DEVELOPMENT BANK RE-EMERGED, BANK OF THE FUTURE

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Abstract

Many technological innovations are reshaping the Banking Industry. Fin Tech though used to explain technology applied to financial sector more often than not is used today to highlight the disruptive innovations affecting the banking industry globally. Sri Lanka too is in a period of transformation with many non-bank players providing services affecting bankers' traditional playing field. It's time to ***re-think, re-shape and re-align*** *banking towards better economic prosperity for Sri Lanka.* ***"Changing Dynamics: Bank of the Future"*** *the theme for this years' convention prompted me present this concept paper to analyze the role of a state run* ***Development Finance Institution****. The role it would play in the Sri Lankan context providing Development Banking solutions across, largescale Project Financing the Middle Market Enterprises, Small and Medium Enterprises, and Micro Finance / Financial Inclusion sectors and a probable model for implementation.*

"Addressing the Sri Lanka Economic Forum yesterday Dr. Nicholas said that Sri Lanka needs to go back to development banking absence of which can dent a more progressive economy and private sector in the country. He questioned the logic of privatizing the then efficient and improving DFIs and alleged that the advisors for that move including multilateral donors had ulterior motives. "When China was keen to join the World Trade Organization the first demand was it should privatize its DFI the Bank of China," Dr. Nicholas recalled. According to him every successful nation benefited from a robust development bank and the examples from Southeast Asia was more profound as DFIs helped local private sector in a bigger way than a traditional commercial banking."

Extract from the Financial Times of 31.03.2017

The birth and history of Development Banking in Sri Lanka

The origins of Development Banking in Sri Lanka dates back to the early 1950's when the proposal to set up Development Finance Corporation of Ceylon (DFCC) was presented by the first World Bank mission, which visited the country in 1952. The unique structure that was created at the incorporation of DFCC was designed through a collaborative effort between the Government of Sri Lanka and the World Bank at a time that Sri Lanka contemplated on a shift from agriculture to industrial development. The World Bank Mission of 1953 was not very optimistic on government led industrialization but recommended the formation of a DFI to support the private sector to undertake industrial projects. This initiative marked the birth of the first development finance institution in the country in 1955 to spearhead development financing in the newly independent island nation.

Until DFCC was formed, Sri Lanka's financial system was dominated by commercial banks that engaged in short term lending. As the private sector was weak in Sri Lanka at that time the government drafted an Act of Parliament for incorporation of the proposed DFI, but the World Bank officials encouraged its formation under the Companies' Act (based on its exclusive lending to the private sector). Consequently, the final compromise text had the features of a company for the DFI to perform quasi-public functions. The government secured a representative in the Board to monitor performance of the institution particularly in fulfilling the developmental objective. The government came in by providing an interest free loan at the start and giving guarantees to foreign loans obtained by the DFCC.

The DFCC has been the financier of trail blazing local entrepreneurs and a source of value addition to their enterprises – particularly during the risky stages. Its lending to small and medium enterprises has also been noteworthy, and some of them have grown to be large and highly resilient.

Another significant milestone in the history of Sri Lanka was the liberalization of the Sri Lankaneconomy in 1977. In the budget speech of November 1977 the then Finance Minister Mr. Ronnie de Mel stated that a National Development Bank would be established as one of the instruments for furthering the economic objectives of the Government in the context of the open economic policies that were initiated with the budget. On the 17th of November 1978 the Finance Minister presenting the National Development Bank Act observed.

"The National Development Bank of Sri Lanka Bill is a very important Bill for the creation of a National Development Bank in this country which we hope will be the foundation the harbinger, the forerunner as it were, of large-scale national development investment and growth in the Island."

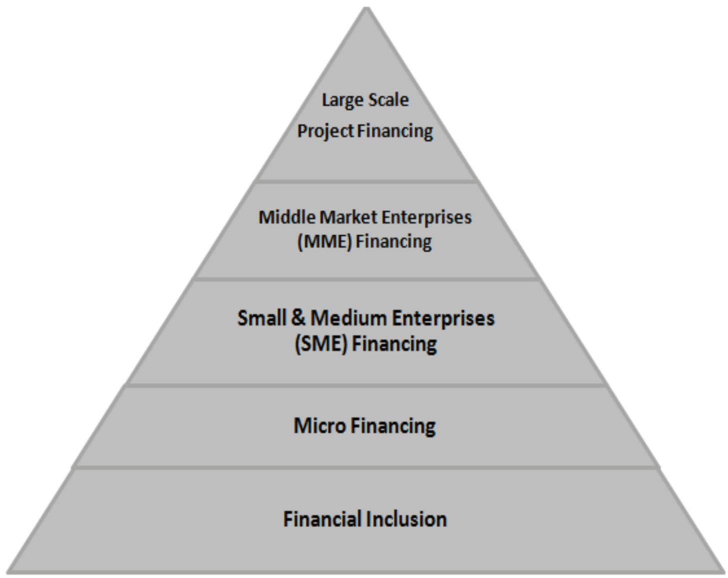
The National Development Bank of Sri Lanka was set up in January 1979 by an Act of Parliament as the second Development Finance Institution for the purpose of promoting Industrial agricultural and commercial development of Sri Lanka by providing medium and long term credit and by mobilizing internal and external capital for investment in such projects. Simultaneously the World Bank approved the first line of credit for the National Development Bank to provide refinance facilities in support of small and medium industry projects.

NDB has acted as the pioneering refinance organization and obtained eight lines of credit from the World Bank and the Asia Development Bank for direct lending operations and another six lines of credit to provide refinance facilities in support of small and medium industry projects, which were disbursed mainly through the Participating Credit Institutions (PCI's)

The Development Finance (DF) pyramid

The DF pyramid will give a broad outlook of the scope while the SWOT analysis in the next paragraph would enlighten the reader on the reasons and the need for a state run Development Financial institution.

Diagram I



The Development Finance SWOT Analysis – Sri Lankan perspective

In order to propose a workable model the following SWOT analysis has been done and would help to discuss the strengths and opportunities and understand the role a DFI would play in a Sri Lankan context considering the current environment and in changing dynamics while focusing on the weaknesses and the threats involved, for effective use of the model.

Strengths	Weaknesses
• A focused and a holistic approach with a good governance structure.	• Difficulties that may be encountered in securing low cost funds for on lending as Sri Lanka is now classified as a middle income earning country.
• Project appraisal in line with DF fundamentals	• Raising funds locally
• Project oriented lending as opposed to security oriented lending	• Existing leading Development Financial Institutions embracing Commercial Banking
• Financing start ups	
• Systematic monitoring and follow up	
• Acting in an advisory capacity	
• Technical Knowhow	
• Negotiate low cost credit lines	
• Technology transfer	
Opportunities	**Threats**
• The change of landscape after civil war.	• Local money lenders
• Financing Public- Private Partnerships	• Easy access to high interest loan facilities without proper evaluation.
• Emergence of a new middle market segment	• Undue political interference
• Increasing SME clientele.	
• Use of new technological advancements for ease of business for penetration into local economies through Micro Finance and Financial Inclusion clientele.	
• Agro based financing	

Strengths and opportunities

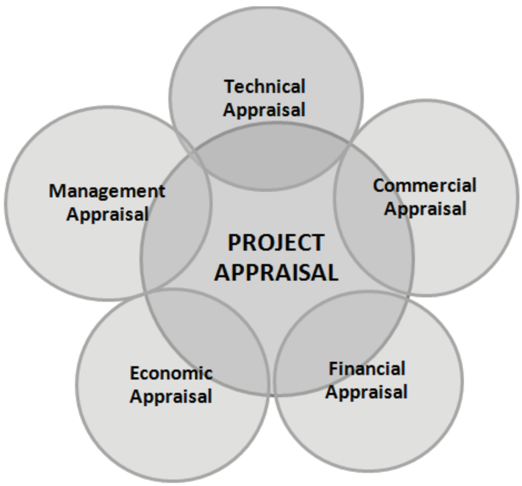
A well-focused and a structured approach with a holistic view point through Development Financing would ensure the needed penetration to the rural localized economies through Financial Inclusion, Micro Financing and Small and Medium Enterprise Financing while the Middle Market Enterprises and the Large Scale entities would benefit from appropriate model discussed below.

- **Lending approach**

The basic Development Finance lending fundamentals through an in-depth project analysis where all aspects in the diagram below are covered should go hand in hand for the success of a project.

The basic lending fundamentals should be applicable for any type of Development Finance highlighted in the DF Pyramid, irrespective of the size of the facility but would differ in the depth of the analysis depending on the size of the facility and the risk involved.

Diagram II



- **Project oriented lending as opposed to security oriented lending and funding start-ups**

The security oriented lending approach as against a development oriented lending approach today has been a drawback to new innovative ideas being materialized and giving birth to good projects. While appreciating a commercial banks' security oriented lending approach to ensure safety of their depositors funds the approach of a Development Finance Institution would be very much different considering the objectives, for which a DFI is formed.

- **Systematic monitoring and follows up**

Another key aspect for successful projects is a systematic approach to monitoring and follow-up of projects.

Monitoring and follow up from a very basic view point would be the follow up for loan recovery.

However from a Development Finance perspective it is at a much broader dimension and at a different magnitude where the involvement of a DFI goes into follow up through a systematic periodic monitoring process covering all details dealt with at the time of appraisal.

- **Use of new technological advancements for ease of business**

The greatest opportunity that we have today in Sri Lanka is the vast advancement of technology; we are in a day and age where the accessibility and the reach through Financial Technology, Telco's are at a great high and moving up further. The maximum usage would help minimize brick and mortar banks.

- **Acting in an advisory capacity, Technical Know How,**

The absence of a DFI has somewhat or to a great extent had a negative impact on the role played in an advisory capacity; the advisory capacity role will be played by a DFI once more in all aspects dealt with at the time of appraisal.

- **Negotiate low cost credit lines, and technology transfer**

In most instances credit lines are offered with an inbuilt Technology Transfer component where the project promoters DFI officers will have opportunity of acquiring new Technology which is of immense benefit for the Country.

Weaknesses and Threats

- **Funding issues**

Difficulties may be encountered in securing low cost funds for on lending as Sri Lanka is now classified as a middle income earning country. However a state-run Development Finance organization would be in a position to address this issue with Government to Government dialogues. Further raising funds locally through other Financial Instruments and savings related products would be an avenue to explore for this purpose.

- **Unhealthy competition**

The prevalent unhealthy competition from local money lenders and easy access to unstructured finance devoid of proper evaluation pose a major threat mainly to the three lower segments in the Development Pyramid.

The absence of a structured approach to Development Financing and an apex organization controlling and directing the PCI could be seen as a major contributory factor for this drawback.

Changing Dynamics and the need for re-emergence of a Development Finance Institution (DFI)

Sri Lanka has been looking at a growth momentum and one of the areas is Foreign Direct Investments. However we have not been able to secure the anticipated level of FDI's thus curtailing our economic growth.

Further the commercial banking sector cater to more short and medium term funding requirements while the long term infrastructure development as well as the subsector expansions under those infrastructure projects may somewhat be curtailed as result.

FDI's Development Finance could play a pivotal role ensuring.

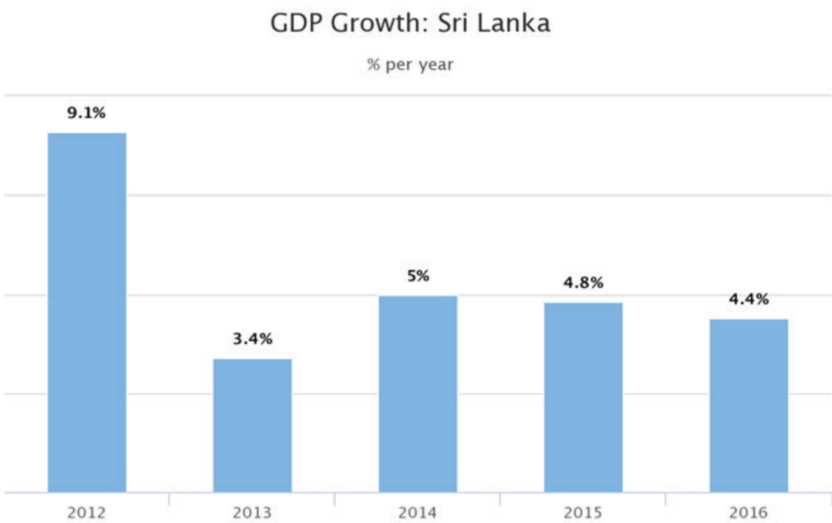
I. Long and medium term loan funding
Ii. Equity financing
Iii. Refinance operations
Iv. Advisory role for entrepreneurs
V. Credit guarantee schemes

Development Finance (DF) through the DF Pyramid and the SWOT analysis on Development Financing would be the back drop on which a new DFI model could be based mainly focusing uplifting the rural economies through Financial Inclusion/Micro Financing Small and Medium Enterprise financing and Middle Market Enterprise Financing.

Since this paper is based on the need to re-think, re-shape and re-align banking towards better economic prosperity for Sri Lanka through a re-emerged vibrant state run Development Financial Institution it is appropriate that we discuss, the Sri Lanka outlook as well and also from a regional perspective, and discusssustainable development through public – private partnerships.

Sri Lanka Economy

GDP grew by 3.8% in the first quarter of 2017 and 4.0% in the second to hold growth in the first half of 2017 to 3.9% year on year, unchanged from the 2016 outcome. Agriculture was hit in the first quarter by continuing drought, causing a 3.2% decline. Rice production fell by 53%, and there were significant declines in tea and rubber, major exports crops. Floods in the second quarter shrank agriculture by 2.9% with further rice losses, even as tea and rubber rebounded.



Source: https://www.adb.org/countries/sri-lanka/strategy

Economic forecasts for South Asian countries

Country	2017f	2018f
Afghanistan	2.5	3.0
Bangladesh	7.2	6.9
Bhutan	6.9	8.0
India	7.0	7.4
Maldives	4.2	4.4
Nepal	6.9	4.7
Pakistan	5.3	5.5
Sri Lanka	4.5	5.0
Average	6.7	7.0

f = forecast number.

Source:Asian Development Outlook 2017 Update

The Priority Investment areas

The two strategic objectives one to strengthen the drivers of growth by promoting diversification of economic activities and productivity enhancement and improving the quality of growth by promoting inclusiveness.

The priority investment areas will be to:

1. Expand the provision of growth-oriented infrastructure (transport, energy, and urban) and logistics;
2. Develop an economic corridor; and
3. Upgrade human capital.

The priority investment areas will be to:

1. Strengthen agriculture infrastructure and commercialization,
2. Improve rural connectivity
3. Improve public service delivery, and
4. Expand access to finance for small and medium-sized enterprises (SMEs).

Key thematic priorities are

1. Promoting private sector development and public - private partnership (PPP);Strengthening environment, climate change, and disaster risk management; and
2. Promoting gender equality.

Sustaining development through public – private partnerships

- **The success of PPP depends on the optimal allocation of risk.**

Project finance for infrastructure extends beyond construction and well into the useful life of the asset. It depends entirely on cash flow generated by the project through user charges or revenues paid by the government. By allocating risk to the party best able to manage it, project finance aligns private profit incentive with the public interest. This makes project finance the preferred financing and governance structure for successful PPP.

- **The main sources of project finance are equity and debt.**

The choice of financing method depends on project requirements and risks, the amount of capital available for direct investment as equity, and the quality of the financing consortium. Debt is the largest component of PPP financing, commonly more in the form of bank loans than bonds. Bonds are more desirable, though, as they allow for long-term financing. More financing can become available for infrastructure PPPs if bond issues allow access to abundant institutional savings, but this requires that project risks be appropriately mitigated.

- **The infrastructure financing gap is essentially a risk gap.**

The large infrastructure gap in Asia coexists with a substantial pool of long-term savings that can be mobilized if offered the appropriate balance of risk and return. Credit enhancement mechanisms can mitigate certain risks from PPPs to make them more attractive to a wider range of capital providers. These instruments include partial credit or revenue guarantees, off-take guarantees, subordinated debt, pooling and tranching, and infrastructure debt or equity funds. Multilateral development banks can do much more to promote credit enhancement products, unlock potential in private capital markets around the world, and bridge the risk gap.
Source: https://www.adb.org/countries/sri-lanka/strategy

The Model

It is of utmost importance that the ground situation is clearly understood before designing amodel.

Demographic andSocial aspects can be considered as two very important areas that need to be taken into consideration for the model.

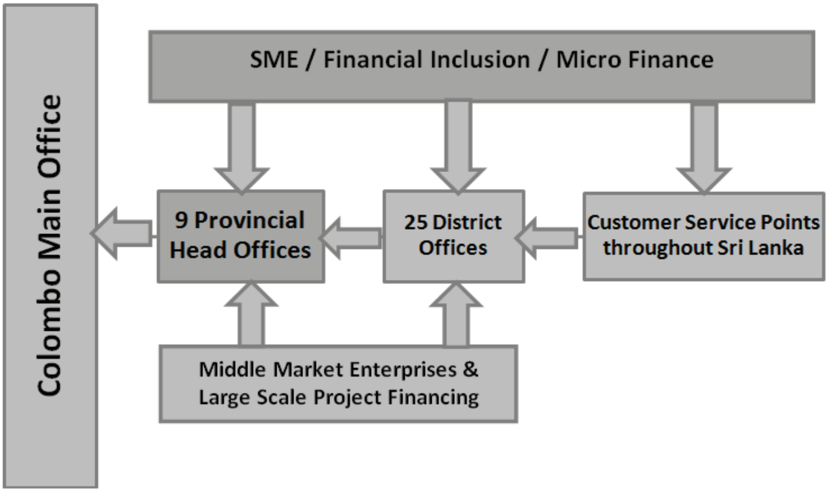
Decentralization against Centralization

In this day and age many technological innovations are reshaping the Banking Industry globally. Sri Lanka too is in a period of transformation with many banking organizations is embracing centralized models as opposed to decentralized models. It is timely and prudent to do so. However initiating a centralized model or moving away from a decentralized model to a centralized model should not be taken hands down.

The context should be properly analyzed. This can be situational and the appropriate model bringing about the best outcome in line with the objectives and considering the demographic and the social aspects should be deployed.

In this backdrop an appropriate model for a DFI from a broad perspective is depicted in the diagram below.

Diagram III



- Colombo office and Provincial office to handle all large scale projects, business leads may come through any of the below subordinate business units

- Provincial Offices to handle MME and higher end SME's and Operations of these segments to be decentralized to the Provincial Head Offices business leads may come through any of the subordinate business units

- District Offices to handle lower end SME's, Micro Financing and Financial Inclusion and Operations of these segments to be decentralized to District Offices.

Conclusion

The priorities of a DFI in Changing Dynamics from a Sri Lanka perspective should ensure

a) Robust economic growth
b) Private sector development through long term funding
c) Optimization of use of advanced technology for innovative DF.
d) Human development
e) Women empowerment
f) Good governance
g) Environmental protection.

Considering the priorities of Development Finance highlighted above and the SWOT analysis done which clearly demonstrates that there is an overarching tilt towards Strengths and Opportunities against Weaknesses and Threats.

A war ravaged country for nearly 3 decades now looking at economic growth after re-establishment of peace and the pivotal role a Development Financial Institution would play in this context by providing Development Banking solutions in no uncertain terms would be an enormous strength and an absolute bedrock on the future development initiatives.

Thus it could be concluded without a shadow of doubt that the re-emergence of Development Banking in Sri Lanka is the need of the hour and it is timely and prudent that an apex organization be set up to take control of Development Financing in the country

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