ADDRESSING HOUSEHOLD DEBT INDUCED VULNERABILITY IN SRI LANKA

Policy Note based on the
Multidimensional Vulnerability Report
compiled by UNDP Sri Lanka

September 2024

HOUSEHOLD DEBT – A MAJOR CONTRIBUTOR TO MULTIDIMENSIONAL VULNERABILITY

Sri Lanka's recent trajectory has unfolded as a succession of formidable challenges, each exerting a profound influence on the populace's well-being. The confluence of the COVID-19 pandemic, economic crisis and natural disasters has dramatically altered the socioeconomic landscape, giving rise to emergent pockets of vulnerability throughout the country. These challenges underscore the urgent need for evidence-based strategic measures to safeguard the nation's stability and fortify its capacity to navigate the multifaceted threats converging on its social and economic fabric.

In a concerted effort to address the prevailing data deficit on the plight of the populace in the face of recent challenges, UNDP undertook the inaugural **National Citizen Survey 2022-2023**[1] in Sri Lanka. This initiative assessed the real-world challenges encountered by 25,000 households nationwide, ensuring an encompassing representation of the country's dynamics and allowing for disaggregation to the district level. The primary purpose of the survey was to capture the ground realities of households in the face of compounded crises, and multiple and overlapping vulnerabilities. T**he survey findings pinpoint household debt status, adaptive capacity in the face of disasters, and educational attainment as the pivotal determinants shaping Sri Lanka's multidimensional vulnerability landscape.** Foremost among these factors is the indicator linked to household debt, emerging as the predominant driver influencing the overall multidimensional vulnerability of Sri Lankan households. **Approximately 33.4% of the populace grapples with multidimensional vulnerability, as well as deprivation concerning debt-related metrics. This includes household acquisition of debt, with households often resorting to measures like pawning personal jewellery or liquidating possessions, for fundamental necessities, such as basic sustenance, healthcare, and education.**

In both urban and rural contexts, the principal factors influencing multidimensional vulnerability are the deficiencies in household debt status and financial liquidity, with adaptive capacity to disasters following closely behind. **Notably, household debt emerges as a pronounced concern and a top contributor to household vulnerability in the Eastern (57%), Northern (41%) and North Central (40%) provinces, prompting heightened policy attention due to its substantial percentage contributions, closely trailed by considerations of adaptive capacity. In a district-wise breakdown Ampara (60%), Batticaloa (57%), Mullaitivu (56%), and Trincomalee (52%) report the highest incidence of household indebtedness.** Irrespective of district, however, the persistent prominence of household debt status and adaptive capacity to disasters underscores their universal significance as formidable challenges, highlighting the far-reaching implications of economic well-being and resilience on the broader community's overall welfare.

Furthermore, an intrinsic linkage between debt and disaster preparedness emerges from the data. Elevated levels of indebtedness contribute to heightened financial insecurity, restricted access to resources, and subsequently, diminished capacities to cope with unforeseen shocks. This symbiotic relationship underscores the intricate interplay between economic stability, financial prudence, and the ability to navigate and withstand unexpected challenges.

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1 UNDP Sri Lanka & Oxford Poverty & Human Development Initiative. (2023) "Understanding Multidimensional Vulnerabilities: Impact on People of Sri Lanka. A Policy Report Based on the Multidimensional Vulnerability Index derived from UNDP's National Citizen Survey 2022-2023." UNDP: Colombo. MVI Report

SNAPSHOT OF HOUSEHOLD DEBT IN SRI LANKA

An overview of household debt in Sri Lanka unveils a landscape where 38.5% of households reported accumulated debt from diverse sources during the study period. **The primary catalysts behind incurring debt include economic activities (42.5%), housing construction or repair (32.8%), and fundamental consumption needs such as food, fuel, and other household expenses (19.3%).** When analysing the borrowing landscape, the dominant sources are banks (38.5%, encompassing both government and private institutions), Samurdhi banks (19.2%), pawning (13.5%), money lenders (11.8%), and finance companies (11.2%). According to this formulation, the percentage of households in debt encompasses both those confronting a **"debt problem"** or **indebtedness** and those that are not.

The Multidimensional Vulnerability Index (MVI) methodology classifies a household as having a debt problem if members borrow to cover basic consumption, education, transport or medical treatments or resort to pawning jewellery or selling belongings to meet income needs. **According to this criterion, 19.3% of households in Sri Lanka grapple with indebtedness, borrowing an average of 4.48 times annually for basic consumption. For households seeking funds for consumption, the primary sources of debt include pawning (31.1%), money lenders (24%), and banks (23.5%).** This pattern underscores a reliance on predominantly informal sources by households engaged in consumption borrowing, often susceptible to exploitative practices.

Both urban and rural areas in Sri Lanka seem to have a high proportion of households (37% and 38% respectively) that are indebted. However, there is a higher proportion of urban households that borrow for basic consumption (26.2%) compared to rural areas (17.9%). Pawning is also the second highest source of borrowing (18.7%) in urban areas as opposed to rural locations (12.5%).

Among the provinces, the Eastern province records the highest proportion of households borrowing for basic consumption (54.7%), followed by the Western (21.3%) and Sabaragamuwa provinces (19.3%). Pawning is highest in Eastern province (30.8%), followed by Uva (17.3%), Western (17%) and Central provinces (14.6%). Borrowing from money lenders is highest in Eastern (19.8%) and Western provinces (19.2%).

A disaggregation by districts indicates that Trincomalee (65.8%), Ampara (54.1%), and Batticaloa (47.9%) have the highest incidence of households borrowing to fulfil basic consumption needs. Over one-fifth of the households in the Colombo, Gampaha Monaragala, and Ratnapura districts also reported that they borrow money to pay for food, fuel and utilities. The highest prevalence of pawning is reported in Batticaloa (57%), followed by Monaragala (38%) and Kilinochchi (27%). Resorting to money lenders is highest in Colombo (23.8%), followed by Trincomalee (19.3%) and Gampaha (17.1%).

In interpreting the snapshot of indebtedness in Sri Lanka, it is important that we recognize the inter-sectoral and inter-regional inequalities in terms of access to income opportunities and quality public services. Educational and health inequalities are greater in remote rural and plantation areas. Better equipped health and educational institutions are mostly concentrated in urban areas, and it is common for people from nearby areas to commute to cities in order to access these services. As a result, many users not only spend long hours to reach them but incur considerable expenses to do so, often also forgoing their daily incomes. Those who cannot readily afford such expenditure have to borrow money or forgo such services resulting in adverse consequences for their health, well-being and social advancement. As for education, many poor households send their children to relatively less-endowed schools. Parents often spend money to provide children with additional educational support but at a cost they cannot easily afford.

Sri Lanka's low level of public expenditure on education and health as a percentage of the GDP has not helped to reduce educational and health inequalities that which disproportionately affects poor households, particularly in disadvantaged areas and regions, pushing them into further vulnerability. Under such circumstances, increasing indebtedness makes their situation much worse, creating the need for urgent and sustained interventions to ameliorate their precarious circumstances. Household indebtedness, interconnected with regional and sectoral disparities in accessing sustainable livelihoods and dependable public services, is poised to exert an intergenerational influence. The enduring ramifications of household indebtedness, potentially ensnaring individuals in an unrelenting cycle without reprieve, necessitate in-depth empirical inquiry and robust research tools to fully comprehend its impact and complexity.

THE ECONOMIC CRISIS AND WORSENING INDEBTEDNESS

To complement the findings of the National Citizen Survey 2022-2023, this study employed a qualitative assessment through Focus Group Discussions (FGDs) covering the informal sector, including women and men, as well as youth across various regions in Sri Lanka. The qualitative insights serve as a valuable complement to the quantitative analysis, offering validation and a deeper understanding of the core findings. Eight FGDs were conducted in key locations, including Colombo, Kurunegala, Kandy, Anuradhapura, Trincomalee, Badulla, Vavuniya, Rathnapura, Nuwara Eliya and Galle.

The FGDs unveiled a stark vulnerability among informal sector workers, particularly in urban and estate areas amid the current economic turbulence gripping the nation. Respondents emphasized a staggering two to threefold increase in the cost of living compared to pre-COVID days, rendering their incomes inadequate to cover daily expenses. **The lack of income, limited opportunities to earn an income, and staggering cost of living appears to have pushed households towards increasing borrowings and indebtedness.** In urban areas, lack of access to home gardens among low-income households, combined with increasing food insecurity due to escalating food prices have exerted greater pressure on such households.

This surge in living costs can be attributed to the removal of government subsidies on fuel, gas, electricity, and water, the depreciation of the Sri Lankan rupee (LKR) and multiple hikes in value-added taxes (VAT) on consumer goods. In a departure from the historical average inflation rate of 10% observed from 1986 to 2022, the year 2022 marked a period of hyperinflation for Sri Lanka. In September 2022, the Year-on-Year (YoY) Headline inflation, as measured by the CCPI, peaked at an alarming 69.8%. Both food inflation and non-food inflation contributed to a substantial erosion of consumer purchasing power. Factors such as the depreciation of the LKR from May 2022 and the increased costs of importing commodities and essentials, including fuel, played a pivotal role. The shift from cost-subsidization to cost-reflective pricing heightened the impact of pricier commodities, leading to a cascading effect on business costs.

For the average individual or family, true recovery entails a return to pre-crisis living standards. According to official inflation figures, real income plummeted by at least 50% in 2022 alone. As of March 2024, the erosion of real income is even more pronounced. With no expectation of a decline in the average price level, regaining lost real income through price reductions is unlikely. The only path to recovery lies in increasing incomes to offset adverse price effects. This necessitates income growth outpacing inflation, both historically and currently. Achieving this depends on sustained economic expansion over an extended period, making the return to pre-crisis living standards a prospect that could take many years.

The prevailing surge in the cost of living has imposed a formidable burden on households, with discernible impacts across key expenditure domains critical for survival. The following elements delineate the ramifications in order of significance:

- Constrained purchasing power has led to a reduction in the consumption of essential food items, highlighting the critical impact on sustenance and nutritional status of vulnerable household members such as children, lactating and pregnant mothers and the elderly.
- Escalations in fuel prices, encompassing essentials like kerosene and gas for cooking, alongside the spike in utility bills, particularly electricity, have become an overwhelming financial strain.
- Reduced opportunities for continuous employment and lowered wages underscore the financial hardships faced by households due to diminished demand for labour.
- The increased costs associated with children's education pose challenges, necessitating prioritization in the case of multiple children and their respective school grades, with implications for schooling expenses and tuition fees.
- The surge in fuel prices has led to a considerable increase in public transportation fares, impacting families who rely on buses and trains. Many children now commute by bus due to the unaffordability of school vans.
- Shortages of medicines and, healthcare workers and the suspension of certain diagnostic tests at government hospitals and dispensaries have hindered access to healthcare, leading to neglected health check-ups and medication. Affordability concerns have resulted in a reliance on public healthcare services.

The realities above highlight the fundamental issue of insufficient household disposable income. Households commonly turn to borrowing money as a prevalent coping mechanism to offset insufficient income for meeting escalating basic expenditures. Among the array of borrowing options, a common, yet unsecure strategy is pawning jewellery, adopted by 37.5% of households. This preference is accompanied by recourse to other sources, including securing credit for goods purchases from local shops (11.5%), obtaining loans from financial institutions (9.2%), and seeking financial support from informal money lenders (4.9%).

Lending from Finance, Microfinance and Leasing Companies

Over the past decade, finance, microfinance, and leasing entities have faced intense scrutiny for disbursing expeditious yet relatively modest loans at exorbitant interest rates, ensnaring borrowers in a perilous "debt trap." This practice has been particularly detrimental to victims of predatory lending, amplifying economic and social challenges, especially in rural areas. According to data from the National Citizen Survey, 3.8% of households resort to microfinance institutions, while 11.2% turn to finance and leasing companies. Among households borrowing from microfinance institutions, 52.2% seek funds for economic activities, and 21.3% do so for basic consumption needs. Similarly, 17.6% of households borrowing from finance and leasing companies utilize the funds for basic household consumption.

While these institutions are ostensibly committed to providing financial services to low-income individuals, offering credit, savings, and other vital financial tools to those overlooked by traditional banks due to insufficient collateral, the reality has deviated from their theoretical objectives.

Microfinance, in particular, was envisioned to expand income generation activities and enhance the capacities of low-income individuals, contributing to improved living conditions and active participation in the economic development of the country. However, in practice, both microfinance and leasing companies have garnered a negative reputation as predatory lenders.

A primary critique directed at these entities is their lack of regulatory oversight compared to licensed banks and finance companies governed by the Central Bank of Sri Lanka (CBSL). Although the Microfinance Act, No. 6 of 2016, established a framework for the licensing, regulation, and supervision of microfinance businesses, creating licensed microfinance companies (LMFCs), concerns persist eight years after its enactment. Approximately 15,000 microfinance institutions are believed to be operating unlawfully in the country, raising questions about the efficacy of existing regulatory measures and monitoring.

In response to the persisting problem, the Government of Sri Lanka introduced a bill to establish a microfinance and credit regulatory authority in October 2023. The proposed legislation, titled the "Microfinance and Credit Regulatory Authority," seeks to establish a regulatory body in Sri Lanka with the objective of overseeing and regulating both moneylending and microfinance businesses. A departure from the previous Microfinance Act of 2016, this bill empowers the regulatory authority to thoroughly regulate microfinance businesses and credit lending institutions.

Under the new Act, individuals and institutions are prohibited from engaging in microfinance activities without obtaining a license. The regulatory authority is granted expanded powers to investigate businesses operating without proper licensing. This represents a significant shift from the repealed Act, where the Central Bank of Sri Lanka (CBSL) could only investigate licensed entities. The responsibilities of the regulatory authority include maintaining a comprehensive database, investigating customer complaints, and providing credit counselling and financial literacy programs to the public. These responsibilities have also been extended to the CBSL and embedded in the National Financial Inclusion Strategy (NFIS). The authority is further empowered to issue regulations governing maximum rates, collection methods, and conditions preceding lending. In the event of complaints, the regulatory authority has the mandate to conduct inquiries. Notably, legal representation during this process is prohibited for both creditors and lenders. Media institutions are assigned the responsibility of validating the authenticity of these businesses before advertising them to the public.

Microfinance businesses now face reporting requirements akin to entities governed by other laws, such as the Financial Reporting Act. The obligations placed on these institutions are more extensive and stringent in terms of reporting. Additionally, the legislation includes secrecy provisions to safeguard the privacy of lenders, though subject to limitations outlined in the Right to Information Act and similar statutes.

As such, the new law will lay the foundation for a responsible lending and borrowing culture. The regular reporting, licensing conditions and proactive disclosure obligations imposed on both the lender and the borrower will potentially help discourage drivers of unhealthy debt culture. Moreover, given that the CBSL is assigned an extended responsibility to strengthen and stabilize the financial system and make qualitative improvements to microfinance regulations and guidelines, the lower and medium level financial transactions of different sectors of the society will now be closely monitored. Besides top-down measures, there is also a need for some form of systematic social audit involving the beneficiary households.

POSSIBLE INTERVENTIONS TO ADDRESS HOUSEHOLD INDEBTEDNESS

The National Citizen Survey findings underscore the necessity for a comprehensive three-tiered approach in crafting interventions to alleviate household indebtedness. Firstly, urgent steps should be implemented to tackle economic challenges, focusing on generating avenues that uplift household income. Simultaneously, a critical review of existing regulatory loopholes is imperative, including the newly tabled Microfinance and Credit Regulatory Authority, accompanied by an effort to enhance financial literacy across the population and participation of beneficiaries in the process. Lastly, it is crucial to fortify social safety nets, particularly recognizing that certain households—such as those with Persons with Disabilities (PwDs) facing acute conditions, and individuals who are sick or elderly and unable to work—may be unable to partake in paid employment even if opportunities arise.

Increasing Household Incomes

1. Advancing a Holistic Approach to Inclusive Agricultural Development:
    a. Allocate resources directly to sectors where low-income groups operate, emphasizing agriculture, fisheries, micro and small enterprises in rural areas and informal activities in urban settings.
    b. With a focus on underserved locations, facilite the utilization of labour resources for output production through small-scale agriculture initiatives, establishing community markets and enhancing other basic services to low-income households in a community environment to enable production of part of the food they consume could address food insecurity issues and provide opportunities to sell excess produce. This will also enhance community wellbeing that often contributes to individual wellbeing.
2. Empowering Farmer Organizations: Develop fertilizer distribution strategies that support farmer organizations, with affirmative action targeting smallholders, particularly women farmers.
3. Land Allocation and Startup Support: Allocate unused land for cultivation, providing startup packages, low-cost credit, and grants to farmers, especially women engaging in auxiliary agriculture like beekeeping and seed production.
4. Strengthening Home Gardens for Production: Reorient the "home gardens" programme towards production, introducing technologies and capacity building through agricultural extension services for women to sell excess harvest in local markets.
5. Enhancing Local Market Mechanisms: Strengthen local market ("pola") mechanisms, providing smallholder farmers with a platform to sell their produce.
6. Promoting Alternative Diets: Mobilize health professional networks (i.e., Family Health Workers) and media to promote alternative diets with locally produced vegetables, fruits, plant and animal proteins, and carbohydrates.
7. Boosting Viability of Informal Production:
    a. Improve access to institutional credit for small producers through nationwide campaigns involving the "Sithamu" female farmer organization network and the Samurdhi Bank.
    b. Promote the integration of small producers into supply chains, supporting technology improvements for increased labour productivity.
8. Establishing temporary public employment schemes: Implement cash-for-work schemes in public works programmes to set a wage floor as in the case of India's Rural Employment

Guarantee scheme.

9. Advancing Skills Development and Employment Opportunities:
   a. Facilitate public-private partnerships for digitally driven labour market services.
   b. Facilitate nation-wide capacity building programmes focusing on financial and digital literacy and entrepreneurship, particularly for youth.
   c. Enhance skill bridging programs to prepare prospective migrants, with a focus on skill range and digital skill matching, while focusing equal attention to reintegration of returning migrants with a view to supporting sustainable livelihood development and entrepreneurship.
   d. Address issues faced by women migrant workers stranded abroad, providing job-search assistance, counselling, and interview skills support.

10. Strengthening Efficiency of Migrant Workers and Others in the Labour Force:
   a. Enhance regulatory mechanisms for migrant worker placement and standard contracting.
   b. Provide high-quality training programmes for migrant workers.
   c. Strengthen legal counsel and protection for migrant workers abroad.
   d. Implement digitalized, inexpensive remittance procedures in collaboration with public and private banks.
   e. Leverage the upcoming establishment of the National Productivity Commission to implement a nation-wide labour productivity plan and strategy.

11. Enhancing Provision of Essential Public Goods and Services:
   a. Reallocation of Public Expenditures: Strategically reallocate public expenditures to prioritize meeting social sector objectives, including health, education, public transport, housing, and nutrition.
   b. Broadening Tax Revenues: Increase tax revenues by expanding the tax base or implementing a special time-bound scheme to ensure sustainable funding for essential services. Moreover, the lack of support for progressive taxation among many present and potential taxpayers is a major impediment to raising state revenue which is critically important for improving quality of public services.

12. Alleviating Child and Elderly Care Responsibilities for Women:
   a. Mitigate the burden of child and elderly care on women by establishing community-based elderly care institutions, both public and private.
   b. Introduce flexibility in these institutions to accommodate the work schedules of primary caregivers, contributing to a more balanced and supportive caregiving environment.

Strengthen the Regulatory Environment for Lending, Evidence on Household Indebtedness and Promote Financial Literacy

1. Examining Microfinance Landscape:
   a. Conducting a study of the microfinance sector, with a specific focus on identifying instances of predatory and gendered microfinance practices, especially surrounding Women-headed Households (WHHs) and an in-depth analysis of resultant coping strategies.
   b. Conducting Microfinance Debt-Audit: Facilitate a comprehensive microfinance debt-audit to assess the extent of borrowings, as well as the repayment of interest and principal associated with existing loans.

c. Implementing Microfinance Debt Restructuring: Initiate a structured process for microfinance debt restructuring to alleviate the financial burden on women and households grappling with existing indebtedness.

2. Enhancing Microfinance Regulation: Strengthen regulatory measures governing microfinance institutions to ensure sound practices, consumer protection, and gender-sensitive considerations in the microfinance sector.
3. Developing a code of conduct for lending institutions, following international best practices in support of national policies and regulations.
4. Implementing the National Financial Inclusion Strategy (NFIS) and Roadmap led by the Central Bank of Sri Lanka to promote financial literacy and behavioural patterns on spending.
5. Conducting a study of informal lending mechanisms such as women's revolving funds and seettu systems in Sri Lanka, and implications of regulatory changes on such mechanisms.
6. Developing a robust survey tool to assess household indebtedness and its gendered impact.

Strengthen Social Safety Nets

1. Strengthening Social Protection Infrastructure: Invest in the establishment of a robust social protection architecture, addressing institutional, legal, financial, administrative, and digital aspects to enhance effectiveness of beneficiary registration and verification, avoid duplications, and ensure efficient delivery and disbursement of benefits.
2. Implementing a community-based monitoring and intervention system (CBMIS) and support/empower communities to record real-time data into a digitalised map disaggregated to the GN division level. Mobilising and training locally based government functionaries attached to the DS office to facilitate the process and ensure transparency, objectivity and accountability of the mechanism.
3. Expanding Social Protection Measures: Scale up social protection efforts by introducing a temporary basic income (TBI) for the working-age population, including informal sector workers and women, and Women-Headed Households (WHHs) along with additional support for vulnerable individuals.
4. Implementing Urgent Cash Transfers through Maternal and Child Health Clinics: Launch an emergency cash transfer and social protection initiative directly targeting women, with a rollout facilitated through Maternal and Child Health Care clinics.
5. Launching Short-Term Food Subsidies: Introduce a short-term food subsidy program, prioritizing Women-Headed Households (WHHs), Persons with Disabilities (PWDs), and other vulnerable groups to address immediate nutritional needs.
6. Examining Economic Realities and Redefining Poverty Measures: Investigate the circumstances of the "new poor" and initiate a comprehensive process to revise the national poverty line, and review Aswesuma criteria, reflecting the current economic realities more accurately.