Presentation made

At the 27th Annual Training Programme (ATP) on

“Credit Supplementation institutions: Going beyond Guarantee for SMEs”

Organized by

The Asian Credit Supplementation Institution Confederation (ACSIC)

Held in KualaLampur, Malaysia

From 24-27 September 2017

INTRODUCTION

Sri Lanka, an emerging economy in South Asia, is a country with a population of 21.2 million and its size of the economy is US$ 80.6 billion. During last five years period the economy grew at a rate of 5.3 per cent annually. Sectoral contribution to the GDP from agriculture, industry and services for the last few years is as given below. In 2016 the economic growth rate is 4.4% and Per Capita GDP is 3,835 US$.

Since independence in 1948, the country followed inward looking economic policies under which import restrictions and substitutions, government intervention in many activities, exchange control regulations and fixed exchange rate were the main features. During this period, the emphasis of the Government was to become self-sufficient in food. Comparative advantage in international trade was not considered much important. To achieve self-sufficiency in food, the Government implemented number of subsidy and incentive programmes to promote agriculture and local industries.

However, in 1978 there was a major policy change under which the regulations for import controls were relaxed. The regulations imposed on banking and financial sector were liberalized and particularly, foreign banks could open branches in the country, exchange rate was allowed to determine on market principles within a specified band which are commonly known as open economic policies. The dominance of the government on the determination of credit flow of the economy was also relaxed. With the introduction of open economic policies, there was an influx of imports ranging from food items, investment goods to luxury and consumption goods without much control. At the same time, a lot of new economic activities were created especially relating to trade and services. Due to import of food items at lower price, local agricultural products became relatively costly and agriculture viewed to be a less productive economic activity compared to industrial and services sector.

However, taking into consideration the employment concentration in the agriculture and the resources utilized in this sector, and also the need to ensure food security, even under liberal economic policies, successive Governments continued their commitment towards the development of agriculture including fishing and animal husbandry. Accordingly, successive Governments have implemented credit guarantee schemes which are one of the components in the subsidiary packages offered for agriculture development of the country.

The Role of the Central Bank of the Sri Lanka

The Central Bank of Sri Lanka focus and functions have evolved since its formation, in response to the changing economic environment. The Central Bank has two core objectives with a view to encouraging and promoting the development of the productive resources of Sri Lanka.

1. Maintaining economic and price stability
2. Maintaining financial system stability

In order to achieve its core objectives as well as to discharge its responsibilities as economic advisor and banker to, and agent of the GOSL, the CBSL undertakes the following functions.

Core Functions

- Economic and Price Stability
- Financial System Stability

Ancillary to Core Functions

- Currency Issue and Management

Agency Functions

- Employees' Provident Fund Management
- Foreign Exchange Management
- Public Debt Management
- Regional Development

One of the agency functions of the Bank is the promotion of regional development initiatives through coordination among all stakeholders, namely, the Government of Sri Lanka (GOSL), financial institutions, foreign donors, other lending agencies and beneficiaries with a view to improving economic conditions of low income groups and reducing poverty. This is achieved through the formulation and execution of cost effective credit delivery programmes which include promotion of credit discipline and inculcation of savings habits among rural communities and the dissemination of information required for these development efforts to those communities.

MSMEs are the Backbone of the Economy in Sri Lanka

The Micro, Small and Medium Enterprises (MSMEs) have been recognized as the backbone of the Sri Lankan economy. They are seen as a driver of change for inclusive economic growth, regional development, employment generation and poverty reduction. MSME sector accounts for more than 75 percent of the total enterprises in Sri Lanka. Their contribution to the domestic production has been more than 50 percent and contributes to around 45 percent of the employment. Recognizing the pivotal role MSMEs have been playing in the economy.

Challenges for SMEs

Since independence, successive governments in Sri Lanka have taken various steps towards developing the SME sector (1) by improving access to finance, (2) technology support, (3) more access to information, (4) support for skills development, (5) better infrastructure, (6) SME networking opportunities, (7) linkage formation, (8) improvement of advisory services and (9) business development drives to support the growth of the SME sector.

Yet, one of the main challenges that SMEs still face is access to financing and working capital to grow their businesses and to attract skills.

The reluctance of the SMEs to use state-of-the-art technology is also identified as another drawback for SME development. Unlike in other countries in the region, the adaptability of SME in Sri Lanka to latest technology is very much limited to lack of know-how, high investment cost ,less accessibility to finance ,etc.

MSME National Policy Framework

Government has formulated its MSME policy in 2016 to promote high potential promising MSMEs and to improve business environment to allow them to realize their full potential. The policy framework will foster micro and small enterprises to grow into medium sized enterprises whist medium sized enterprises to grow into large enterprises. The policy framework broadly set out its direction into six core areas i.e. enabling environment, modern appropriate technology, entrepreneurial culture and skills development, access to finance, market facilitation and research and development. The policy recognizes the imperative importance of access to finance by MSMEs hence, special focus is given to it.

Small and Medium Enterprises (SMEs) play vital role in any in the world. It contributes lots to the national output and creates many job opportunities to the nations who are living in rural arrears. SME sector improves the general economic conditions of an economy. Benefits accruing from SMEs include job creation, innovation and improving the general health of the economy. SMEs are usually the source of new ideas and products and through such innovation they fuel a nation's economic engine. Through job creation SMEs contribute towards poverty alleviation, social stability and local and regional development. However, in most economies SMEs face constraints when accessing formal sector credit and this prevents them from achieving their full potential. The market failure in the credit market for SME's stems mainly from four factors. These are high administrative costs of small scale lending, asymmetric information, the high-risk perception on small firms and lack of collateral. These factors are explained briefly below:

1. High administrative cost: Most of the admin cost are independent of size of the loan hence, per unit cost of extending small loan is relatively high. In addition, MSMEs lack accounting and business documentation skills so cost of analyzing loan proposals and monitoring loans may be expensive compared to large businesses.
2. Asymmetric Information: Poor informational standards and lack of credit histories or track record of MSMEs result the lending institutions to charge high interest rates. This discourages good MSMEs as they are panelized with high finance cost due to high interest rates.
3. High Risk Perception: Due to many reasons, lenders believe that MSMEs has been a high-risk sector hence require them to produce immovable properties as collateral even for small size loans.
4. Lack of Collateral: Lenders put high weight on collateral than the business viability and potential due to asymmetric information problems and high-risk perception. However, MSMEs generally lack sufficient collateral as they are more labor intensive and still at the start up level.

Credit Guarantee Schemes in Sri Lanka

A credit guarantee is a form of insurance that helps to protect the interest of a lender in the event of non-payment by a borrower. The credit guarantee given by a third party covers the risk of default by borrowers. The person or the entity who guarantees a loan granted by a lender is obligatory to honor the guarantee, if and when the borrower defaults provided that the lender has taken appropriate action to recover but failed. A credit guarantee scheme is a tool for credit risk mitigation and credit enhancement. It substitutes the requirement of providing collateral by the borrower. If the borrower fails to repay what he borrowed, the lender could resort to Credit Guarantee Scheme to recover the losses incurred by him due to the default by the borrower. Credit Guarantee Schemes will not extend any credit direct to borrowers and its role is to ease the interaction between the potential borrowers and the lenders. The credit guarantee schemes are mainly launched to support lending by banks and other financial institutions to MSMEs as lending institutions are reluctant in granting loans to MSMEs due to their high inherent risk. Since there is a general perception among bankers that lending to SMEs is risky, availability of a credit guarantee scheme will change that mindset of bankers with regard to lending to SMEs. Since the guarantor provides a risk cover banks are less reluctant to lend to MSMEs. The credit guarantee schemes will make it possible for a large number of MSMEs to access credit from banks.

History of Credit Guarantee Schemes in Sri Lanka

The Monetary Law Act (MLA) of Sri Lanka contains provisions at Section 108(1) for the Central Bank of Sri Lanka (CBSL) to act as the agent of the Government and to act on behalf of the Government in guaranteeing, issuing or participating in the loans of banks in Sri Lanka. Subsequently, in 1964, Medium and Long-term Credit Fund (MLCF) was established in CBSL to cater to the credit needs as the capital market wasn't developed sufficiently to finance such needs. Several refinance schemes as well as credit guarantee schemes were introduced using the funds of MLCF. In 1974, MLA was amended to strengthen the credit guarantee operations towards MSMEs.

The history of Credit Guarantee schemes (CGS) in Sri Lanka dates back to 1967 when the CBSL introduced the first credit guarantee scheme, as the agent of the Government, to guarantee loans extended by local banks to farmers for paddy and other crop cultivations under the New Comprehensive Rural Credit Scheme (NCRCS) which is a refinance scheme of CBSL. All credit guarantee schemes operated in Sri Lanka since 1967 were financed and operated by CBSL. The first credit guarantee scheme for the Micro, Small and Medium Enterprises (MSMEs) was introduced by CBSL in April 1978. This was to protect MSMEs as there was a fear of large scale closure of MSMEs after liberalization of the economy in 1977. The scheme implemented through two state-owned commercial banks, i.e. Bank of Ceylon and People's Bank and Development Finance Corporation with the Industrial Development Board. The guarantee cover was 75% of the amount default and this scheme experienced very high claim rate due to high default rate.

For the first time in 1979, Government of Sri Lanka received a credit line from International Development Association (IDA) of the World Bank (WB) exclusively to provide credit to SMEs. This credit programme was known as Small and Medium Industries Lending Program (SMI-1). The scheme administered by National Development Bank and lent the proceeds of the credit line through a network of around 10 Participating Credit Institutions (PCIs). One of the conditions of the IDA credit line was that on lending to SMEs under the credit line should be covered with credit guarantees. CBSL set up and financed a CGS in 1979 to guarantee loans extended by PCIs to MSMEs. The extent of the guarantee cover was 60% and the default rate was, although less than the previous scheme, still high.

In addition to the above scenario, there is another highlighted body who practicing the credit insurance and guarantee for extremely exporters in Sri Lankan context. It is Sri Lanka Credit Insurance Corporation (SLECIC).

Sri Lanka Credit Insurance Corporation (SLECIC)

Sri Lanka Export Credit Insurance Corporation (SLECIC) is the leading provider of trade-related credit insurance solutions in Sri Lanka with more than three decades of robust presence. SLECIC is committed to provide attractive and innovative Export Credit Insurance and Guarantee support services for the development of exports of Sri Lanka.

- Credit Insurance (Seller's Risk)
- Credit Guarantee
- Buyer Information

Credit Guarantee Schemes in Operation at Present

Currently CBSL has been operating eleven credit guarantee schemes through Regional Development Department (RDD) of the Bank but of those eleven following five schemes are actively in operation;

1. Plantation Sector Reform Project,
2. Small Holder Tea Development Project,
3. Second Perennial Crop Development Project,
4. Tea Development Project, and
5. New Comprehensive Rural Credit Scheme

Salient Features of Ongoing Credit Guarantee Scheme

Type of Project	**Date of Commencement**	**Apex Agency of Loan Scheme**	**Extent of Liability**	**Premium Payable**
1.Plantation Sector Reform Project (PSRP)	1996	CBSL	70% of refinance amount for Tea 50% of refinance amount for processing and purchase of	1.5%

			vehicles	
2.Small Holder Tea Development Project (SHTDP)	1989	CBSL	50% of the loan in loss or the amount granted subject to a maximum of SLR.2.0 Mn.	0.5%
3.Second Perennial Crop Development Project	1998	CBSL	60% of loan in loss or amount granted whichever is lower subject to a maximum liability of SLR. 1.6Mn	1.5%
4.Tea Development Project (TDP)	1999	CBSL	60% of loan in loss or amount granted whichever is lower subject to a maximum liability of SLR. 1.6Mn	1.5%
5.New Comprehensive Rural Credit Scheme		Interest Subsidy/Credit Guarantee Scheme funded by the GOSL Coordinated by the CBSL	60% of loan in loss or amount granted whichever is lower	0.005%

Credit Guarantee Schemes: Weaknesses

Credit Guarantee Schemes have been in operation since 1978 and has contributed significantly in promoting small and medium scale projects and agricultural and other projects. However, still the success of these schemes is limited due to weaknesses such as,

1. Lack of entrepreneurial abilities among borrower
2. Lack of entrepreneurial abilities among borrower
3. Relatively high administrative cost to the banks
4. Reluctance of banks to provide credit due to high associated with MSMEs
5. In the past, credit guarantee system has never been used as a supplement to security cover due to number of reasons.

6. Legal Constraints
7. Limited institutional capacity
8. Frequent rejection of claim payments in terms of Operating Instructions due to:
9. Non-submission of claims by Banks in time i.e. within six months from the date of Demand Notice
10. Poor monitoring of projects by PFIs after the loan has been defaulted especially in the case of small loans
11. Lack of evidence about follow up action i.e. reports on inspection undertaken
12. Abnormal delay in serving the Demand Notice once the loans goes into arrears:
13. Practices followed by Banks in the credit especially on project evaluations and acceptance of securities not being prudent.

Credit Guarantee Schemes have never been used as a supplement to security cover due to number of reasons such as legal constraints, limited institutional capacity and attitudes of borrowers on state sponsored loans. However, in the recently introduced schemes, steps have been taken to promote PFIs to consider and to evaluate the viability of the project rather than security offered by the borrower.

It has been commonly observed that there is a delay in submission of claims, no proper evaluation of projects, follow ups and adherence to guidelines issued by CBSL or GOSL. It has also been observed that once the claim is paid the PFI's attention to recover the loan is very minimal. Another aspect is that, although the insurance industry in Sri Lanka is relatively developed none of the insurance companies show interest in credit guaranteeing.

Establishment of National Credit Guarantee Institute for Small and Medium Scale Entrepreneurs

Central Bank of Sri Lanka carries out credit guarantee operations as an agent of the government of Sri Lanka. However, to promote the credit guarantee as a market instrument and to carry out the credit guarantee operations on a sustainable and self-sufficient level, establishment of a separate entity for credit guarantee operations is required. This is the case for almost all other member countries. They have separate entities to carry out credit guarantee operations.

This will facilitate the credit guarantee operations to be carried out with a commercial perspective as well as a development perspective. It may issue credit guarantees to the borrowers directly. The guarantee may act as collateral and will avoid the collateral required by many PFIs. This will further facilitate to introduce many innovative products.

The various government institutions have implemented the credit guarantee schemes, which were specific to various sectors by periodically. However, there is no proper mechanism at national level to offer long term Credit guarantees for Small and Medium Scale Entrepreneurs. Therefore, it is proposed to establish this National Credit Guarantee Institute (NCGI) as a sustainable solution to the problem of access to finance of the Small and Medium Scale Entrepreneurs, who are unable to obtain funds for their investment needs.

Sri Lanka has no prior experience regarding the establishment of separate credit guarantee institute, Asian Development Bank (ADB) agreed to provide necessary technical assistance to develop a suitable mechanism for that and USD 2.0 million grant was provided for this purpose. It was carried out a comprehensive demand analysis to analyze to prevailing demand in the market for this kind of credit guarantee facilities by utilizing this grant and the continuous consultation process had with the banks and other all relevant stakeholders in order to develop the proper structure for the proposed NCGI. According to its results, it has been proven that the huge demand is in the market for the proposed type of credit guarantee facilities. Therefore, it has been proposed to establish this institute as a limited public company with the contribution of private sector, where the government is the major shareholder.

Way forward

The credit guarantee products may extend not only to the Agriculture and Industry but also to the services sector. Further credit guarantee can be issued for some selected fields and special credit guarantee schemes for the young talented people and women entrepreneurs having knowledge and skills but lack finance, can be implemented as in the case of India.

The ongoing credit guarantee schemes of Central Bank of Sri Lanka (CBSL) cater only for agriculture/plantation sectors, SMEs and animal husbandry. But, when considering the sectorial shares of GDP, it is observed that the service sector contributes more than 50 per cent to GDP.

However, no credit guarantee scheme for service sector. Therefore, implementation of credit guarantee schemes for service sectors is a need for the economy and at the same time proper monitoring of such systems will be cost effective when compared to other credit supplementation instruments such as training and capacity development.