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The Role of Banks in Development

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The Secretary, Ministry of Finance and Planning, Dr. W.M. Tilakaratna, in this second anniversary lecture to the Rural Banking and Staff Training College of the Central Bank, has emphasised the urgent need for banks to adopt dynamic credit policies. He has called for a change in the perceptions, attitudes and will of the banking sector in Sri Lanka; commenting that most of the Commercial Banks in Sri Lanka continue to follow inappropriate banking policies. The banking system, he states, must spearhead the drive to increase productivity and employment in the rural sector and he expresses the hope that the banking community would become alive to its enlightened self interest.

This is a subject that is of great importance to all of us, at this particular stage of our economic development. In recent years, the Government has undertaken a massive development programme to lift the country out of the "low investment - low growth" syndrome, that it was trapped in for many years. The proportion of GDP invested has doubled, and Sri Lanka's economy has grown in real terms at an average rate of over 6 percent, at a time when the global economy has been experiencing the most severe recession of the post-war era. The Government has played a leading role in the investment effort. This was necessary, because substantial investment in infra-structural development was a sine qua non for the attainment of sustained growth and increased labour absorption, in the Sri Lankan economy. Efforts to rehabilitate the economy quickly, after years of controls and virtual stagnation, resulted initially in a trading and construction bias in the growth process. That phase of development is now over.

The Government has rationalised its policies to promote production in the "real" sectors of the economy. The medium term development stra-

tegy requires the active support of the Banking Sector; if it is to be successful. I shall argue that a substantial re-orientation of attitudes in the Banking Sector, is necessary; both from the point of view of the developmental needs of the country and also in terms of the enlightened self-interest of the banking community.

To begin by harking back to a talk I gave over ten years ago: Many of the remarks made at that time are still extremely pertinent. While considerable progress has been made on some fronts, regrettably a number of the shortcomings in the Banking Sector, that I identified at the time, still persist. That address set out to examine the inadequacies of our banking system. It called for the expansion of the commercial bank network, especially into the rural areas, for the mobilisation of savings and the supply of credit. In other words, there had to be an improvement in both the volume and content, or quantity and quality, of banking facilities. As I implied earlier, the progress made in the period of over a decade that has passed since then, has been remarkable in quantitative terms, but rather meagre in qualitative terms.

Being an optimist, I shall begin with the positive achievements. At this time it is necessary for all of us to think and act positively. The future of our country requires that we meet the challenges facing us, bravely, without losing touch with reality.

There has been a great expansion in the institutional financial sector since my address in 1969. At that time there were 155 branches of Commercial Banks. This constituted an average of one Commercial Bank branch for every 80,000 people. Today, there are 671 branches (excluding NSB branches), which means that Sri Lanka now has one branch for every 22,500 persons. In developed countries, population per Bank Office is very small. It amounts to about 1,000 - 1,500 persons in Belgium Switzerland, Germany and France, and about 3,000 in the United Kingdom. Such coverage in a highly competitive environment means that not only is there competition for the depositors' money, but high quality financial services are also provided to the customers. Steps have been taken in recent years to increase the level of competition in the banking sector in Sri Lanka. The growth in the coverage of the institutional financial sector has been impressive.

The expansion of the institutional financial sector is also reflected in the increase in the number of bank accounts held by the public, in relation to population. Even on the basis of the extreme assumption that every bank account was held by a separate individual, only 4.5 percent of the population held bank accounts, in 1969. The corresponding figure today is 28.9 percent. Even after allowing for the fact that the number of people with more than one account and the number of accounts held by corporate bodies are likely to have increased markedly, this constitutes a very significant increase.

There has also been a substantial increase in deposit mobilisation. Time and savings deposits on a per capita basis for the whole economy have increased from Rs. 80.8 in December 1969 to Rs.1,417.6 in June 1983. All this adds substance to the claim that the institutional banking sector has experienced considerable quantitative expansion. Further expansion of the branch network must be based on sound economic criteria. The increasing monetisation of the economy, especially in the Mahaweli area, will provide scope for future expansion.

There has been unprecedented development of the banking system in Sri Lanka, during the last five years. Particular emphasis has been placed on extending coverage in the rural areas. In addition to the expansion of the branch network many foreign banks have also commenced operations in the country. This has helped to introduce a welcome degree of competition and dynamism into the banking sector. It has also encouraged foreign investment and foreign trade. A total of 14 branches of foreign banks and two representative offices have been opened in Sri Lanka since 1977. Two foreign banks have also been allowed to open rural branches. This was done to harness the considerable expertise these banks have in the field of rural credit. It is hoped that indirect benefits will also accrue through the demonstration effects.

The institutional framework of the banking system has been diversified during the last five years. A number of new institutions such as the National Development Bank and the Sri Lanka Export Credit Insurance Corporation have been created to strengthen the financial system of the country. These institutions were designed specially to finance development and export oriented activity. Merchant banking has been introduced

into the country. The Merchant Bank of Sri Lanka Limited, a subsidiary of the Bank of Ceylon, began operations in August 1982. The People's Bank has established a subsidiary, called The People's Merchant Bank Limited, in collaboration with Guinness Mahon and Company. The State Mortgage and Investment Bank is being developed to provide a wide range of financial services, especially in the housing sector. The National Savings Bank has also expanded its branch network and has acted as a catalyst in mobilizing savings.

The rapid development of the Sri Lankan Banking System in recent years has not been confined to the expansion of the branch network but has been extended to include the entry of new foreign banks, and the diversification of the institutional framework. A number of new instruments and facilities have also been introduced. An off-shore banking scheme was launched in May 1979, whereby commercial banks operating in Sri Lanka were allowed to maintain Foreign Currency Banking Units (FCBU's) and to accept deposits and provide credit in designated foreign currencies. The rationale behind this scheme is to promote Colombo as an international financial centre and also to mobilise additional resources for the development of the country. Another innovation has been the attractive concessions made available under the Non-Resident Foreign Currency Accounts Scheme (NRFCA). Account holders are able to operate on these accounts free of exchange control and can continue to maintain them for a period of ten years, after their return to Sri Lanka. These accounts bear attractive interest rates. Interest receipts are free of income tax and the capital is free of wealth tax for stipulated periods. These incentives have helped to swell foreign inward remittances from

Rs. 100 million in 1976 to Rs. 5,789 million in 1982. Other notable developments in the financial sector have been the introduction of Certificates of Deposits (CDs) and the activation of the short-term money market.

The Central Bank has played a very active role in improving financial intermediation in the economy. It has been an important agent of the macro economic policies designed to bring about growth in investment, output and employment, while maintaining financial stability. The Bank is following a realistic interest rate policy which not only serves the end of maintaining financial stability, but also contributes to the savings effort. The Central Bank has used the array of instruments at its disposal, to stabilise prices. Monetary aggregates have been controlled by restricting domestic credit expansion. It is in this context that a secondary market in Treasury Bills has been developed. The Government, through the Central Bank, has also been trying to improve the quality of credit flows in the economy. Various steps have been taken to match commercial bank credit flows with the development priorities of the Government. The flow of credit to priority sectors has been encouraged by the Central Bank's refinancing schemes.

It is most unfortunate that the successes achieved in terms of branch expansion, institutional diversification and development of new financial instruments have not been matched by improvements in the supply of credit. At the very outset, it is important to concede that Banks are not charitable institutions. I certainly do not advocate that Banks should embark upon activities that have no prospect of profitable operation in the foreseeable future. However, I cannot over emphasise the fact that there must be a marked change in the perceptions, attitudes and will of the Banking Sector in Sri Lanka.

In my address in 1969, I said "..... we are not looking for the kind of Banker whose archetype stalks the streets of London with bowler and broly". I regret to say that even today most of the commercial banks in Sri Lanka continue to follow inappropriate banking policies. These institutions must become more sensitive to the developmental needs of the country. They must move away from the narrow confines of commercial banking to development finance. In the Sri Lankan context this means becoming more sensitive to the credit needs of the rural sector and small entrepreneurs.

The banks continue to concentrate their efforts on financing the trade and distribution sectors, particularly the import-export trade. Recently the enlarged flow of foreign inward remittances has also been an easy source of income. Such activities are certainly important and vital for the good health of the economy. However, I am certain that the banking infrastructure that is available in the country today has the potential of going beyond these easy options, without diminishing the long-term profitability of the institutional financial sector. In fact, it would be in the long term interests of the commercial banks to become actively involved in the development effort. To put it in simple terms if Sri Lanka grows, then the flow of business available to Banks operating in Sri Lanka will also grow. I sincerely hope that the banking community will become alive to its enlightened self-interest. Credit must not be confined to trading activities, it must also flow to areas that show potential for growth of income and employment. The Sri Lankan economy is still dominated by farmers, cottage industries, small industries and small businesses. Credit flows that are concentrated in the urban sector and big business must not

neglect the potential of the largest sectors in the economy.

No meaningful and balanced development is possible in Sri Lanka until and unless the rural population is made more productive. This objective is unattainable without the expansion of rural credit. The banking system must, therefore, spearhead the drive to increase productivity and employment in the rural sector. In the long-run, this will not only improve the quality of life of the vast majority of the people in this country who live in our villages, but it will also increase profits as the level of economic activity in the country increases.

There would be a return flow which would enhance the profitability of banks by raising their deposit base and lending capacities. In addition a good way of bringing down unit costs is to expand business. Aggressive deposit mobilisation with well thought-out schemes for lending would spread costs more thinly. I hope members of the banking community will have the vision and foresight to bear the trade-off that might occur between short term and medium to long term profits; particularly as I am confident, that this trade-off need not be very significant. I shall argue below that the recent changes in the incentive structure within the economy, calls upon banks to re-orient their attitudes and policies, if they are to utilise more effectively the hard core deposits they have mobilised. Before that I would like to dwell a little bit longer on the potential in the rural areas and small scale sector.

Commercial banks continue to be adverse to financing the higher risk ventures that are usually associated with the small scale sector. However, this sector has considerable growth and employment potential.

Institutional lenders continue to be unduly cautious in their assessment of the potential of small business projects. The traditional conservatism of the bankers has generally made them impose strict conditionalities, particularly in terms of collateral, which tend to drive small entrepreneurs away from institutional financial intermediaries. Small businessmen find that they do not have access to loan investment or debt finance. The Commercial Banks are still very reluctant to back projects and people. We must distinguish between money-lending and banking.

Criteria of assessment for lending must be efficiency and viability of operations rather than collateral on offer. In addition, one of the important elements of development banking is to assist in the growth and development of entrepreneurs. Commercial Banks in Sri Lanka have not been quite alive to these challenges. This may well be due, on the one hand, to lack of technical expertise in assessing the potential of small-scale operations and on the other, to a lack of personal contact with small entrepreneurs.

As far as the traditional agriculture sector is concerned, there is evidence that there has been an expansion of institutional credit. However, informal rural lenders have continued to be a significant source of financing, particularly as institutional credit volumes fluctuate from year to year. One of the characteristics of the rural credit picture in Sri Lanka is the poor level of recovery. This is clogging the channels of credit. As a result, farmers have been compelled to turn to money-lenders whose usurious and parasitic lending practices drive many of them into the invidious debt-poverty cycle. Policy-makers and bankers must ensure that there is an effective flow of agricultural credit. It must be recog-

nised that difficulties arising from a poorly implemented agricultural credit system, does not mean that the idea is inherently bad.

At this point it is important to have a clear idea of the purpose of rural credit. The people seeking credit fall into two groups. There are those who require financing for productive economic activity — i.e. the production of goods and services. In addition, there are those who seek credit to secure their subsistence. It is the former group who require the attention of the banking sector. The latter are marginalised economic groups who are being helped by major components of the Government's development programme e.g. Mahaweli, other major and minor irrigation/settlement schemes, Integrated Rural Development Programmes etc.

Nobody is asking the Banks to give money away. Their development role is to help bring on stream the untapped productive potential of the rural and small-scale sectors.

By doing this, they would of course indirectly improve the life chances of the poorest through the income and employment multiplier effects.

It is important that Banks do not act as mechanisms for siphoning out the surpluses that are being generated in the rural sector. A conscious effort must be made to increase availability of these surpluses through credit in the rural sector itself. This in turn would provide incentives for entrepreneurs to locate new economic activities in these areas. This would generate positive employment and income effects.

There is an urgent need for dynamic credit policies. The Government's medium term strategy envisages an increasing role for the private sector. The immediate priority of the Government is reconstruction and recovery. The medium-term strategy of the Government is to maintain the growth momentum while

maintaining price stability. The public investment programme will be progressively scaled down, releasing resources for the private sector to take advantage of the opportunities created by the substantial infrastructural development that has taken place in recent years. The domestic savings effort should benefit from prudent monetary policy and realistic exchange rate policies. The Banks must play their full part by adopting attitudes that help realise the full potential of the opportunities created by the increasing private sector orientation in the country's investment strategy.

Japan and the Federal Republic of Germany provide good examples of benefits that can be gained through a close and dynamic relationship between the banks and entrepreneurs. In many instances banks have actually undertaken equity participation in sectors with growth potential.

Serious consideration should be given to this in a context where fiscal and financial incentives are being used to provide the proper environment for increased private investment in the productive sectors of the economy, particularly export oriented activities.

I would like to conclude by discussing the importance of the role this training institute (Central Bank's Rural Banking and Staff Training College) is playing in evolving development oriented attitudes among commercial bankers, so that, they become vital instruments for accelerating social and economic development in the country. Banks must show leadership and take an active part in stimulating economic growth. The Institute is attempting to provide proper training to bank employees so that they are better able to assess the potential of priority sectors in the economy. In particular, skills are being imparted so that the unorganised sector can be provided with assistance, management training and close supervision of economic activity. Greater familia-

rity with the needs and potential of hitherto neglected sectors would also enable bank officials to help customers identify projects.

One of the major problems in disbursement and management of credit is the lack of reliable information on the credit needs of the country. The rural branches of banks must have officers capable of designing a credit budget for the area covered by the branch. The quality of bank staff must be constantly upgraded so as to meet the challenges before us. There is a need to have continuing training programmes, refresher courses seminars and workshops to train bankers from the lowest to the highest level, so that, they are sensitive to the evolving needs of development.

It is not sufficient for only the bank staff to be educated. They in turn must educate their customers particularly the "small man".

Banks can provide expertise in the designing, implementation and management of projects. Trained staff can assist in supervising credit, so that small borrowers are educated on the need to repay their loans. Customers can be shown credit can be used for expansion and diversification. Banks can even organise a marketing information system to enable the small entrepreneur to market his surplus. I have for sometime been discussing the possibility of setting up a Small Business Advisory Agency with various governmental organisations. The basic objective would be to upgrade the small "Mudalalies" and entrepreneurs. I commend this idea to the banking community. I must stress the fact that very little can be achieved in terms of banking development without a programme to develop the skills of the staff as well as the skills of the clients. The staff for their part must become an integral part of the community in which they operate. Staff must perceive themselves to be catalysts for growth and development.