HOW BANKS CAN FACILITATE PUBLIC - PRIVATE PARTNERSHIPS IN DEVELOPMENT?

W.A. Wijewardena*

Former Deputy Governor - Central Bank of Sri Lanka.

A salient feature of Sri Lanka's banks is that they operate in a local set up and, therefore, have to seek business opportunities from within that set up. In their quest for new business opportunities, they could always profit by adopting a business strategy that aligns them to the economic policy pursued by the government of the day. In Sri Lanka's post conflict economic re-building scenario where the government has given a high priority to re-build the war devastated Northern and Eastern Provinces, many local banks have stepped up their operations in the two regions by accommodating the credit demand of the small micro farmers and small and medium scale enterprises. While this is a good strategy to pursue in the immediate aftermath of the war, it does not constitute a wholesome strategy which they could follow in the medium to long run. That strategy comes from a different dimension of the development strategy of the present government. That is the priority which the government has placed on the development of the infrastructural facilities of the country to help the private sector entrepreneurs to take advantage of the facilities and ensure a sustainable long term growth.

Development of Infrastructure

Infrastructure means many aspects of economic life, like human infrastructure comprising human knowledge base, talent pool and skills and physical infrastructure comprising roads, ports, airports, irrigation schemes and power plants, to mention but a few important ones. Human infrastructure is basically developed by the provision of quality education, continuous training and learning and inclusive health care facilities. The physical infrastructure is supplied by investing in the construction of the facilities concerned. While both types of infrastructure facilities are essential for an economy to maintain a high sustainable economic growth, in this article, we confine ourselves only to the second category, namely, the provision of physical infrastructure facilities.

---

* Consultant on banking, financial and economic matters. Formerly Deputy Governor of the Central Bank of Sri Lanka. He can be reached at waw1949@gmail.com

[1] For details, see, L.A Wickrameratne, "The Development of Transportation in Ceylon, c 1800-1947" in History of Ceylon, volume III, University of Ceylon (1973) pp 303-16; Indrani Munasinghe, The Colonial Economy on Track, The Social Scientists Association, (2002); B. Bastiampillai, The Administration of Sir William Gregory, Tisara Prakasakayo (1968).

In view of the importance of the development of roads and ports in economic development, the British gave a high priority to investments in roads, railways and ports[1]. The British did not concentrate on these infrastructure facilities to the exclusion of irrigation facilities necessary for domestic agriculture; in fact, a fair amount of money was allocated for the improvement of irrigation facilities from very early on during the British rule[2]. Though this was not on the same scale on which such irrigation facilities were undertaken by the ancient Lankan kings, it was a significant volume of investments made by the colonial rulers[3]. A significant feature of the investments made in infrastructure facilities in Sri Lanka during the colonial period as well as in the post independence period has been that all those investments were made as exclusive public investments. However, that was the development model that was in vogue throughout the world and the Sri Lankan authorities too simply followed the same global trend.

Limitations of the government sector

But this is not going to be the same in the future due to four reasons.

First, sooner or later, the government will realise that it cannot continue to finance physical infrastructure facilities on the scale that is required for the country to accelerate and sustain its economic growth at a high level close to double digits. In the past, it was possible for the government to mobilise resources from donors and multilateral lending institutions like the World Bank and the Asian Development Bank for infrastructure development on concessionary terms because Sri Lanka had been at that time categorised as a poor country which is eligible for such concessionary assistance. However, in the early part of the new millennium, Sri Lanka crossed the threshold of the poor country to the status of a lower middle income country and thereby became ineligible for concessionary borrowing any more. Consequently, Sri Lanka has been forced to seek funding for such infrastructure facilities from commercial markets abroad and it can do so only at the risk of raising its foreign debt levels[4].

Second, since the governments are slow in adopting ever changing advanced management practices and lack facilities to improve the technological base underlying those infrastructure facilities, they become subject to a faster decay and eventual disuse by the nation[5]. As a result, though the public sector is poised to undertake many new infrastructure projects, the economic life or the usefulness of those projects to the national economy are subject to dispute. Consequently,

---

[2] See, S.V Balasingham, The Administration of Sir Henry Ward, Tisara Prakasakayo, (1968)

[3] The details of the irrigation work done by the colonial administration are given by A.C.M Ameer Ali, "Rice and Irrigation in the 19th Century Sri Lanka" in The Ceylon Historical Journal, October, 1978, pp 250-74.

[4] With the ballooning trade deficits which cannot be financed out of service flows to the balance of payments, foreign debt servicing in the future will be a daunting challenge for Sri Lanka.

[5] A good example is provided by the reservoirs constructed under the Mahaweli Project. At the time of their construction, the contractors had used the state of the art technology for their operation and it was necessary for the Mahaweli Authority to maintain them properly and upgrade the technology regularly. However, a multi-disciplinary team from the Central Bank that examined the Mahaweli Reservoirs in 2004 found that the maintenance and upgrading adopted were far from adequate and the reservoirs had the risk of complete failure and the breach of the dams if necessary measures are not taken on a priority basis. See, Central Bank of Sri Lanka Annual Report 2004, pp 69-70.

the public sector may choose to get private entrepreneurs to finance those projects under a new economic development model in which the public and private sectors would team up in providing essential infrastructure facilities.

Third, traditionally, the infrastructure facilities involving a high expenditure and long gestation periods were shunned by the private sector because of lack of financing, inability to sell the output and recover the costs and there was no enabling economic model that facilitated them to get involved in such infrastructure facilities. But over the years, new economic and financial models have been developed where the private sector could safely and effectively participate in such projects. The models like design, build, own and operate or build, own and operate or build, own operate and transfer and many more that have been developed during the last three decades or so have enabled the private sector to participate in high cost infrastructure projects[6].

Fourth, large private firms that have the capacity to undertake large infrastructure projects have developed ability to raise funds on a large scale from both domestic financial markets and international commercial markets. Hence, the previous disability which they had with respect to funding and consequently the inability to undertake large projects is no longer a material issue for them[7]. Governments which have realised this new development have now begun to rely on the private sectors' ability to design, develop, build and operate infrastructure projects.

Public Private Partnerships or PPPs

In view of the emerging developments outlined above, new models of both private and public sectors getting together and initiating large development projects have now been developed. These models were first developed and tried out in developed countries which had the problem of having to economise in the use of public funds by way of ensuring the maximum return on investments and curtail government expenditure programmes to maintain a good macroeconomic balance in the respective economies. The first such programme was initiated in the United Kingdom in 1992 by John Major's government under a model called Private Finance Initiative. As reported in an IMF study, as of 2004, the Initiative has been responsible for about 14% of public investments in the UK[8]. Subsequently, several other countries, namely, Chile, Ireland and Mexico too have started private public partnerships in their respective countries.

---

[6] These models are not new to Sri Lanka. The kings of ancient Lanka had licensed the local leaders to construct reservoirs and sell the water to farmers so that they could recover the costs, maintain the reservoirs and pay a rent to the king. See: W.I Siriweera, A Study of the Economic History of Pre-modern Sri Lanka, Vikas Publishing, New Delhi, 1994, pp 38-48

[7] Many private companies in Sri Lanka which are rated higher than the sovereign rating of the country are in a position to raise bigger volumes of funds at lower interest rates than the government.

[8] IMF Fiscal Affairs Department, Public Private Partnership, 2004.

Advantages of PPPs

According to the IMF study under reference, Public-Private Partnerships or PPPs have several advantages over the pure public investment programmes initiated by governments out of public funds.

First, it is a method of sharing risk of commercial businesses by governments with the private sector. For instance, if a commercial project is undertaken purely out of public funds by a government, the government has to bear the full risk if it becomes commercially unviable in the future. Many public projects involving the construction of ports in Latin America had to suffer from this weakness because later the ports were found to be commercially unviable or could not generate the projected income flows. But if a project is undertaken with private participation, better risk management and business restructuring methods could be used if there are signs of the projects becoming commercially unviable.

Second, PPP is a method of acquiring advanced management practices and technology by a government which does not have capacity to develop the same on its own. This is specifically important to developing countries since those countries use an insignificant amount of resources for research and development. In high tech areas like oil exploration and development, the use of the private sector technology and knowledge base is of paramount importance.

Third, governments can effectively utilise private sector talents and skills in running commercial businesses if they go for PPPs. Usually, governments do not produce entrepreneurs, but bureaucrats who are good at controlling and regulating economies. But for commercial projects, what is needed is business acumen. Hence, PPPs are a sure way of enlisting private talents and skills for national development.

Methods of PPPs

There are in fact several methods of PPP that have been utilised by countries which have gone for it. The IMF paper under reference has listed the following important methods:

1. Build, Own and Operate or BOO: The private sector builds projects under government's licence and then runs them commercially by selling the output direct to consumers or to the government which supplies the same to consumers either free of charge or at subsidised prices.
2. Build, Develop and Operate or BDO: Similar to BOO but the private sector has to first develop the project before it starts operating the same.
3. Design, Construct, Manage and Finance or DCMF: In this model, the private sector plays the leading role of the project; it is specifically important to projects involving high technology such as oil exploration, power plants etc.
4. Buy, Build and Operate or BBO: An existing asset is bought by the private sector from the government and then developed according to the emerging market requirements.

5. Lease, Develop and Operate or LDO: Same as BBO but in this case the private sector comes to own the project as a lessee.
6. Build, Operate and Transfer or BOT: Similar to BOO but at the end the project is transferred to the government.
7. Build, Own, Operate and Transfer or BOOT: Same as BOT but the private sector owns the project while it is being operated.
8. Build, Rent, Own and Transfer or BROT: During the period of operation, the private sector rents the project from the government.
9. Build, Lease, Operate and Transfer or BLOT: Same as BROT but in this case instead of renting, the project is leased by the private sector.
10. Build, Transfer and Operate or BTO: Here, the government owns the project but it is operated by the private sector under a management contract.

So, bankers have a new business opportunity in the style of financing long term infrastructure developments in which the basic business model would be PPP.

Potential PPP Candidates

The potential candidates for PPP in Sri Lanka will be the following types of projects:

1. Construction of domestic airports to cater to both the domestic and foreign tourism.
2. Building of highways where the road users will be charged an appropriate road toll.
3. Development of ports and ancillary port services like construction of warehouses, supply of port services etc.
4. Running hospitals, prisons and higher educational institutions as joint ventures.
5. Power plants that use hydro, thermal and coal as the input of operations.
6. Hotels as joint ventures for the tourism sector with the government providing land and the private sector all other inputs.
7. Improvement to railway system through electrification of the existing railway lines.
8. Development of rapid transit systems to alleviate urban road congestions.

All these projects require high capital investments and therefore, it is advisable to commence them as PPPs in view of the budgetary constraints of the government.

Financing of PPPs

Banks will encounter the problem of arranging appropriate financing for these types of projects. Since the resource base of the banks in Sri Lanka is basically deposits and in the deposits too, they are practically of short to very short medium term in maturity, it will not be possible for banks to tie up their short term resources for long term investments without facing liquidity problems arising from the mismatch of resources and resource utilisation. Hence, novel methods of mobilising resources for PPP financing have to be explored by banks.

In this context, it will be useful for banks to consider the following resource mobilisation methods.

1. The issue of long term debentures: Historically, banks in Sri Lanka have depended heavily on deposits to build their resource bases. The mobilisation of deposits is a costly activity since the banks have to maintain a wide branch network to facilitate the prospective depositors to seek deposit services of banks at a lesser transaction cost. Since deposits mobilised by banks are small in size, banks have to incur a high administrative cost to efficiently service their customers. These problems do not arise in the case of debentures because they are large in size, have to be serviced only once or twice a year, such servicing could be outsourced to external agencies and the issue costs are relatively lower than those of mobilising deposits. Banks need not have its own staff to arrange for and the administration of the debenture issues; that function too could be efficiently outsourced to external agencies.

2. Arranging for back to back loans from international lending banks: There is a sizeable global long term lending market which banks could tap to raise funds for long term lending for PPPs. So far, only a few leasing companies in Sri Lanka have tapped this market. In a situation where global interest rates are lower than those prevailing in the domestic markets, banks could reduce the cost of their borrowed funds by tapping this source. However, one problem which banks may face is the exposure to exchange rate risk if the Sri Lanka rupee is expected to depreciate against the borrowing currency. To protect themselves from this risk, banks will have to enter into appropriate hedging and swap arrangements in advance.

Risks of PPPs

Having secured funding for financing PPPs, banks should now assess the risk factors involved in such financing and take appropriate action to mitigate such risks. The risks involved are as follows:

1. Political Risks: When political parties hold diametrically opposite ideologies relating to how the private sector should be used for economic development, changes in government or government policy will pose a significant risk to those who are involved in PPPs. In the past, of course, there was a continuation of the open economy policy to a reasonable degree by the two main political parties that came to power during the period between 1977 and 1994. Against this move toward a policy consensus, the current social trends in the country appear to be unfavourable for getting the private sector to play a leading role in economic growth of the country. The society has become more or less pro state sector and anti private sector. Hence, it is reasonable to assume that there is a high political risk for PPPs and a sudden policy reversal by government may not be favourable for its continuation. Banks will therefore have to take notice of this risk and protect themselves by getting into legally enforceable contractual arrangements.

2. Price Risks: In all PPP projects, an output has to be sold to consumers and the price to be charged from them will form the main income stream of the project. If the government is bent on enforcing price controls or deciding prices administratively guided by the elusive objective of protecting consumers, the project will face the problem of recovering its costs within the stipulated period. When explicit subsidies are promised by governments, in view of the cash flow problems faced by them, it so happens that even the promised subsidies are not delivered in time to producers. It is therefore necessary that in the PPP documentations, all these subsidy and pricing issues have to be clearly sorted out to avoid any ambiguity in interpretation of the cherished objectives of PPP projects.

3. Legal Risks: In Sri Lanka, there is no supporting or governing legal framework for PPPs. Hence, it is possible that when there are disputes with respect to provisions in PPP agreements or mid way changes in the PPP or economic policy structures, it will be difficult to seek redress through the country's judicial system. In the absence of a guiding law, the courts too may take a different view on the use of the state assets for PPP projects as has happened in many judgments delivered by Sri Lanka's Supreme Court in adjudicating public interest litigations placed before it. Accordingly, several public interest litigations made by some concerned citizens have in the past resulted in the original privatisation agreements being annulled by the country's legal system. Bankers who finance PPP Projects, therefore, stand to lose if such eventualities occur in the future as well.

It is necessary that banks make an appropriate risk assessment before they venture into financing PPP Projects.

Conclusions

In conclusion, it should be mentioned that the current wave of PPPs throughout the globe has provided a new business opportunity to Sri Lanka's banking sector. The government is desirous of developing the country's infrastructure but it does not have sufficient resources to undertake the same. In this background, it will necessarily have to enlist the support of the private sector to develop the needed infrastructure facilities. Since the government's declared policy has been to keep ownership of the country's key infrastructure projects, it cannot go for a complete privatisation programme as has happened in the past. A way to enlist the support of the private sector without compromising this objective is to promote PPPs. In this new business environment of PPPs, banks in Sri Lanka have a new business opportunity which they cannot miss.