BOUNCING BACK – THE OPPORTUNITIES AND CONSTRAINTS

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Post war Sri Lanka has indeed opened up new vistas for development, not only in the North and East, but the entire country. Assuming that our elected representatives will do what needs to be done establish sustainable peace,banks have not only an opportunity but a responsibility to contribute to the peace dividend. However, the Sri Lankan banking industry is also constrained by several factors such as paucity of long term funding, high cost of capital, low risk capacity due to lack of scale. Banks will need to meet these challenges and look at innovative financing arrangements if they are to play their due role in building a prosperous nation.

The conclusion of the war against a ruthless terrorist organization and bringing the entire country under the writ of the government after more than two decades has indeed presented the country with another opportunity to propel itself forward at a pace hitherto not experienced. To do so, the peace dividend will need to be consolidated and economic development of the entire country and the restoration of North and East in particular will play a key role in this consolidation. To put it in another way, an economic war will have to be fought with the same sense of purpose and motivation as the military action over the next few years. Every citizen of this country has a stake in ensuring victory in the economic war and banks in particular have a very important role to play in this endeavour as they are by far the most important intermediary for gathering savings and channeling these for investment and productive use .

The economic war that has to be fought throughout the country has to address areas such as Law and order, Education, Health Services, Transport, Infrastructure, Agriculture, Fisheries and Waste Management as priorities. It is not that areas such as induse in the next 12 to 24 months. In particular, in the North and East, significant investment will need to be made to rebuild the social and economic infrastructure.

While the initial investment in social infrastructure will necessarily have to be made by the government, funding for this will have to come from both domestic and foreign sources. In the case of the private sector, only a relatively few corporate entities will be able to attract foreign debt capital in the short term and most will need to depend on banks in Sri Lanka or the domestic capital markets for their funding. However, the reality is that the banking sector will have to pay the most significant role since our capital market is much less developed than the banking system. When industrial, tourism and other service sector developments follow, it will be the private sector that will lead the way. The short term and immediate opportunity for banks will arise from increased demand for banking services, microfinance and credit for Small and Medium Enterprises (SME). However, the improved level of confidence should also lead to greater investment not only in the North and East but all over the country and projects with investments in the region of USD 50 to 100 m should follow giving a boost to the banking sector. Such projects are necessary to leapfrog Sri Lanka into the future and increase growth rates to near double digit.

There is much to do and so little time to do it in and given the ground realities, banks bear a big responsibility to ensure that entrepreneurs, be they be large or small have access to credit and savers can entrust their savings without fear to the banking system. To see how well placed banks are to rise to this challenge, we need to ascertain where the local banking industry currently is in respect of the following factors all of which have a bearing on the effectiveness of the role that banks can play:

a) Intermediation costs
b) Credit quality
c) Attractiveness to capital providers
d) Risk capacity

Interest rates and Intermediation Costs …….

Interest rates and intermediation costs are two key issues that banks get criticized about by practically everybody. Comparisons are often drawn with other countries in the region to point out that banks in Sri Lanka are not sufficiently sensitive to these factors that have an impact on investment and development. Table 1 gives the risk free short term interest rates of several Asian countries and Table 2 gives the prevailing intermediation cost as measured by the interest margins.

What Tables 1 and 2 clearly show is that the risk free interest rates in Sri Lanka is way above all comparator countries and the interest margin is on the high side but not the highest. However, behind this seemingly acceptable statistical average does lie a cause for real concern with regard to the margins that are applicable to certain classes of borrowers such as SMEs, second tier corporate borrowers and consumers. It is no secret that even today when banks are offering prime borrowers short term credit facilities at 13 % per annum or even lower, SME borrowers are charged 24% p.a. while consumer loans and advances even go up to 36% p.a. While banks must

price risk correctly, it would seem that they are under pricing the risk of so called prime borrowers and getting a cross subsidy from the others.

Table 1 - RISK FREE RATES (July 2009) - GOVT. DEBT SECURITIES

Country (Alphabetical order)	Short TermTreasury Bill % per annum	5 yr Bond % per annum
Bangladesh	3.0	9.2
Indonesia	6.8	9.0
Malaysia	2.0	3.7
Philippines	4.3	6.0
Sri Lanka – 2008	19.1	19.6 (4 year)
2009 June	11.4	13.0
Thailand	1.1	3.0

Source: Respective Central banks, Primary issues

Table 2 - NET INTEREST MARGIN OF BANKS

Country (Alphabetical order)	Net Interest Margin %
Bangladesh	6.0
Indonesia	6.5
Malaysia	2.5
Philippines	4.2
Sri Lanka	4.7

Source: Various Central Bank websites, Analyst Reports

Credit Quality ....

Often it is alleged that banks in Sri Lanka are risk averse. This does not seem to be borne out by the facts in Tables 3 and 4 . Table 3 shows that except for 2008 and 2009 there has been consistent credit growth. The sharp expansion of credit in 2006 was one factor that led to the progressively tight monetary policy regime imposed by the Central Bank during 2007 and 2008. The credit contraction in 2009 is symptomatic of the global and local economic environment that prevailed from late 2008.

Table 3
Loans, Deposits and NPL Trend – Commercial banks

	Loans		Deposits		NPL's	
Year	**Rs Bn**	**Annualized growth %**	**Rs Bn**	**Annualized growth %**	**Non Performing Loans Rs Bn**	**NPL Ratio %**
2003	432	-	651	-		
2004	528	22	792	22	75	9.1
2005	672	27	945	19	71	7.0
2006	881	31	1,121	18	73	5.6
2007	1,031	17	1,307	16	78	5.2
2008	1,146	11	1,410	8	101	6.2
2009 May	1,114	-3	1,542	9	144	8.9

Source: Central Bank of Sri Lanka

The level of NPLs is an indirect measure of the credit risk appetite of banks although embedded in it may be deficiencies in risk management and other management shortcomings. As there is no real evidence to suggest that Sri Lankan bankers are inferior to their counterparts in our comparator countries, a comparison of the NPL levels in those countries is useful. These are given in Table 4. The number for Bangladesh is distorted due to very high level of NPLs of over 25 % in the state banking sector in that country. It would appear that our banks are not less risk averse than anyone else.

Table 4 – NON PERFORMING LOAN (NPL) RATIOS

Country (Alphabetical order)				Gross NPL %
Bangladesh	–	June	2008	13.0
Indonesia	–	Nov.	2008	3.5
Malaysia	–	Sept.	2008	5.1
Philippines	–	June	2008	5.2
Sri Lanka	–	Dec	2008	6.2
		May	2009	8.9
Thailand	–	Dec.	2008	6.5

Source: IMF, Central Bank of Sri Lanka

Attractiveness to capital providers……

This is an area often not given its due importance by bank management. Bank management are well aware of their responsibility to depositors but at times lose track of the fact that there can be no growth without capital. In the context of Sri Lanka, given that the capital market is not highly developed, the capital required for growth has in the main got to be provided by shareholders in the form of new equity capital or retained profit. Equity providers will expect to be adequately rewarded for the risk they take and profitability is a key factor that will receive their attention. Banks are often criticized for making large and unconscionable profits but Tables 5 and Figure 1 will be revealing, especially in the context of high risk free interest rates that have prevailed in this country.

Figure 1

Source: Nihal Welikala,(NDB); Sunday Times

Table 5 – Return on equity and risk free rates

Country		**ROE %**	**Risk Free Rate (relevant period) %**	**Risk Premium %**
Bangladesh -	2007	13.8	11.7	2.1
	June 2008	21.3	10.6	10.7
Indonesia -	Aug. 2008	26.0	8.0	18.0
Malaysia -	Dec. 2007	19.7	3.4	16.3
Philippines -	June 2008	9.6	4.4	5.2
Sri Lanka -	**2008**	14.9	19.6	(4.7)
	Est. 2009	14.0	12.0	2.0
Thailand -	Dec. 2007	7.3	3.1	6.2

Source: IMF, Central Bank of Sri Lanka, other Central Bank websites, Annual Reports

Note on Table 5: Risk free rates in this table are the medium term government local currency bond rates for the relevant ROE period. For some countries including Sri Lanka, a sample of banks have been used for ROE calculation.

Figure 1 shows that after 2004, the Return on Equity of banks has steadily gone down and in 2007 and 2008 have been well below the Risk Free rates. Table 5 gives the comparative position in other countries which shows a dismal picture for equity holders in Sri Lankan banks vis a vis other countries.

All of the above appear to indicate that banks while making relatively large headline profits are not particularly profitable from the perspective of capital providers. To understand why, we can analyze the distribution of income of banks. This is depicted in Table 6. This Table indicates while employee costs and overheads are in the top percentile, these are not out of line. With regard to employee cost one should bear in mind that these could vary depending on the level of outsourcing prevalent in each country (relatively low in Sri Lanka) and the combined overheads and employee costs may be a better indicator of cost structures. One should not also forget that there are hidden costs relating to employees in Sri Lanka such as subsidized loans and it is difficult to make a meaningful analysis of employee costs across countries without studying these in issues in greater detail.

Table 6 – Distribution of Income

Country	Employees %	Overheads %	Provision %	Taxes %	Shareholders (dividends and retained profit) %
Bangladesh	16	19	15	28	22
Indonesia	27	22	15	11	25
Malaysia	25	22	8	12	33
Philippines	25	49	7	6	13
Sri Lanka	28	24	10	21	17
Thailand	21	32	11	10	26

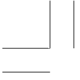
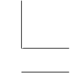
Source: Annual Reports in websites, sample of banks

However, what is clear is that apart from Bangladesh, Sri Lanka imposes by far the highest tax burden on banks. This is especially relevant in the context of the much higher cost of capital as indicated by the risk free rate in Sri Lanka when compared with regimes where the tax is significantly lower. Capital formation through adequate profit retention and making investment in banks attractive to equity capital providers is essential if the banks are to play the full role expected of them in rebuilding the nation and this is a matter that requires the immediate attention of policy makers. Banks for their part will need to address issues that affect their cost base and efficiency and embrace shared services for non-core tasks more aggressively in order to drive unit costs down.

Risk capacity ....

The risk capacity of a bank is determined by its risk policies. As stated earlier, there is no evidence to suggest that the banking industry in Sri Lanka is in general risk averse when related to the environment in which they operate. While some may argue that tighter lending policies would reduce delinquent loans, the flip side is that this could cut out significant sections of the community from access to credit. Another factor affecting risk capacity is scale. While banks may be comfortable providing short term working capital funding up to their statutory single borrower limit, a single bank would rarely take a long term exposure of more than USD 10 to 15 m for a new project. Even with syndication, it is hard to provide long term debt funding beyond about USD 60 m for a single project from the domestic banking system without resorting to cross border fund raising or risk sharing. The relatively small size of Sri Lanka's economy is a factor in this phenomenon but the difficulty to think big in business and give effect to such thinking is also a limiting factor in getting the real GDP growth rate to the desired double digit level.

The paucity of domestic long term savings (retirement funds) is another factor that affects risk appetite. Over the years, successive governments in Sri Lanka have commandeered retirement savings funds to meet budget deficits crowding out private sector access to such funds and inhibiting the development of an active long term corporate debt market. The larger private sector projects such as those related to telecommunication, port development and power generation have had to depend on overseas debt capital either directly or using the banking system. Even for such cross border fund raising, overall cost and pricing become cheaper when the transaction size is over USD 250 m. The domestic banks are not large enough for transactions of this magnitude. Thus, there is a case for one or two much larger banks to emerge through consolidation to address this issue as well as to regionally expand. Niche players can continue to ensure sufficient choice is available to customers locally. Until such time as banks build up scale, credit concentration risk will pose a problem when it comes to financing large scale projects of the private sector. Although the single exposure limit in Sri Lanka is fairly generous and banks often argue that when lending to conglomerates, the risk is dispersed by exposure to diverse businesses, in reality this is not a sound argument when management control of the borrowing entities lie with the same group of people, unless cash flows are completely ring fenced. Thus from a risk mitigation perspective, it is in the interests of the banks to promote the faster development of the domestic capital market. Banks will also need to pay greater attention to structures where the credit risk of

new projects is shared with fund providersd and to this end the recent advent of Islamic Banking in the Asian Region opens up opportunities through structured products which should not be ignored.

In conclusion ……..

Post war Sri Lanka has indeed opened up new vistas for development, not only in the North and East, but the entire country. Assuming that our elected representatives will do what needs to be done establish sustainable peace, banks have not only an opportunity but a responsibility to contribute to the peace dividend. However, the Sri Lankan banking industry is also constrained by several factors such as paucity of long term funding, high cost of capital, low risk capacity due to lack of scale. Banks will need to meet these challenges and look at innovative financing arrangements if they are to play their due role in building a prosperous nation.