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The Pathfinder Economic Alert

New Instrument for Financing Sri Lankan Development
For the Attention of Bankers and Financiers.

Sri Lanka, which was a low-income country (per capita income below $2,000) until a few years ago, has now reached lower-middle-income country status ($2,840). Of course, while Sri Lanka can be proud of this achievement, middle-income country status requires it to operate within a new paradigm. In the 80's and to a lesser extent in the 90's Sri Lanka was the 'Darling' of donor agencies who were generous in providing concessionary financing to poor countries which had liberal economies and polities. However, as a lower-middle-income country Sri Lanka is no longer entitled to such finance. The country is now more dependent on international capital markets to finance its development work.

In such situations, a high premium should be attached on being innovative in financing our economic development i.e. infrastructure; skills and educational advancement; promoting Sri Lanka as an international service centre for shipping and aviation; and power and energy. Furthermore, at a time of global and domestic financial uncertainty, Sri Lanka needs to be innovative in raising external finance. One such mechanism that that is able to mobilize financing over and above the accepted sovereign ceiling (the country's limit of exposure) at lower cost is technically known as 'Asset Backed Securitization of Future Flow of Receivables' such as remittances. Securitization is a form of secured borrowing involving the transfer of assets to a Special Purpose Vehicle (SPV) that finances the assets with securities backed by the value of the assets.

Securitization: Lower Cost & Longer Maturity

Securitization is particularly useful when a country is confronted with liquidity constraints and heightened sovereign risk. The adverse developments in Sri Lanka's balance of payments makes it timely to explore this option for raising much needed foreign financing at this time. As the money raised would be backed by a regular flow of remittances that is ear-marked to fund the repayment of the amounts borrowed through the creation of SPV's, the costs involved are less than those associated with borrowing from international capital markets through **unsecured** bond issues. The interest rate differential tends to be greater when the risks associated with the economy are elevated, and bond yields are higher. **This means that securitization can be**

particularly useful in uncertain market conditions similar to that confronting Sri Lanka today. Furthermore, securitization enables borrowing with longer maturity. Sri Lankan banks are well placed to explore securitization due to their healthy balance sheets and ratings.

There is already a strong track record of financial institutions leveraging the value of the cash that emigrant workers remit to their home countries. It has been widely practiced in Latin America, in particular. The size and stability of worker remittances have caused a surge of interest among financial institutions, academics and others in recent years. Banks in developing countries have securitized remittance cash flows Remittance securitizations - or, issuances of remittance-backed bonds - involve parties in remittance-receiving countries harnessing the value of remittances in order to access capital markets. Remittance flow securitization can enable developing country banks to raise funds at advantageous rates. These future-flow transactions present an opportunity to ensure better services and lower costs to remittance senders and receivers because they depend upon the bank's capacity to retain or grow its market share of the cash flow securitized. Remittance securitization could, therefore, provide strong incentives for improving the banking services offered to migrant workers, particularly the poor women who contribute so much to the country's economy.

On the downside, the earmarking of future remittance flows for debt repayment constrains the flexibility involved in the use of a country's foreign exchange earnings. However, as these borrowings need to be repaid anyway, the advantages of lower costs and longer maturity outweigh any loss in flexibility. **It is also noteworthy that the country and individual banks currently have significant headroom before they reach the danger level on this front.** Furthermore, there are relatively high fixed costs associated with such operations (please see 5 below). Here again, this can be more than off-set by lower interest costs/longer maturity.

Research Findings

The main findings of a research study on this subject by Suhas Ketkar and Dulip Ratha published by the World Bank include the following:

Securitization of future flows and existing receivables (e.g. remittances) can provide a way of raising development finance for developing countries which are no longer eligible for concessional aid, especially during times of low liquidity and heightened perception of sovereign risk. **Future-flow securitization is a foul-weather friend for investment grade entities in countries where sovereign risk becomes elevated.**

1. Such transactions can be structured to mitigate sovereign risk so that a developing country borrower can access longer-term financing at lower interest rates than unsecured bonds. Typically such benefits of lower interest rates or longer maturity far outweigh the high fixed costs of undertaking future flow securitization, especially in an environment of elevated economic risk.

2. The size of future receivables of developing countries that are suitable for securitization is much larger than (more than ten times) the current level of issuance at under $10billion annually. In South Asia the potential for securitization lies in remittances, credit card vouchers and telephone receivables.
3. However, future flow securitization increases the level of inflexible debt of the issuer at the micro level, and of the nation at the macro level. However, the current level of securitizing future flows is nowhere near the danger level in any country.
4. Governments may find this asset class attractive because, when planned and executed ahead of time, it can provide a way of assessing markets during times of liquidity crisis. There are also significant externalities associated with future flow deals.
5. However, securitization transactions can be very costly to an issuer, because such transactions are relatively new and (so far) less amenable for standardization. Fees for obtaining investment banking expertise, legal services and credit rating can be very high, and preparation times very long in undertaking a future flow securitization deal.

Let's Explore

In view of the country's current needs and developments in the international financial markets the Pathfinder Foundation recommends that the financial sector authorities in Sri Lanka explore the feasibility of promoting the securitization of remittances, in order to secure relatively low cost and long term financing for development purposes.

This is the Twenty – Eighth in the series of Economic Alert articles published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org

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