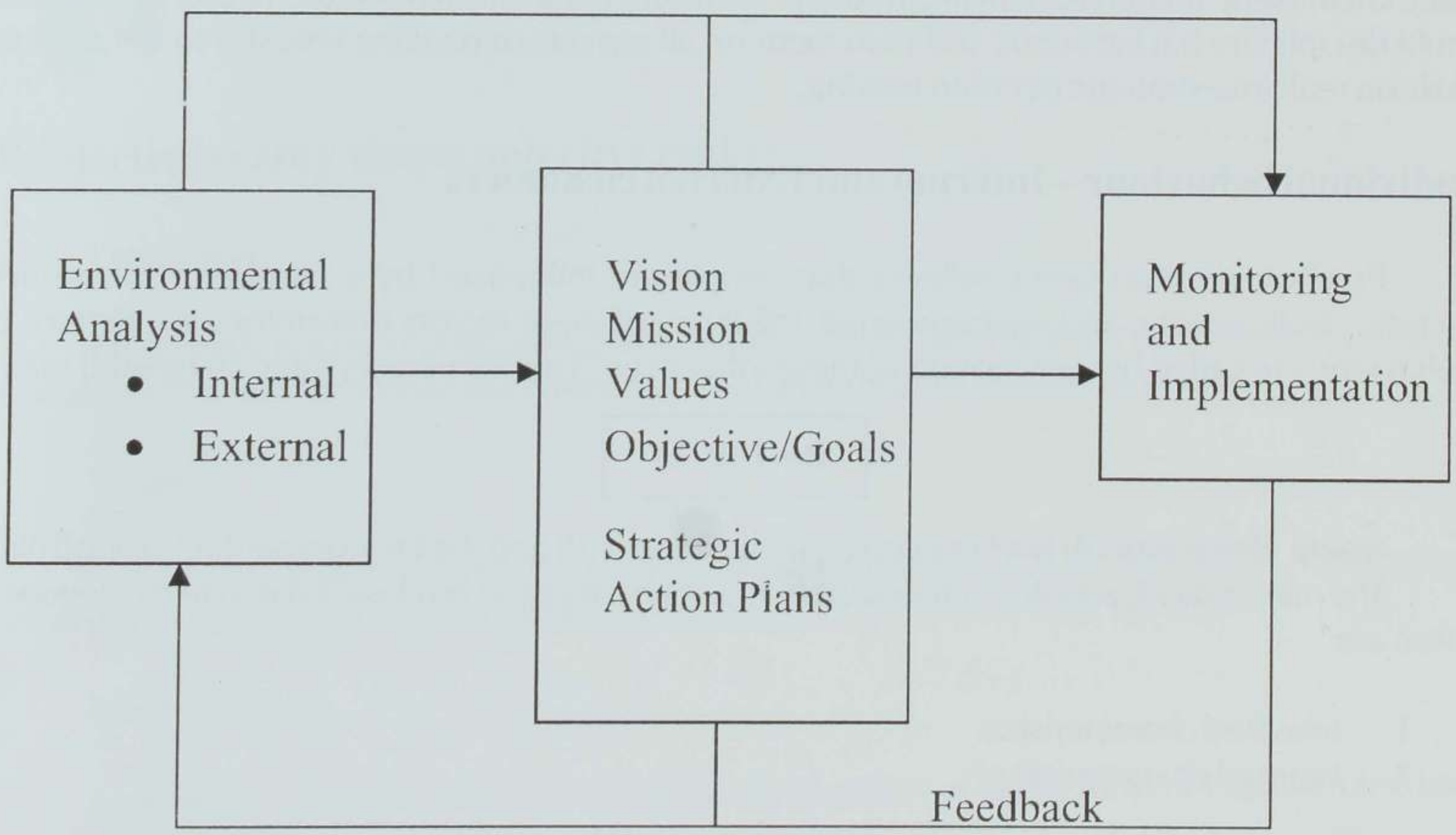
If organization or industry does not introduce planned changes at the appropriate time, external and internal forces will gain entry into the industry or organization and change all the variables for the sake of change and not as expected by the organization or industry, thus creating an unmanageable situation.

But the dilemma of the management consultant is how to introduce planned organizational development changes to the banking industry or a particular bank. Because by the time you identify external and internal forces which require such changes and come up with a plan, it may be too late to introduce planned changes because environmental forces are too fast and too powerful like rapidly changing storms.

Strategic Plans and real-time strategies

The owners expect high returns on their investment; the employees try to maximize their benefits; depositors demand safety and high returns on their deposits; borrowers demand competitively lower rates even with weak collateral ; the regulators expect high profitability with low risk and high solvency level. The management consultants would give a formula to the corporate management called the Corporate Plan or Strategic Plan to prepare a clear path to direct the bank they manage.

Strategic Planning Model



Is this the answer to the strategic questions?

The rationale for the existence of a business is provided by the answers to the following:
Where was it?
Where is it now?
Where does it want to go?
How does it go?
When does it go?
What prevents it from going there?

Once management has a corporate plan with set targets ,it expects to play a monitoring and controlling role but the problem today is the widening gap between the real situation and the strategic plan itself. The volatile environment variables storming at the banking industry have narrowed the time gap. Three or five year corporate plans have become only a well bound decorative book. Therefore it becomes strategic planning verses real-time strategies. The responsibility of formulating short term real-time strategies has become the responsibility of corporate or senior management. That means no structured decisions. All key decisions are unstructured. Responsibility then passes on to the experience, talents and judgment of the corporate or senior management rather than the external consultant who prepared smart attractive corporate plans. The issue then is - are there specialists or experts in the corporate management? Real time strategies demand more judgmental decisions. Therefore corporate managements should have personnel with multi disciplinary skills, knowledge and experience to cope up with any strategic decision making related to banking industry. Therefore banks should recruit young people with multi disciplinary backgrounds and train them on all aspects of banking industry to enrich their skills on real-time strategic decision making.

Individual behaviour – Internal and External customers

Psychologist Kurt Levin believes that people are influenced by a number of diversified factors - both genetic and environmental. Influence of these factors determines the pattern of behaviour. He called his conception of these influences "The field theory" and suggested that

$$\boxed{B = F(P, E)}$$

where Behaviour (B) is a Function (F) of the Person (P) and the Environment (E) around him.

The main individual factors influencing human behaviour can be classified into two categories, these are

1. Inherited characteristics
2. Learned characteristics

Inherited characteristics

Inherited characteristics include Physiological aspects, Intelligence, Gender and certain Personality factors, such as the religion observed or philosophy of the family, age and genetic history of the family

Learned characteristics

These characteristics include an individual's attitudes, personality, values, perception, and norms about the environment around him or her

Attitudes:

More precisely, an attitude can be defined as a persistent tendency to feel and believe in a particular way towards some object.

Perception:

Perception is the process by which information is transmitted to our mind and interpreted in order to give some sensible meaning to the world around us. It is the result of a complex interaction of various senses such as feeling, seeing, hearing etc

Subjective reality verses objective reality

Personality:

Personality is a set of traits and characteristics, habit patterns and conditional responses to certain stimuli that formulate the impression that an individual makes upon others.

Values:

Values are assumptions of what is right, good or important to the individual. Values are of great importance to the individual because they guide him\her in their behaviour.

Norms:

Essentially collective values that are usually manifested in the form of explicit rules, laws, codes of practice and implicit group attitudes or culture.

The individuals with Inherited and Acquired characteristics form different behaviour situations such as Interpersonal behaviour, Small group behaviour, integrated organizational behaviour, Social behaviour, Cross country behaviour.

These behavioural aspects are important to the banking industry in two ways: one is that of the customer - because in the service industry, customer is still expected to enter into the conversation process as the industry has high contact level with the customer. To open an account or to obtain a loan, customer is still expected to visit the bank. That means the individual characteristics of the customer has a major impact on the customer behaviour. The other is that of the employee: employees are internal customers of the bank. Though technology has taken over part of the bank's operations, still the employee or internal customer plays a key role in the industry.

Mega trends in lifestyle, economic and cultural variables have changed both inherited and acquired characteristics of individuals. In the good old days almost all of the banks' staff were of high integrity, loyalty, commitment and positive attitudes. They fitted in well with the organization's requirements. They maintained high professional and behavioural standards when interacting with the customers. But today they are foot-loose and planning to jump from one employment opportunity to another. Trainers are busy with improving the attitude of the staff, introducing training programs on behaviour, social etiquette, dress etiquette etc.

Outsourcing and HR issues

The impact of HR aspect and customer behaviour have jolted the industry with the issues involved in maintaining competitive advantages on bank image, customer service, professionalism and stability.

The introduction of outsourcing to manage rising personnel costs has created a storm in the banking industry shaking its original status. Outsourcing has today extended to the global level and it's called global outsourcing, going beyond geographical boundaries. How can a bank fit these outsourced employees to its organizational requirements and culture? How can the discipline required for the industry be maintained? The key problem is how can a bank maintain or improve relationship management with foot-loose ,out sourced employees?

Is outsourcing a silent killer or a saviour of the industry?

Skilled worker verses Knowledge worker

20th century was the century of skilled workers but the 21st century is dominated by the knowledge workers. The skill requirements of arithmetic, book keeping, accounting has transformed to knowledge requirements in software packages, computer based financial analysis etc.

The "New Realities" written by famous management guru Peter F Drucker illustrates this transformation revolutionary manner as follows:-

"A very large number of knowledge workers, perhaps the majority, will still be working in and for businesses. Yet their position is quite different from either that of yesterday's bosses or that of yesterday's workers. They are employees but at the same time are the only real capitalists through their pension funds. They do have a "Boss" and are thus "Subordinates" but are themselves "Bosses"...........Knowledge worker is thus a colleague and associate rather than a subordinate. He has to manage as such.

Infiltration of more knowledge workers to the banking industry means more complicated issues in how to manage people?

IT Invasion without boundaries

Today Technology plays a key role in the banking industry and the main outcome has been to reduce customer contact level and time by expediting delivery of the services using network banking and online systems to get a competitive advantage.

The key issue is where the boundary is. The industry started networking its branches and now it has been extended to internet and mobile phones. The call centres are also connected to the network system. The call centres have expanded beyond the geographical boundaries. Banks are now caught up in the IT storm. Recently most banks developed network banking systems using Microsoft Windows XP platform compatible systems. But now Windows Vista has arrived which requires wide screens and high performance PC's making Windows XP systems outdated.

Time will come to change over to Vista system shedding the currently used System Hardware and Software. Changing system resources, upgrading the system and retraining staff entail heavy costs.

Banking industry has to enhance computer security to safeguard itself against hackers and computer virus. Hence they have to go along with system developers incurring heavy expenditure. Thus banks are caught up in a dual war against risks and safeguards.

IT department becomes a major budget consumer; it adds to transaction cost and makes banking industry very expensive and almost a luxury.

Another issue is that banks are losing relationship with customers due to the intervention of IT. Customers are losing their relationship and loyalty towards a particular bank and due to the competitive environment, they are shopping around to fulfill their banking needs from different banks. The relationship and behaviour of a customer is thus unpredictable and in the long run, the bank has to find new ways of mobilizing deposits.

Data and information which is generated and manipulated by the systems has piled up to a data warehouse, creating a situation where employees and customers do not know which data needs to be mined.

The centralization with IT enables setting up of centralized back offices, credit factories and call centers, weakening valuable customer relationships.

Out sourcing using IT, facilitates outsiders to view most confidential customer and bank data thereby challenging the existing rules and regulation of a bank. This situation becomes more complicated as outsourced employees get access to internal bank data.

The complicated IT environment is invisible to the naked eye and bankers are subject to the mercy of software and hardware engineers who know what type of frauds and sabotage can occur

Greek Temple to Mobile Bank

The early experiments sometimes fizzled out but a new wave of technology has taken mobile phones to the point where they can be of use to financial services such as receiving stock exchange updates, do banking transactions, check account balance etc

Although intended use of the mobile phone is to make phone calls and text messages gradually mobile technology is sneaking into the banking industry. With the latest developments such as Mobile internet technologies (WAP, GPRS, EDGE, Mobile applications) it has become a 'must have device' making it the remote control of modern day life.

The crucial question related to IT supported banking industry is - "Is it supported by IT or dominated by IT?"

Regulators, on whose side?

The regulators are very busy protecting customers and introducing risk management in many areas. Basel 1 introduced capital adequacy and credit risk management in 1990s; for year 2008 onwards it has an expanded the risk areas creating three pillars of risk

Credit risk

Operations risk

Market risk

Today most bankers are busy developing business continuity and disaster recovery plans to minimize operational risks which demand extra cost and idle assets. Credit risk management narrowed down the risk and profitability game played by the bank through relationship management. The bank for international settlement (BIS) is planning to enforce more regulations in the future such as Disclosure of off balance sheet items, bringing in additional Accounting standards etc. International terrorism and illegal businesses force bankers to play a detective role to detect and prevent money laundering and terrorist activities and thereby necessitate bringing in "Know Your Customer" concept (KYC).

Opportunities for corporate crimes in these areas were not previously known to the banking industry because the industry was well managed by professional bankers with ethics, simple products and operational procedures. When the industry expanded and the competition increased beyond ethical levels, avenues began to open for corporate crimes. The Pramuka Bank incident itself gives a good example of corporate crimes related to the banking industry. Then where is the trust and the faith in bankers who developed this industry from London Lombard Street who collected others' money and returned it with utmost safety while lending to very good borrowers.

While society demands good governance is Corporate Crime another silent killer in society?

Conglomerates entering into banking industry

While storms are blowing from all over and continue, another storm in the form of the large conglomerates is entering the banking industry. These institutions will play a competitive role taking advantage of the companies of such conglomerates. Then competition will not be fair to all players.

Corporates began to avoid the banking sector by operating through monitory instruments like commercial papers, capital instruments, debentures, share issues and issuing of different type of globalized instruments such as Global depository receipts. Then banks turned to retail and SME sector with the concept of "small is beautiful" but with globalization, small is getting smaller and their survival time is shortened.

Supermarkets and Shopping Malls force small retailers to put up shutters, eliminating competition and depriving relevant shoppers of their choice. Product differentiation of small companies are quickly captured by the bigger ones. The herbal toothpaste products of small producers being captured by Signal Herbal toothpaste in Sri Lanka and India is a case in point.

Banks and their Core Business

The bankers have moved to capture markets such as personal and vehicle loan markets and to look at other income avenues such as credit card, leasing and factoring business. What therefore is the core business of banks today?

In this scenario one wonders whether banks are in the banking business or in the facilitating business.

The storms continue to blow with rapid development of internet based payments with the expansion of e-commerce via internet payment gateways, Real-time gross settlements deprive the banks of the benefit of the Float. What is the future of documentary based international trade or cheque payment systems?

Banks are searching for new channels

The expansion of non banking financial institutions such as finance companies and specialized saving banks into all commercial banking activities, other than demand deposits, cause commercial banks to lose part of their business volumes. But on the flip side of the coin, banks now hit back by venturing into the leasing business at rates that non-banks cannot afford and also use the capital allowances under leasing to reduce the tax burden on their other interest income.

Due to narrowing margins banks cannot afford castle type buildings to house their branch-offices. Instead they resort to small front offices or super market banking centres with a single employee at a terminal connected to the main network.

The banking industry is tottering with powerful storms blowing from all directions. Customers and investors seem to be watching while corporate management teams are busy with formulating real time strategies for survival or growth. What are the solutions? Formulation of strategies and business alliances, shared technology with competitors, mergers and acquisitions, moving away from core-business (core-banking) are the order of the day. But still there should be someone to look after collection of money, keeping it in safe custody and lending part of it, as it is the root of sustainability and growth of the economy.

To quote ***Theodore Levitt in "Management Myopia – Innovation in marketing new prospective for profits and growth"***

Every major industry was once a growth industry. But some that are now riding a wave of growth enthusiasm are very much in the shadow of decline. Others that are thought of as seasonal growth industries have actually stopped growing. In every case the reason growth is threatened, slowed or stopped is not because the market is saturated. It is because there has been a failure of management.

According to Theodore Levitt it is natural to experience different business cycles in industries. Sometimes existing industries can vanish and new industries may emerge.

For any industry to survive there must be a united and professional approach to safe guard the industry from strong storms in spite of competition, by improving profits, market share and maximizing investment returns to the share holders.

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PROFILES OF AUTHORS

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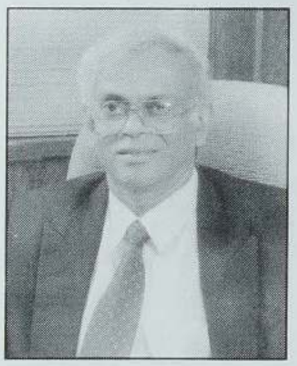
Dr Nimal Sanderatne has had a varied career. He has been a journalist, central banker, commercial banker, development banker, investment banker and university don. Currently he teaches at the University of Peradeniya, is a writer of fiction, a newspaper columnist and book publisher. Till recently he was Visiting Senior Fellow of the Postgraduate Institute of Agriculture (PGIA) of the University of Peradeniya and founder Chairperson of CEPA from its inception. Among the positions he has held are those of Advisor, Research and Training, Director of Statistics and Director of Economic Research of the Central Bank; Chairman of the Bank of Ceylon; Chairman of the National Development Bank. Dr Sanderatne was Senior Fellow of the Institute of Policy Studies (IPS) in its formative years. He is the author of several books and of over 70 articles in Journals or as chapters of books.

W A Wijewardena



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Mr. W A Wijewardena has counted 33 years of service in the Central Bank in numerous capacities: in the Economic Research Department as an Economist, Senior Economist, Deputy Director and finally as the Acting Director; in the Currency Department as its Superintendent; in the Rural Credit Department as its Director; in the Employees' Provident Fund Department as its Superintendent. He held the position of Assistant to the Governor prior to his elevation as the Deputy Governor.

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He is Member of the Financial Sector, Capital Markets, Taxation and Legal Reforms Clusters of the National Council for Economic Development (NCED) and also a Member of the National Payments Council and Inter-Regulatory Institutions Council.

He is a Graduate of the University of Ceylon, Colombo and a Fellow of the Institute of Financial Services, London.

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During her period of service in the Ministry of Finance, she represented the Government on the Boards of Sri Lanka Institute of Information Technology, De La Rue Lanka Currency & Security Print (Pvt) Limited, the Ceylon Electricity Board, the

Sri Lanka Export Development Board, DFCC Bank and Sri Lanka Telecom Limited. She also represented the Ministry of Finance on the Tariff Advisory Council.

Mrs. Cooray has been the leader/member of Sri Lankan delegations to negotiate Free Trade Agreements with India, Pakistan and several other countries. She has also participated in loan negotiations on behalf of the Government and the Central Bank of Sri Lanka with several international organizations. As a representative of Sri Lanka / Central Bank of Sri Lanka she has presented papers on a number of subjects at various international meetings and seminars.

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Mr. Goonewardena has a multi disciplinary professional background. Apart from his qualifications as an Attorney-at-Law he is also an Associate Member of the Institute of Chartered Accountants of Sri Lanka (ACA), the Chartered Institute of Management Accountants - UK (ACMA) and a Charter Holder of the CFA Institute - Charlottesville, USA (CFA). He also has a Masters Degree in Business Administration (MBA) from the Postgraduate Institute of Management, University of Sri Jayewardenepura.Mr. Goonewardena specializes in Financial Law and Communications Law. He has been involved in advising various parties nationally and internationally in loan syndications, bank restructurings, securitizations, derivatives, due diligence on acquisitions and taxation.

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Dimantha Seneviratne is the Head of Credit Risk Management, HSBC Sri Lanka and Maldives. He counts over 17 years in banking, mainly Corporate Finance and Risk Management of which, 10 years with the HSBC group, in Sri Lanka and overseas postings. Prior to joining HSBC, he was with Sampath Bank and Overseas Trust Bank, Colombo.

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Dimantha is an Executive Council member of Association of Professional Bankers, Sri Lanka for the last 7 years and currently serves as its Assistant Secretary. He is also a member of the SLBA Sub-Committee on Risk Management and Implementation of Basel II and the Basel II -Project coordinator for HSBC Sri Lanka & Maldives within the HSBC Asia Pacific main project team. As Head of Credit Risk Management, Dimantha is responsible for the overall credit quality of Corporate and Personal Banking asset base. He has undergone extensive training overseas in Corporate Finance, Trade, Personal Finance and Treasury Risk management including intensive attachments with the group offices.

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Rose Matilda Siriwardhane is the Director of Payments and Settlements Department (PSD) of the Central Bank of Sri Lanka (CBSL) since 2002. The PSD is responsible for performing a wide spectrum of payment and settlement related functions, viz. facilitating policy making on payment system issues, operating and monitoring of RTGS System, overseeing payment system, effecting Asian Clearing Union (ACU) transactions and 'Back Office functions' of the Central Bank's rupee and foreign exchange transactions. Since she joined the Bank in 1975, she has worked in various departments of CBSL including Economic Research Department, Development Finance Department, Centre for Banking Studies, Exchange Control Department and Banking Department. She was actively involved in implementing the RTGS System, which went live on 8 September 2003. She currently acts as the bank-wide risk management officer.

She is the secretary of the 'Committee for Contingency Events and Disaster Recovery for LankaSettle' of CBSL. She is a member of the CBSL's 'Financial System Stability Committee', 'National Payment Council', 'Foreign Reserve Management Committee' and 'Risk Management Committee'. She is also a director of the LankaClear Pvt. Ltd.

She headed the teams which drafted: the Red Book – 'Payment Systems in Sri Lanka', which was published by the Bank for International Settlements in 2004; and the "Financial System Stability Review", which was published by the CBSL in 2006.

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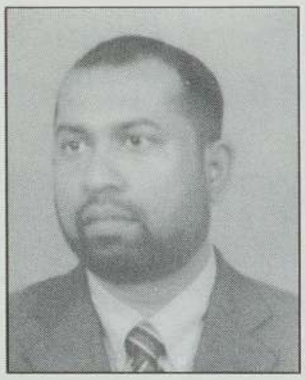

Manoj Akmeemana is the Manager Planning at Sampath Bank Ltd., and has over 18 years experience in branch banking, retail credit, strategic planning and using performance management tools including the balanced scorecard. He also has overseas banking exposure, especially in consumer banking at Commercial Bank of Qatar.

Manoj is an Associate of the Institute of Bankers of Sri Lanka and prize winner of several subjects at the IBSL final examinations. He also holds diplomas in Bank Management from IBSL, and Credit Management from Institute of Credit Management, Sri Lanka. He holds a Masters Degree in Business Administration (MBA) from the Postgraduate Institute of Management, University of Sri Jayawardenapura and obtained his first special degree in Business Administration from the University of Sri Jaywardenapura. He is a Member of the Chartered Institute of Marketers (MCIM), UK, and has completed the final examination of the Certified Management Accountants (CMA), Australia. Manoj has obtained a Merit Award for Higher Professional Level Module Certificate in Strategic Management from the University of Cambridge, UK.

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Mahohari graduated from the University of Kelaniya, having read Mathematics and Physics for the degree. Subsequently, she joined the Banking Industry and counts over 16 years of experience serving Standard Chartered Bank, National Development Bank and presently at DFCC Bank in the capacity of Senior Vice President, Group Treasury. Her area of specialty is Treasury and Market Risk Management and Fixed Income Securities. Manohari has received wide training both locally and overseas at Standard Chartered Bank Singapore, Dubai and Mumbai.

She holds a Master's Degree from the Postgraduate Institute of Management, University of Sri Jayawardenepura and posses a Dealing Certificate from the Association Cambiste International (ACI) which is a prime qualification in the Treasury world. Manohari is a regular lecturer at the Center for Banking Studies at the Central Bank of Sri Lanka and a visiting lecturer of the Institute of Bankers Sri Lanka.

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Dr. Chintha Dissanayake

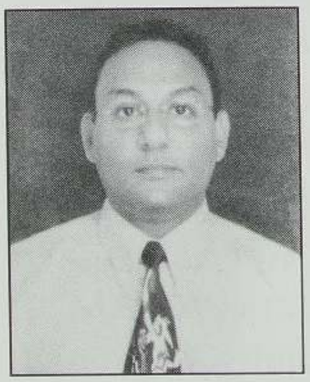
In 1986, Chintha graduated from Kings College, University of London with a BSc. (Hons) in Biology. Then decided to change direction slightly, and continued her studies in the human science of Psychology. Chintha's long training in Industrial & Occupational Psychology commenced in 1987 with a diploma in Psychology, then a MSc. and PhD in Applied Occupational Psychology from the Cranfield University. In 2002, she graduated from the University of Leicester's Law faculty with a MA in Law and Employment Relations.

As an Occupational Psychology Consultant, Chintha provides psychology solutions to small and large businesses including Barclay's Bank, C&A Retailers, Coutts Bank, Electrolux, Ethnic Minorities Business Services, Fords UK & Europe, Gartmore Investment, Department for International Development, Marie Curie Centre, Macmillan Nurses, National Air Traffic Services, Prison Service College and Thomson Tour Operations.

Chintha remains up to date in her knowledge through active professional memberships of the British Psychological Society (BPS); the Commission des Psychologues, Brussels; the European Association of Work and Organizational Psychology (EAWOP); and the Society for Industrial and Organizational Psychology (SIOP), Inc. USA, International Conference Review Committee, and a founding membership of BPS's new Special Group in Coaching Psychology.

Currently, she is liaising with an university in Sri Lanka, to establish a BPS accredited Occupational Psychology academic program to help promote better employment practices in Sri Lanka.

Niroshana Seneviratne



Niroshana Seneviratne is a Fellow member of the Institute of Chartered Accountants of Sri Lanka and a lecturer at the Institute. He is also a Fellow Member of the Institute of Bankers of Sri Lanka and had been a lecturer at IBSL. He is currently a Chief Examiner for IBSL examination and a lecturer in Financial Management. He is also a Certified Information Systems Auditor, (CISA USA) and had been a member of the board of Information Systems Audit & Control Association (ISACA) Sri Lanka Chapter. He obtained his Masters in Management from the University of Sri Jayawardenapura and currently a visiting lecturer for the MBA Program at the University of Colombo.

Mr. Seneviratne counts more than 15 years in the banking sector and currently attached to NDB Group as an Assistant Vice President. He has been a regular writer and a paper presenter at various banking forums and a regular contributor to the associations' annual volumes and journals.

He is a regular lecturer for CIMA and ACCA examinations on Risk Management and Auditing subjects at leading business schools. He is also a visiting lecturer at the Centre for Banking Studies at the Central Bank of Sri Lanka.

Gayani Godellawatta

Gayani Godellawatta is a Deputy Director of the Central Bank of Sri Lanka, presently attached to the Finance Department as Deputy Cheif Accountant. Prior to that, she was with the Bank Supervision Department for 15 years as an Examiner, Senior Examiner, Senior Assistant Director and Deputy Director of Bank Supervision. While at Bank Supervision Department, she headed the policy division and was involved in formulating important legislation/regulations such as amendments to the Banking Act, Basel II guidelines, Directions on Single Borrower Limit etc. She was a member of the Basel II sub-committee formulated by the Sri Lanka Banks' Association (SLBA) representing Central Bank of Sri Lanka.

She is an Associate Member of the Chartered Institute of Management Accountants (CIMA) and holds a Postgraduate Diploma in Business Administration from the Postgraduate Institute of Management (PIM), University of Sri Jayewardenepura. Ms Godallawatte has undergone extensive trainning on Bank Regulation which includes brief assignments at the IMF, USA, the Centre for Central Banking Studies, UK and the South East Asian Central Banks (SEACEN) Training and Research Centre. She is a resource person at the Centre for Banking Studies of the Central Bank on subjects relating to Bank Regulation, Accounting and Finance. She also served as a visiting lecturer at the Institute of Bankers for its Certificate Course on Banking Regulation.

Viruli de Silva

Viruli de Silva is an Associate Member (AIB) and a Post Graduate Diploma holder in Bank Management (Dip. In Bank Mgt.), of the Institute of Bankers Sri Lanka (IBSL).

She also holds a Diploma in Management from the Open University of Sri Lanka (OUSL) and a Advanced Certificate in Executive Management from the Post Graduate Institute of Management (PIM), University of Sri Jayewardenepura, Sri Lanka. She is currently reading for a Masters Degree in Business Administration (MBA), at the PIM.Viruli counts over 28 years of banking experience and is presently with Seylan Bank Ltd., as an Account Relationship Manager, attached to Corporate Banking Department. She commenced her banking career at Commercial Bank of Ceylon Ltd. in 1979 and has worked in areas of International Trade, Corporate Banking, Retail Banking, Branch Banking, Operations etc., prior to joining Seylan Bank in 1999.

Viruli is presently an Executive Council member of the Association of Professional Bankers, Sri Lanka. She was the first Secretary of the Millennium Toast Masters Club, Sri Lanka.

Mr. Thejaka Perera

Thejaka Perera was enrolled as an Attorney-at Law in 1999. He also holds a Bachelor of Science (General) Degree in Physical Sciences from the University of Colombo. In 2002 he obtained Post-Attorneys Diploma in Intellectual Property Law from Sri Lanka Law College and The Asia Pacific Legal Institute, Washington D.C. USA. He also holds Post-Attorneys Diploma in Banking and Insurance Law from Sri Lanka Law College.

After a brief practice at the bar, he joined Commercial Bank of Ceylon Limited as a Management Trainee. Upon completion of the training he was appointed as an executive officer (Foreign Exchange and Money Market Dealer) at the Commercial Bank Treasury-Dealing Room. He joined DFCC Bank in year 2004. And presently working as a Senior Dealer at DFCC Group Treasury.

D.M.L.C Kumara

Mr. Kumara holds a B.A (Hons) degree in Economics from the University of Peradeniya a Masters degree in Management Special in Business Administration from University of Sri Jayewardenepura. He is also a Member of Sri Lanka Association of Economists.

Mr. Kumara has been a lecturer at local universities on Marketing Research,Corporate policies and Practices, International Business Management, Social Psychology, Organizational Behavior.

During his carrier at the Bank of Ceylon he has gained wide experience by serving in rural as well as urban branches Districts and Provincial Offices and Head Office units such as Research Division, Restructuring Project, Province sales Management, Training Department and presently as the Director of Training of Bank of Ceylon.

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