

COMMERCIALIZATION OF MICROFINANCE

SRI LANKA

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FOREWORD

The microfinance industry has evolved significantly over the past two decades. However, the outreach of the industry remains well below its potential in the Asia and Pacific region. If the full potential of microfinance for poverty reduction is to be realized, it is essential to expand its outreach substantially. It is in this context that commercialization of the industry has become a subject of in-depth study. Although many industry stakeholders appear to believe firmly that commercialization is necessary, there is inadequate understanding of the complex process of moving toward a sustainable microfinance industry with a massive outreach.

The Microfinance Development Strategy of the Asian Development Bank (ADB), approved in June 2000, provides a framework for supporting the development of sustainable microfinance systems that provide diverse, high-quality services to traditionally underserved low-income or poor households and their microenterprises. One element of this strategy is support for development of viable microfinance institutions that can set in motion a process of commercialization of microfinance services. As a first step, ADB approved in November 2000 a regional technical assistance project on Commercialization of Microfinance, to improve understanding of the process of microfinance commercialization as well as its challenges, implications, and prospects. The project, which was financed from the Japan Special Fund, has three components: country studies on microfinance commercialization, in-country workshops to discuss the country studies and specific institutional experiences, and a regional workshop to discuss each country study and institutional experiences in a comparative context.

The countries chosen for study—Bangladesh, Indonesia, Philippines, and Sri Lanka—represent different stages of development and commercialization of the microfinance industry.

The Sri Lanka country study was carried out by Stephanie Charitonenco of Chemonics International Inc. and Dulan de Silva, an independent consultant. Their report, presented here, was first presented at the Country Workshop on Commercialization of Microfinance, 24–26 October 2001, in Galle, Sri Lanka. Workshop participants provided valuable input to refine the report and improve its relevance. The Central Bank of Sri Lanka assisted the team of consultants in carrying out the study. Mr. A.J. Jayawardena, Governor of the Central Bank of Sri Lanka, delivered the keynote address at the Country Workshop and provided valuable comments. ADB is grateful to the Central Bank for this assistance.

This publication is one of a series of papers resulting from the project. The series comprises four country reports (on Bangladesh, Indonesia, Philippines, and Sri Lanka, respectively) and a regional report covering these countries.

It is hoped that this publication series will contribute to a better understanding of the issues involved in commercialization of microfinance and lead to better approaches toward a sustainable microfinance industry that will provide a wide range of services to poor and low-income households not only in the Asia and Pacific region but also in other regions.

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ABBREVIATIONS

ADB	Asian Development Bank
CBSL	Central Bank of Sri Lanka
CRB	cooperative rural bank
GDP	gross domestic product
HNB	Hatton National Bank
MFI	microfinance institution
NDTF	National Development Trust Fund
NGO	nongovernment organization
RDB	regional development bank
SDB	SANASA Development Bank
SBS	Samurdhi Banking Society
SEEDS	Sarvodaya Economic Enterprise Development Services
TCCS	thrift and credit cooperative society
UNDP	United Nations Development Programme
USAID	United States Agency for International Development

CURRENCY EQUIVALENT

Currency Unit	=	Sri Lankan Rupees (SLRe/SLRs)
SLRe1.00	=	\$0.011
\$1.00	=	SLRs90 (monthly average, May– September 2001), unless otherwise noted

Sri Lanka moved from a managed float exchange rate system to a freely floating exchange rate system, effective 23 January 2001. For the purposes of calculation in this report, a rate of \$1.00 = SLRs90.00 is used. This was the exchange rate generally prevailing during this country study.

NOTES

- (i) The fiscal year of the Government of Sri Lanka ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

Executive Summary

This report analyzes the progress toward commercialization made to date in Sri Lanka's microfinance industry,ⁱ which is relatively large and diverse in terms of outreach and institutional types compared to that in other countries in the region. The report also explores the remaining challenges and the implications for a wide variety of stakeholders including microfinance clients, practitioners, government officials, and funding agencies. In addition, it recommends positive approaches to the commercialization of microfinance while preserving the traditional social objective of microfinance institutions (MFIs)ⁱⁱ of expanding access by the poor to financial services.

UNDERSTANDING MICROFINANCE COMMERCIALIZATION

Microfinance commercialization is a new concept and the term carries with it a negative connotation among many domestic microfinance stakeholders, who equate it with exploitation of the poor. Microfinance professionals worldwide, however, are increasingly using the term to include "the application of market-based principles to microfinance," with the realization that only through achievements in sustainability can MFIs achieve levels of outreach commensurate with demand. There is a growing realization that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services.

This report considers commercialization of microfinance at both micro and macro levels. At the micro level, MFI commercialization implies institutional progress along a continuum, as follows.

- Adoption of a for-profit orientation in administration and operation, such as developing diversified, demand-driven financial products and applying cost-recovery interest rates.
- Progression toward operational and financial self-sufficiency by increasing cost recovery and cost efficiency, as well as expanding outreach.
- Use of market-based sources of funds; for example, loans from commercial banks, mobilization of voluntary savings, or other unsubsidized sources.
- Operation as a for-profit, formal financial institution that is subject to prudential regulation and supervision and the ability to attract equity investment.

At the macro level, commercialization of the microfinance industry means the increased provision of microfinance by MFIs sharing the above characteristics in an enabling environment. Commercialization of the microfinance industry involves several factors, including the degree to which the policy environment and legal and regulatory framework are conducive to the proliferation of commercialized MFIs, the availability and access of commercialized MFIs to market-based sources of funds, and the existence of institutions that support microfinance such as apex institutions, credit information bureaus, microfinance trade associations, microfinance technical training, and providers of business development services.

PROGRESS TOWARD MFI COMMERCIALIZATION

- **The microfinance industry in Sri Lanka is at a fairly early stage of commercialization.**

Organizations based on the cooperative model, such as the cooperative rural banks (CRBs), the thrift and credit cooperative societies (TCCSs), and a few nongovernment organizations offering microfinance (microfinance NGOs) have made the most progress

toward commercialization, although the performance of individual institutions within each of these categories has been highly mixed. The most commercial of these providers, in terms of their achievements in financial self-sufficiency and access to commercial sources of funds, are together estimated to provide about one third of the microfinance services.ⁱⁱⁱ The noncommercial providers of microfinance include numerous unsustainable government microfinance programs, several hundred poorly performing CRBs and TCCSs, and around 200 weak, small- and medium-sized microfinance NGOs.

- **Microcredit market saturation appears high at about 80%.**

Based on household data and the current average outstanding microloan amount of SLRs17,339 (\$193), the upper bound on potential demand among low-income households and their microenterprises is estimated to be around SLRs22.9 billion^{iv} (\$254.9 million) in 2.3 million microloans. At the end of 2000, MFIs had approximately SLRs18.2 billion (\$202.3 million) outstanding in 1.65 million microloans. This current supply represents about 80% of the total potential demand for microcredit, in terms of overall amount and number of microloans.

- **Cooperatives are the dominant microfinance providers and the movement continues to influence how NGOs deliver microfinance.**

Microfinance in Sri Lanka has its roots in the cooperative movement, which was formalized in 1911 with the passage of the Cooperative Societies Ordinance. Today the market is pluralistic, with high penetration by many different types of institutions employing a wide range of microfinance models and methods. Given the continued dominance of the cooperative model, however, it is not surprising that MFIs rely heavily on savings mobilization to fund their loan portfolios. The CRB and TCCS networks together mobilize almost SLRs20 billion of deposits, more than enough to satisfy their needs for lending.

- **While many cooperatives are sustainable, their performance varies.**

Among the more commercialized microfinance providers are about three quarters of the 1,476 CRBs that are estimated by the Cooperative Development Department to supply profitably about one third of the country's total microcredit, among other types of loans. The CRBs fund these loans entirely from deposits. Because of the lack of standard accounting and reporting practices among CRBs, it is not clear how many would be profitable after appropriately adjusting for loan loss provisions, write-offs, and subsidies. However, far fewer TCCSs are believed to have commercially viable operations.

- **More than one third of the supply is provided through government programs that can be considered supply-led and not commercially viable.**

More than a third of the total number of outstanding microloans is supplied through a large government microfinance program that promotes the Samurdhi Banking Societies (SBSs) and numerous directed credit programs. Most of these government microfinance programs are narrowly targeted, feature subsidized interest rates, have weak repayment enforcement, and entail large recurrent costs. They are generally considered to be unsustainable. The microcredit supplied through the bulk of these government-sponsored programs is akin to disguised grants, which provide disincentives for the private sector to develop commercial microfinance operations.

- **A few microfinance NGOs are attempting to commercialize their operations but most remain unsustainable.**

The largest NGO in Sri Lanka—Sarvodaya Economic Enterprises Development Services (SEEDS)—provides 5% of the total number of microloans, and has been progressing steadily toward financial self-sufficiency while providing microloans of only SLRs8,000 (\$89) on average. Self-reported data suggest that a few other leading NGOs, such as Janashakthi (Women's Development Foundation),

may also be approaching financial self-sufficiency, although a substantial portion of their income is from interest earned on fixed deposits. The vast majority of smaller and lesser-established NGOs, which number around 200, are not operating on a very sound basis.^v The number of small NGOs with profitable microfinance operations is widely believed to be less than five; lack of transparency and standardized financial reporting impede a detailed assessment of their financial soundness.

- **There is limited involvement in microfinance by commercial banks.**

The country's financial system remains characterized by a gap in the demand for microfinance and the supply by formal, private sector providers. Private commercial banks largely concentrate on short-term lending to medium- and large-sized enterprises and salaried employees in the formal sector. A few notable exceptions exist, including the Hatton National Bank, Seylan Bank, and Sampath Bank; however, their combined number of microloans outstanding was only 1.2% of the industry total at the end of 2000. None of their microfinance programs are profitable, despite their adoption of nontraditional delivery methods.

COMMERCIALIZATION OF THE MICROFINANCE INDUSTRY

- **MFIs rely heavily on savings mobilization to fund their loan portfolios, indicating a fairly high level of commercialization in terms of access to funding sources.**

Collectively, MFIs mobilize over SLRs29.8 billion in total deposits, of which SLRs19.1 billion is savings. It is not surprising that cooperatives are the largest mobilizers of small savings accounts, given their membership and governance structures. The CRB and TCCS networks mobilize almost SLRs20 billion from their members. The SBSs and regional development banks (RDBs) also collect a significant amount of savings. They and the cooperative networks all mobilize more savings than they can use for their lending operations. The balance of these

savings resources flows into the traditional financial sector and acts as an additional source of liquidity and loan capital for larger loans in the formal financial system.

- **Government policies and interventions discourage new entrants into microfinance and hinder the commercialization of existing MFIs.**

The legal and regulatory framework further impedes commercialization in a variety of ways. It fails to enforce laws against microfinance NGOs mobilizing savings deposits and offers no clear legal path for those institutions to transform into formal financial institutions subject to prudent supervision. The cooperatives, which are the largest suppliers of microcredit as well as significant savings mobilizers, are not adequately regulated and supervised. The lack of a sound legal and regulatory framework for microfinance NGOs and cooperatives places clients' savings at risk and thus threatens the reputation of the entire microfinance industry.

MICROFINANCE COMMERCIALIZATION CHALLENGES

- **Weak institutional capacity and over-emphasis on social mission curtails MFI progress toward commercialization.**

At least half the current provision of microfinance is by MFIs that have weak institutional capacity and an aversion to applying commercial principles. In particular, many MFIs suffer from weak governance, lack of clarity in their mission, low levels of understanding of banking and finance, inappropriate accounting practices, and inadequate management information systems. Negative perceptions of commercialization prevent much of the industry from striking a balance between commercial and social missions and from becoming sustainable. Institutional weaknesses and negative perceptions of commercialization are two of the main challenges to commercialization of the microfinance industry.

- **Pervasive government presence in microfinance with subsidized, directed credit programs hampers progress toward commercialization.**

The government microfinance programs, and specifically the largest of them—the SBS program—do not operate on a sustainable basis. While SBS loans carry a respectable interest rate of 3% per month (on a declining balance basis) with loan terms of 3 months to 2 years, the program’s administrative expenses exceed its revenues. Emergency loans via the SBS program carry lower interest rates and also have high administrative expenses. Thus, neither loan type covers its full operational costs. Through other Samurdhi loan programs, the Government provides loan capital that is onlent through the state commercial banks and other financial institutions to the final borrowers at highly concessional interest rates (for example, under many programs, the channeling institutions are subsidized to keep the final lending rate down to 10% per annum). These rates would be insufficient for them to operate the program on a commercial basis if they were using their own funds.^{vi} The availability of cheap credit through many of the government programs crowds out private microfinance NGOs and other microfinance providers that do not have access to such large subsidies.

- **Ad hoc debt forgiveness damages the repayment culture necessary for commercialization.**

Many private MFI practitioners cited recurrent debt forgiveness as the chief impediment to their achieving and sustaining high repayment rates. In the most recent instance, loans below SLRs20,000 granted for paddy and banana cultivation during 1999/2000 (*maha* season, October–January) and 2001 (*yala* season, March–July) were written-off as a result of a government decision to provide relief to farmers whose cultivation was adversely affected by drought. Accordingly, the two state banks, the six RDBs, CRBs, and TCCSs in Badulla District wrote-off approximately SLRs187 million (\$2.1 million). The last major debt forgiveness program, Farmers’ Relief Scheme, began in 1994 (and was extended

through December 1999); however, practitioners noted that the Government had also waived repayments for small loans by state commercial banks and some loans under its microfinance programs. All instances of debt forgiveness, both large and small, affect not only repayments by clients growing the affected crops but also general client attitudes toward repayment.

- **An inadequate regulatory framework for cooperatives puts clients’ savings at risk and hampers commercialization of the cooperative networks.**

The 1,476 individual CRBs are organized under 306 government-dominated multipurpose cooperative societies and are only loosely supervised by the Cooperative Development Department. Despite the lack of strict supervision, the CRBs collectively had mobilized SLRs10.9 billion in savings in 5.5 million accounts by the end of 2000. A few are regulated by the Central Bank of Sri Lanka (CBSL)^{vii} by virtue of their participation in the national deposit insurance program; however, this regulation and supervision is only loosely applied to the CRBs that may be subject to it. As with the CRBs, the TCCSs are governed by the Cooperative Societies Law of 1972 and are subject to minimal supervision by the Cooperative Development Department. As a whole, the TCCSs mobilized savings of over SLRs1.7 billion by the end of 2000. Both the TCCSs and CRBs have federations that are only loose networks with no management authority to supervise the cooperatives. The lack of strong supporting federations for the cooperatives leaves clients’ deposits at risk if the individual banks (of the CRB network) and the primary societies (of the TCCS network) are not properly managed. Unfortunately, the Cooperative Development Department is not currently equipped to provide prudent regulatory oversight to the thousands of cooperatives under its supervision.

- **Savings mobilization by microfinance NGOs places clients’ savings at risk and threatens to damage the credibility of the industry.**

Under the Banking Act of 1988 and the Finance Companies Act of 1988, an institution must be

licensed as a bank or a finance company in order to collect deposits. This applies to all deposits, whether from members or nonmembers, and includes compulsory savings that may be a precondition for obtaining microcredit. However, in practice, the prohibition on savings mobilization has generally not been enforced; virtually all microfinance NGOs mobilize mandatory and voluntary savings from members. This practice without legal authority places clients' savings at risk, which in turn places the microfinance industry's reputation at risk should a microfinance NGO fail and depositors lose their savings.

- **Lack of a supportive legal and regulatory framework for MFIs discourages commercial entrants.**

The legal options are limited for semiformal MFIs (for example, microfinance NGOs) that want to transform themselves into formal institutions. Sarvodaya Economic Enterprise Development Services (SEEDS), the most commercial of the microfinance NGOs, sees its best option to formalize is by becoming a bank. But this is likely to be a difficult and inappropriate legal form for transformed microfinance NGOs, because of banks' high minimum capital requirements of SLRs500 million (\$5.6 million). The savings and development bank category for regulated financial institutions may be the most appropriate legal form given its lower initial minimum capitalization of SLRs100 million (\$1.1 million). However, exceptions and adaptations to the regulations would need to be made to accommodate the specific needs of microfinance institutions. The prudential standards applied to banks, such as reporting requirements, limits on unsecured loans, requirements concerning loan documentation, supervision methods, and branching restrictions are incompatible with successful MFI operations, which accept alternative forms of collateral and use simplified application forms, among other nontraditional lending practices.

- **A strong microfinance network is needed.**

There is one microfinance network, the Sri Lanka Microfinance Network, which started in the early

1990s and is still a loose network with no formal membership; anyone interested is invited for meetings. The members meet monthly and have few activities—an annual microenterprise fair to promote the marketing of products produced by MFI clients, commentaries on studies done in the microfinance field, and meetings and studies of relevance to the sector. The Microfinance Network suffers from a lack of focus and needs to be institutionalized with formal membership and activities.

- **Provide training centers for microentrepreneurs and microfinance.**

There is a dearth of training programs and marketing and technology services for entrepreneurship and small business development. The most common service providers to date have been microfinance NGOs that offer integrated social services; however, the supply is well below the potential demand for business development services. In addition, there are no organizations that specialize in microfinance training; no domestic universities or other training institutions offer regular courses specific to microfinance. The lack of training opportunities may be traced back to the dearth of personnel qualified to teach local and international best practices in microfinance.

IMPLICATIONS OF COMMERCIALIZATION

- **Potential for more demand-driven outreach.**

The basic premise behind microfinance commercialization is that commercial MFIs are more likely to be sustainable and become more efficient in the long-run than noncommercial MFIs. Advocates believe that increased commercialization will yield greater outreach, including to the poor, and more product diversity, resulting in more clients served and their diverse needs better met over time. This theory has proved true in such countries as Bolivia, where commercial MFIs dominate the market. As a result, low-income clients have multiple choices of financial service providers and products at lower cost than

when only noncommercial MFIs dominated the market.^{viii} Much of the remaining unmet demand for microcredit in Sri Lanka is a result of both lack of potential clients' awareness of their options as well as the need for MFIs to gain a better understanding of client needs and to adopt products and services to meet those needs. As microfinance commercialization and competition develop, MFIs will need to improve their understanding of client needs and preferences and adapt products and services to better respond to clients' requests.

- **Lack of clear profit potential, which curtails competitive pressures.**

Until the microfinance industry demonstrates more profit potential, new commercial market entrants are unlikely. Profit potential will be difficult to demonstrate until the Government stops promoting its subsidized microfinance and targeted credit programs. Given that a third of microfinance is currently supplied by the Government, its exit from the market would open up a large market for existing MFIs to expand and would encourage new commercial entrants. Only after this market is recaptured will the potential for competition emerge.

- **Potential for mission drift.**^{ix}

Many Sri Lankans are concerned that increased microfinance commercialization could result in mission drift, implying that MFIs will reduce their emphasis on targeting the poorest sectors of society and will gradually increase their loan sizes. In fact, average loans sizes for both the Hatton National Bank (HNB) and Seylan Bank have risen in recent years. This trend can be expected to continue until the Government curtails its direct interventions in the microfinance market. These banks are simply targeting the markets where they see the least competition and the most profit potential. How much mission drift this entails depends on a variety of factors. One factor is the extent to which semiformal MFIs seek to transform into regulated entities as a prerequisite to mobilizing significant voluntary savings (to help them substantially increase their outreach on a sustainable basis, e.g., SEEDS). Becoming a formal, regulated financial institution

can result in targeting higher-income clients with larger loans, as a result of profit pressures from equity shareholders. Another factor is the prevailing regulatory and supervisory framework. Prudential standards applied to commercial banks may not be appropriate for formal MFIs and may require the latter to shift their focus up-market to ensure compliance. Mission drift may remain low in semiformal MFIs that are content with serving a localized market on a competitive basis (e.g., Janashakthi). Such institutions will likely enjoy fewer opportunities to diversify their risks and not be able to take advantage of economies of scale in their operations.

POSITIVE APPROACHES TO MICROFINANCE COMMERCIALIZATION

The array of challenges to the commercialization of microfinance in Sri Lanka implies specific roles for several key stakeholders including the Government, the donor community, the MFIs, and microfinance support institutions. Recommendations on the roles of these actors follow.

Roles of the Government

The main roles the Government should play in commercialization of microfinance are to create and maintain an enabling policy environment and an adequate legal, regulatory, and supervisory framework for microfinance. There is a need for the Government to undertake a private-public sector partnership to produce a cohesive national framework for microfinance development and rationalize its pervasive presence in the microfinance market. This entails phasing out several major direct government microfinance programs in favor of more indirect support of the microfinance sector. Direct financial sector interventions should be minimized to prevent market distortions and to allow private sector provision of microfinance services, using proven methodologies for sustainable microfinance delivery. The Government should also consider complementary, grant-based approaches, such as

social services and training, to reach certain sections of the microenterprise market (for example, the lowest rung of the working poor, as well as the “hard core” poor). Investments in physical infrastructure and provision of social services should be undertaken, especially in rural areas, to improve the business environment and to improve effective demand for microfinance. Specific recommendations follow.

Create and Maintain an Enabling Policy Environment

- **Ensure macroeconomic growth and stability.** Several measures should be undertaken to ensure positive economic growth that enables the provision of microfinance to expand in a sustainable manner. These include resolving the secessionist conflict, which continues to destabilize the population and dampens economic growth by necessitating high defense expenditures. Further, curtail ad hoc policy changes, including tax relief measures that cause significant decreases in national income or increased government expenditures related to the public sector wage increases and various smallholder debt relief packages. Such policies can worsen inflationary pressures and dampen economic growth.
- **Promote agriculture sector growth.** Tariff policies should be rationalized and ad hoc changes in them minimized. Poorly targeted agriculture subsidies would be better directed to improvements in agriculture inputs, processing, and marketing facilities. Given that agriculture production supports more than one third of the labor force, these and other measures aimed at increasing agriculture productivity might go a long way toward providing a large, economically-viable client base for MFIs seeking to commercialize their operations.
- **Strengthen the financial sector.** Further efforts to restructure the two state-owned commercial banks are needed to improve their performance. This should be undertaken with a view toward

eventual privatization. Many of the government-sponsored agricultural credit programs currently being implemented by the banks undermine their ability to achieve sustainable outreach, especially in terms of their microfinance portfolios. Consideration should be given to allowing the banks more autonomy coupled with accountability, similar to the situation with RDBs. The reported profitability of the RDBs (with an estimated 80% of their portfolio considered as microfinance) may be a testament to the potential for sustainable microfinance outreach that such changes may bring. However, it is uncertain how profitable RDBs would be after appropriately adjusting for loan loss provisions, write-offs and subsidies.

Minimize Direct Interventions

- **Stop ad hoc debt relief.** Many private MFI practitioners cited recurrent debt forgiveness as the chief impediment to their achieving and sustaining high repayment rates.
- **Phase out government programs.** By the end of 2000, some 940 Samurdhi Banks had been established, an increase of 75 over 1999. This significant growth and presence require a rethinking of their management and operations. Presently, the banks have boards made up primarily of clients, but the staff (about 20,000 total) are from the Samurdhi Authority and, as such, wield great power within the organization. The microcredit and savings are funded entirely by the clients and not by the Government/ Authority or by funding agencies. There is a need to consolidate the gains in outreach achieved under the program, by moving the SBS from public to private local ownership. In addition, because the Samurdhi Program has been so successful at reaching the bottom end of the market, other government interventions, such as the directed CBSL projects and the state-owned commercial banks, are not needed in the microfinance sector.

- **Curtail the implementation of microfinance programs by the Central Bank's Rural Credit Department.** The implementation of at least a dozen rural credit projects is currently being supervised by the CBSL's Rural Credit Department (and at least two are directly implemented by them). Many of these projects have targeted, subsidized microcredit components. The project features of targeting certain segments of society, subsidizing onlending interest rates, and weak repayment enforcement should be phased out as soon as possible; they conflict with efforts to encourage private sector MFI sustainability.
- **Reduce government ownership and control of the RDBs.** Although the RDBs were given greater autonomy in 1998, the main shareholder remains the CBSL and shares are also held by other government agencies. To minimize adverse political interference in the RDBs and strengthen the market orientation of these banks, the CBSL and the other government shareholders should progressively reduce their ownership control. Promotion of private investment in the banks through privatization should be seriously considered in the near future. The RDBs appear ripe for privatization, because each of them has reported profits in serving their respective rural financial markets over the last couple of years.

Strengthen the Legal Framework

- **Resolve legal ambiguity regarding savings mobilization by microfinance NGOs.** Savings mobilization by microfinance NGOs without legal authority is placing clients' savings at risk, which in turn places the microfinance industry's reputation at risk. The Government should require and enforce all microfinance NGOs to deposit savings into a formal financial institution and not onlend them to microfinance clients, or require that all such deposits be covered under the national deposit insurance program.
- **Create a new legal structure for microfinance institutions.** Consideration should be given to developing a new tier of financial regulation for financial intermediaries specializing in microfinance operations, including voluntary deposit mobilization from the general public. Such regulation and supervision should be tailored to the specialized microfinance operations and reinforce sustainable growth, drawing from recent positive international experiences in Africa (such as in Uganda) and Latin America (such as in Bolivia). Initial applicants might include a few of the best performing CRBs, TCCSs, and microfinance NGOs. Introduction of such a tier could improve accountability and transparency of MFI operations. The ability of these institutions to mobilize deposits legally and to obtain deposit insurance is crucial to enhance their financial self-sufficiency and the commercialization of the microfinance industry. Strengthening the CBSL to be able to undertake regulation and supervision of the few MFIs that may be suited to such a transformation would be a necessary prerequisite.

Improve Banking Regulation and Supervision

- **Increase the capacity of the Central Bank of Sri Lanka.** The types of institutions regulated by the CBSL should be expanded in accordance with the growth in recent years of several types of nonbank financial institutions, especially those that mobilize savings. Since many of these institutions engage in significant microfinance operations, regulation is of particular concern in light of the need to protect poor savers. The CBSL has a supervision force of only about 75 persons and they appear to be fully occupied supervising the entities currently subject to its regulation. CBSL personnel should be shifted from direct implementation of microcredit projects to supporting the development of market-friendly and effective microfinance regulation and supervision.

- **Adopt appropriate regulation and supervision for microfinance.** To protect deposits, savings-mobilizing MFIs should be subject to some form of prudential regulation and supervision. Given that the CBSL does not currently have the capacity to regulate and supervise all MFIs, alternative forms of oversight should be considered. Regardless of structure, the regulatory framework should ensure that deposit-mobilizing MFIs have strong governance structures, with qualified, active board members, effective internal control and risk management systems, and thorough auditing by an independent third party at least once per year. In addition, the regulatory framework should adopt strict risk classification criteria, requiring higher levels of loan provisioning and quicker write-offs than are required of traditional financial institutions. Minimum standards for performance should be set and key indicators monitored, such as for capital adequacy, asset quality, and liquidity.

Roles of Funding Agencies

- **Support an enabling policy, legal, and regulatory environment.** Funding agencies should work with the Government to ensure an enabling environment for microfinance conducive to MFI progress toward commercialization. This includes advising on macroeconomic and sectoral policies, as well as the legal, regulatory, and supervisory framework. It also entails encouraging the Government to stop granting broad debt relief and supporting refinancing loan programs with subsidized interest rates.
 - **Build MFI institutional capacity.** Funding agencies should help to build institutional capacity by providing exposure to and training in microfinance best practices, along with performance-based support for capacity building. This will help MFIs expand their outreach and develop cost-effective sustainable operations (through the use of so-called “smart subsidies”).
- In other words, funding agencies should use technical assistance more than direct subsidies to MFIs to ensure a level playing field for interest rate setting and avoid creating distortions in the market. If onlending funds are provided, they should be coupled with time-bound, quantitative performance indicators, the achievement of which determines the timing and amount of subsequent funding. An integral part of this second major role for the donor community is its assistance in the development of commonly accepted microfinance industry standards in organizing, operating, financing, and reporting.
- **Support innovation in enterprise development and microfinance.** Funding agencies should promote the development of innovative microfinance methodologies and products as well as complementary, grant-based social service programs. The responsibility for (pre-microcredit) social mobilization efforts and (post-microcredit) business development services or “credit plus” activities (such as business training, setting product standards, and marketing assistance) should be passed to purely socially-oriented NGOs. Microfinance NGOs reaching for sustainability will then be more able to concentrate on satisfying the financial needs of their clients. In addition, assistance from the donor community will be vital in developing and piloting new or adapted delivery methods and products that can be used to increase access to financial services by underserved groups.
 - **Promote formal-semiformal financial sector linkages.** The Hatton National Bank (HNB) currently partners with about 15 NGOs to find suitable clients, with NGOs providing the social mobilization and HNB lending directly to the clients. Donor efforts may assist in removing some of the obstacles between the microfinance NGOs and commercial banks so that more mutually beneficial business relationships can develop between them.

Roles of MFIs

- **Balance commercial and social objectives.** MFIs are vulnerable to social mission risk if they do not have a clearly defined target market and monitoring mechanisms to ensure that they are providing appropriate financial services to the intended clients. MFIs are exposed to commercial mission risk if they do not set interest rates (and fees) high enough to cover costs and if they are not managed as a business. MFIs have pursued their social missions but need to balance these with commercial objectives. To expand outreach commensurate with demand in a sustainable manner, it is imperative that the MFIs move toward financial self-sufficiency through a combination of strategic and business planning, adoption of cost-recovery interest rates, and increasing efficiency. The success of the most financially self-sufficient and largest microfinance NGO in Sri Lanka, SEEDS, demonstrates that only through achievements in financial self-sufficiency can outreach be expanded in a substantial and sustainable manner.
- **Become more responsive to clients.** To become more client-responsive, MFIs will need to learn how to collect and analyze data on client preferences and know when to make changes. MFIs should work with skilled and independent market researchers who can help clients identify and articulate their microfinance needs without swaying clients' responses to survey or focus group questions. As clients express their interests, new product ideas will undoubtedly emerge. Microfinance providers should also work to understand the reasons behind client desertion. Exit interviews and surveys can help an MFI to understand and avoid client desertion, by developing successful client recovery strategies.
- **Improve institutional capacity.** Given that institutional capacity in the vast majority of MFIs is extremely weak, improvements in several areas should take top priority. Missions should be

clarified to incorporate a sustainable view of microfinance provision. Efficiency in operations should be made an institutional priority. Weaknesses in ownership and governance should be acknowledged and minimized through the establishment of clear lines of responsibility, staff incentives that promote sustainable outreach, and adequate systems to monitor progress toward commercialization. Improving boards by including directors who have an understanding of business and finance is crucial. MFIs need to charge interest rates higher than those of commercial banks, yet lower than those of money lenders. Preparation and audit of standard income statements and balance sheets will increase the transparency of MFI operations and enable performance improvements, ultimately leading to access to commercial sources of capital. In addition to the above general suggestions, specific MFI recommendations are as follows:

- *Strengthen the ownership and governance of the CRBs.* The ownership and management of the CRBs need to be improved, possibly consolidating the banks at the national or provincial levels and partnering them with other financial institutions, such as the RDBs or a major commercial bank. This recommendation is likely to be viable only if the multipurpose cooperative society can see that it can have a greater profit potential from such a restructuring.
- *Strengthen the management and systems of the TCCSs.* Lack of central management is a key constraint in shifting either the CRBs or the TCCSs as a whole into sustainable operations. The TCCS movement should consider moving toward greater central management not only at the national level—with SANASA Development Bank serving as an apex body—but also at the district level. For this, a first step should be to strengthen the technical skills of the TCCS management at the national and district levels. The TCCS

accounting system and management information systems need to be streamlined so that they are compatible at the primary, district, and national levels. Greater computerization must accompany the process. The auditing process must also be reorganized.

- *Improve the transparency of microfinance NGOs' operations and accounts.* Microfinance NGOs should separate their nonfinancial activities from their financial services and work toward defining a generally accepted chart of accounts in coordination with the CBSL. Once the chart of accounts is accepted, MFIs should have their annual financial accounts independently audited. The process of developing financial and reporting standards can then gain momentum with a view to establishing reliable ratings, which are a prerequisite to access increasingly commercial sources of funds.

Roles of Support Institutions

- **Second-tier lenders (apex organizations).** The National Development Trust Fund (NDTF) is the main supplier of loan funds to microfinance NGOs, providing loans to 56 of them. Despite its efforts to have a capacity building focus, its main attention has been on loan recovery. Although the NDTF appears successful at refinancing funds, it is managed by traditional commercial bankers seconded from the People's Bank, who need greater exposure to best practices in microfinance. NDTF should be restructured to create a second-tier funding and capacity-building agency for MFIs.
- **Credit information bureaus.** Credit information coverage and quality should be increased to allow MFIs to use this valuable tool. Thought should be given to expanding coverage to loan amounts less than SLRs100,000 (\$1,111), including other information (such as client past delinquencies

and defaults, current outstanding balances with information on guarantees and collateral, and the credit histories of guarantors and co-signers) relevant to microfinance providers. Such information should be accessible to a greater range of semiformal financial institutions, such as the CRBs and TCCSs.

- **Microfinance Network.** The Sri Lanka Microfinance Network needs to focus more on the core subject than on “credit plus” work. The Network needs to be institutionalized and have its membership base expanded and categorized by such groups as practitioners and funding agencies. The Network should also require regular statistics from its members (based on a common accounting format) on their financial and nonfinancial programs. This could be a start to establishing standards and a rating system of MFIs based on widespread adoption of those standards. The Network should also organize a working group on appropriate legal and regulatory reforms, especially regarding MFIs mobilizing savings.
- **Microfinance training institutions.** Currently the capacity within Sri Lanka for training in microfinance is very limited. This is a major issue; there are very few institutions providing training or capacity building of microfinance. The main institutions are CBSL Centre for Banking Studies, International Center for Training of Rural Leaders, SEEDS Management Training Institute, Rural Development Training Institute, and SANASA Training Institute. Two of these five institutions were established by SEEDS and TCCSs, respectively, to train their own staff and they have little capacity to train other persons. Of the three government training institutions active in this field, the Rural Development Training Institute's main strength is social mobilization training. This leaves only the CBSL's Centre for Banking Studies and the International Center for Training of Rural Leaders as facilities that could offer microfinance capacity-building training. The latter is strong at training in

management and accounting for microfinance at the community-based organization level. But both have weak capacity to offer training on local and international microfinance best practices. Donor organizations need to develop the capacity and range of skills of one or two existing

training institutions if MFIs are to make any headway in microfinance commercialization. The training hubs of the Consultative Group to Assist the Poorest may be helpful in this regard until sufficient domestic training capacity is developed.

This report analyzes the progress toward commercialization of Sri Lanka’s relatively large and heterogeneous microfinance industry.¹ It also explores the remaining challenges and the implications, prospects, and positive approaches to the commercialization of microfinance.

METHODOLOGY AND ORGANIZATION

The study on which this report is based includes theoretical considerations from the “financial systems”² paradigm and practical field experience in analyzing the commercialization of microfinance. The main findings and recommendations presented here are the product of extensive consultation through individual and group meetings in Colombo with a wide variety of microfinance stakeholders including government ministries and microfinance programs, the Central Bank of Sri Lanka (CBSL),³ state-owned commercial banks, private commercial banks, licensed specialized banks, nonbank financial institutions, domestic and international nongovernment organizations (NGOs), donor organizations, community-based organizations, and microfinance institution (MFI)⁴ clients. In addition, the main findings and recommendations from several domestic and international studies with relevance to microfinance commercialization have informed this study, as noted throughout.

The study team also gathered data during field visits to Hambantota, Kandy, and Matara. It is important to note that all institutional and financial data are self-reported by the MFIs and were surveyed by the authors, unless otherwise noted. Readers should be mindful that these self-reported data are often based on estimates. This is because of the widespread practice by MFIs of not separating microfinance from other social programs (an issue with most small and

medium-sized microfinance NGOs) or from traditional financial institutions, such as public sector banks.

The remainder of this chapter elaborates on the framework for analyzing the commercialization of microfinance used throughout this study and establishes the country context as it affects the microfinance industry. The next chapter examines the historical development of MFIs and microfinance institutions in Sri Lanka and assesses the progress that its microfinance industry has made toward commercialization. Chapter 3 explores the challenges to microfinance commercialization such as negative stakeholder perceptions; policy, legal, and regulatory bottlenecks; internal MFI weaknesses; and the lack of key support institutions. Chapter 4 addresses implications of commercialization in terms of outreach, competition, and mission drift.⁵ Chapter 5 concludes the report with recommendations for positive approaches to the commercialization of microfinance by proposing roles for the government, funding agencies, MFIs, and microfinance support institutions.

UNDERSTANDING “COMMERCIALIZATION” OF MICROFINANCE

Several notions exist about the meaning of the term *commercialization of microfinance* and no consensus in the field has yet emerged. Microfinance professionals worldwide, however, are increasingly using the term to mean “the application of market-based principles to microfinance” or “the expansion of profit-driven microfinance operations.”⁶ Advocates believe that donor funds are limited and that only through commercialization can microfinance achieve maximum outreach; financial institutions operating on commercial principles tend to yield increased efficiencies, which can translate into

lower costs to low-income borrowers. This report adopts a comprehensive view of microfinance commercialization at two levels, proposing that it involves both institutional factors (MFI commercialization) and attributes of the environment within which the MFI operates (commercialization of the microfinance industry).

Microfinance Institution Commercialization

In this report, MFI commercialization is considered as progress along a continuum, which is depicted in the diagram below (Figure 1.1) and described as follows.

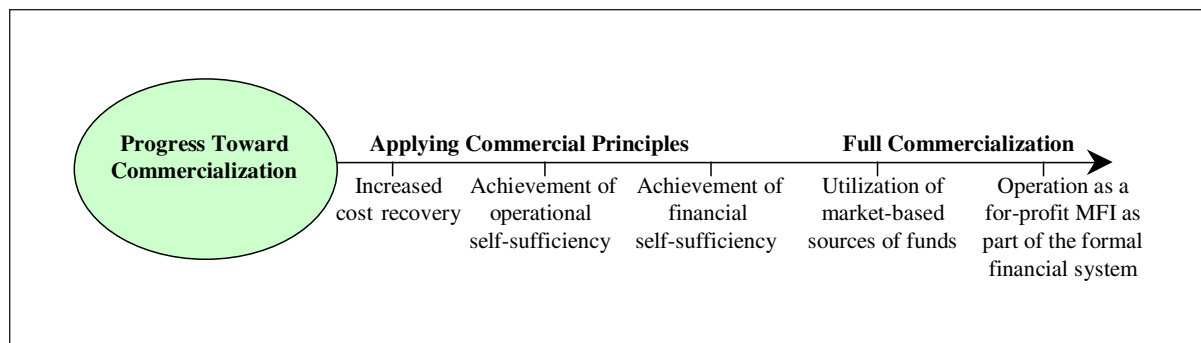
- Adoption of a for-profit orientation in administration and operation, such as developing diversified, demand-driven financial products and applying cost-recovery interest rates.
- Progression toward operational and financial self-sufficiency by increasing cost recovery and cost efficiency, as well as expanding outreach.
- Use of market-based sources of funds, for example, loans from commercial banks, mobilization of voluntary savings, or other nonsubsidized sources.
- Operation as a for-profit, formal⁷ financial institution that is subject to prudential

regulation and supervision and able to attract equity investment.

Commercialization of the microfinance industry is considered to be the increased provision of microfinance by MFIs sharing these characteristics. Progress toward MFI commercialization is usually hastened by a strategic decision of an MFI's owners/managers to adopt a for-profit orientation in administration accompanied by a business plan to operationalize the strategy to reach full financial self-sufficiency and to increasingly leverage its funds to achieve greater levels of outreach. The recognition that building a sound financial institution is vital to achieving substantial levels of outreach essentially means that MFIs need to charge cost-covering interest rates and continually strive for increasing operational efficiency.

Advocates of this approach rightly argue that charging cost-covering interest rates is feasible because most clients would have to pay, and indeed do pay, even higher interest rates to informal moneylenders. MFIs that charge cost-covering interest rates are an attractive option for this clientele even though the interest rates that an MFI might charge may seem high relative to the corresponding cost of borrowing from a commercial bank. The relevant basis for interest rate comparisons in the eyes of the client is the informal sector where she or he can usually access funds—not the commercial banking sector, which rarely serves this market.

Figure 1.1: The Microfinance Commercialization Continuum



As an MFI's interest and fee revenues cover first its operating costs and then the cost of its loanable funds, the MFI may be considered as increasingly operating on a commercial basis. MFI profitability enables expansion of operations out of retained earnings or access to market-based sources of funds.

Operating as a for-profit, formal financial institution may be the most complete hallmark of MFI commercialization, because it implies subjectivity to some form of prudential regulation and supervision and that the MFI is fully integrated into the formal financial system. An MFI's movement toward commercialization depends on internal factors, such as owner/manager willingness to adopt a for-profit orientation and ability to cover costs over time, and many external conditions discussed in the next section. MFIs strive for varying degrees of commercialization; not all aim to become formal financial institutions.

Commercialization of the Microfinance Industry

Commercialization of the microfinance industry involves several factors including the degree to which the policy environment is conducive to the proliferation of commercial MFIs, the extent to which the legal and regulatory framework supports the development and growth of commercial MFIs, the availability and access of commercial MFIs to market-based sources of funds, and the existence of key support institutions for the microfinance industry. The key environmental attributes that determine commercialization of the industry can be divided into five main categories:

1. Policy Environment

- Government policies that affect the ability of MFIs to make progress toward commercialization (examples of policies that may hamper MFI commercialization are interest rate caps and selective, ad hoc debt-forgiveness programs).

- Presence of subsidized government or donor-supported microcredit programs that may stifle the development and growth of commercial MFIs.

2. Legal Framework

- The legal environment for secured transactions—the creation (legal definition), perfection (registration), and repossession (enforcement) of claims—as well as for microenterprise formation and growth.⁸

3. Regulation and Supervision

- The regulatory and supervisory framework governing MFIs that mobilize voluntary savings from the public or financial institutions in the broader financial markets, and the institutional capacity of the regulating body to carry out its mandate effectively.

4. Money Markets and Capital Markets

- Availability and access of MFIs to commercial sources of capital (existence of second-tier lenders [including apex institutions], private investment funds, commercial bank loans to MFIs, etc.).

5. Support Institutions

- Existence of apex institutions, credit information collection and reporting services, ratings agencies, microfinance trade associations, and providers of microfinance training.

THE SRI LANKAN CONTEXT

Understanding the country context within which MFIs operate is essential for the analysis of issues that affect the demand for and supply of microfinance and that affect the general health of the microfinance industry and the ability of MFIs to commercialize. These contextual factors include the overall level of social development

and the availability of social services and infrastructure, which impact the ability of microfinance clients to engage in economic activities and how profitably microfinance can be provided. Policies that have impact on general macroeconomic growth and stability as well as on development of such sectors as agriculture and finance, are also important considerations. Furthermore, the legal and regulatory framework is a key area of analysis to determine the needs and opportunities for a more efficient microfinance industry and for MFIs to progress toward commercialization.

Socioeconomic Indicators

Sri Lanka's population as of end-2000 was 20.0 million,⁹ increasing by 1.7% annually. This increase was because of both natural increase and net migration in 2000. However, the average annual population growth is well below that of most countries in South Asia because of the demographic transition (aging population) and improvements in socioeconomic conditions that have taken place in recent years. Sri Lanka has achieved human development outcomes more consistent with those of high-income countries (See Annex 1 for more social indicators).

Sri Lanka began liberalizing its economy in the late 1970s, ahead of other developing countries. Despite escalation of the secessionist conflict in the 1990s, economic growth has been healthy because of generally good macroeconomic management and progress in trade liberalization, privatization, and financial sector reform. Sri Lanka is now South Asia's most open economy (with total trade accounting for more than 70% of gross domestic product [GDP]), and has a relatively well developed capital market infrastructure. Its per capita income (\$841 in 2000, equal to about \$2,500 on a purchasing power parity basis) remains the highest in South Asia, after the Maldives.¹⁰ The economy has grown at an average rate of just over 5% annually in real terms over the last decade and unemployment and inflation remain at or just above historical lows¹¹ (See Annex 2 for more economic indicators).

Compared to several of its Asian neighbors, however, it is clear that Sri Lanka's development has been well below its potential. For example, Sri Lanka had the same per capita income as the Republic of Korea, Malaysia, and Singapore in the 1960s. Thirty years later these three countries have average per capita incomes several times higher than that in Sri Lanka. The most obvious reason for this is the continued secessionist conflict (which began in the mid-1970s) that has taken a heavy social and economic toll on the country's performance. In addition, public institutions and governance have weakened gradually over the years while they have grown in terms of budget and employment. The public sector continues to dominate the financial sector and remains highly politicized. Per capita employment in Sri Lanka's public sector is the largest in Asia. Regulations regarding land transfers and exit policies in the labor market have exacerbated the situation by constraining efficiency in the private sector.¹² It is testimony to the private sector's strength that employment in the private sector has increased significantly during the last decade despite these constraints.

Economic growth in the country has also been skewed. Based on the Household Income and Expenditure Survey for 1995/96 of the Department of Census and Statistics, it is generally accepted that approximately 25% of the population face income or consumption poverty.¹³ Poverty is predominantly a rural phenomenon, with roughly 85% of the poor residing in rural areas.¹⁴ Farmers with few nonfarm sources of income, cultivating small plots of land, and casual workers account for a large share of the poor.¹⁵ Rural poverty is also reflected in inequitable access to economic infrastructure. Only about 40% of rural areas have access to electricity and piped water.¹⁶

Sri Lanka's economy recorded a real growth rate in GDP of 6% in 2000, significantly above the 4.3% growth in 1999 and the 10-year annual average growth rate of 5% (see Annex 2 for other macroeconomic data). CBSL liberalized its foreign exchange markets in 2001, allowing commercial banks to determine the exchange rate freely. Inflation was contained at 6.2% (as

measured by the Colombo Consumer's Price Index [CCPI]) but on a year-end basis it was 10.8%.

Despite Sri Lanka's healthy economic growth, significant fiscal slippage was recorded in 2000 that continued through 2001. In place of a surplus, the current account deficit was 6.4% of GDP and the overall fiscal deficit, excluding grants, rose to 9.9% of GDP (the highest since 1995 when the deficit was 10.1%). Four factors led to the increased fiscal deficit and domestic borrowing, especially in the latter half of 2000: rising international oil prices, increase in defense expenditures, unusually low rainfall that reduced hydropower generation and increased dependence on relatively costly thermal power generation, and delays in the privatization process because of depressed international market conditions.¹⁷

The combination of these factors may increase inflationary pressures further and dampen economic growth. Inflation, as measured by the CCPI at the end of September 2001, was about 15% higher than in the same month the previous year.¹⁸ A downturn in economic growth could negatively affect demand for microfinance at least in the near term. What impact this may have on microfinance supply and its progress toward commercialization depends mainly on how increased fiscal pressure affects government direct interventions in the microfinance market

and on how commercial banks respond to potentially weak demand from their traditional clients.

Agriculture Sector Development

The agriculture sector employs 36% of Sri Lanka's labor force and contributed 19.7% of the GDP in 2000.¹⁹ The sector comprises what could be a significant market for MFIs. Agricultural performance was mixed in 2000 and the overall growth rate of the agriculture sector decelerated from 4.5% in 1999 to 1.2% (provisional) in 2000, the lowest since 1996.

The main focus in agriculture has been on gradually removing state interventions with a view to improving efficiency and competitiveness. Restrictions on the sale and use of land, poorly targeted agriculture subsidies, and the availability of more attractive nonfarm labor opportunities have constrained growth. The Government owns roughly 80% of all land, two thirds of which is used by private farmers under various tenure arrangements (Table 1.1). Ownership is complicated by an outdated system of land titling, which can lead to lengthy legal disputes over land rights. Weak land tenure and registration hinder the use of land as a potentially valuable source of collateral for microcredit, especially from many formal MFIs that rely on traditional forms of collateral. Although CBSL

Table 1.1: Landownership in Sri Lanka, 1991

Land Area Type	Hectares ('000)	% of Total
Total land area	6,570	100.0
Private land	1,166	17.7
- Freehold	1,065	16.2
- Land grants	101	1.5
State land	5,404	82.3
- Alienated under various schemes	818-1,000	12.5-15.2
- Vested in land reform commissioner	406	6.2

Source: Gunetilleke 2001, p. 47.

does not insist on commercial bank loan collateral requirements, CBSL regulations take into account, for provisioning purposes, the types of collateral backing up loans.

Water losses because of poor management of Sri Lanka's irrigation systems have further hindered productive use of arable lands. In addition, inconsistent tariff policies in the agriculture sector and ad hoc changes in tariffs, implemented with a view to either protect farmers or consumers, have dampened agriculture productivity. Reviving this productivity is critical to improving the incomes of the poorest communities and to boosting broad-based economic growth.

Financial Sector Development

Sri Lanka began deregulating its financial sector in 1977. Now, the Government plays a smaller role in the commercial banking sector than it did 20 years ago. However, the banking system remains dominated by two state commercial banks, which account for 55% of the banking assets. There were 26 commercial banks in the country at the end of 2000, consisting of 2 state banks, 8 domestic private banks, and 16 foreign banks. Most commercial loans are provided for trading and are short term. In terms of recent growth in total outstanding credit, the housing and property development and industrial sectors grew by 20% each and absorbed 13% and 11%, respectively, of total credit outstanding at end-September 2000 (point-to-point growth) (Figure 1.2 shows the breakdown of commercial loan use). Interest rates edged up slightly in response to mid-year CBSL monetary tightening in 2000 (Table 1.2). This trend has reversed since early 2001, when CBSL began reducing its repurchase and reverse repurchase interest rates and lowering statutory reserve requirements for commercial banks.²⁰

CBSL is responsible for regulating and supervising commercial banks, licensed specialized banks, and licensed finance companies as set forth in the Monetary Law Act, the Banking Act, and their amendments.²¹ Commercial banks each require minimum initial

capital of SLRs500 million (\$5.6 million), the regional development banks (RDBs) were launched with initial capital of SLRs150 million (\$1.7 million) each, and savings and development banks each require SLRs100 million (\$1.1 million) initial capital.²² Standard international directives apply to regulated entities, covering such areas as loan classification, provisioning, and reporting requirements as well as auditing standards (the statutory reserve ratio was removed by CBSL on foreign currency deposits not placed abroad and lowered for rupee deposit liabilities from 11% to 10% effective 19 October 2001 as part of efforts to stimulate the economy).

While the regulatory and supervisory practices of CBSL have been strengthened in recent years with regard to the entities currently under its jurisdiction, it has not kept pace with the growth in financial intermediation by selected nonbank financial institutions, such as the cooperative rural banks (CRBs), the thrift and credit cooperative societies (TCCSs), the Samurdhi banking societies (SBSs), and other semiformal MFIs. Since many of these institutions engage in significant microfinance operations, regulation is of particular concern in light of the need to protect the interests of poor savers.

Since 1992, the Government has implemented significant regulatory, supervisory, and institutional reforms in the financial sector. Such improvements include improved disclosure requirements and loan recovery mechanisms. However, limits on foreign ownership in commercial banks and insurance companies were raised in 2000, to 60% and 90%, respectively, with a view to improving the capital base of domestic banks and encouraging modernization.

Financial sector facilities and services continued to improve in the increasingly competitive environment. With a recent expansion of bank branches, banking density improved in terms of the number of people served per commercial bank branch. The availability of modern services such as automated teller machines, credit cards, and telephone banking services expanded. All these encouraged

Figure 1.2: Commercial Bank Loans by Purpose and Maturity, as of September 2000

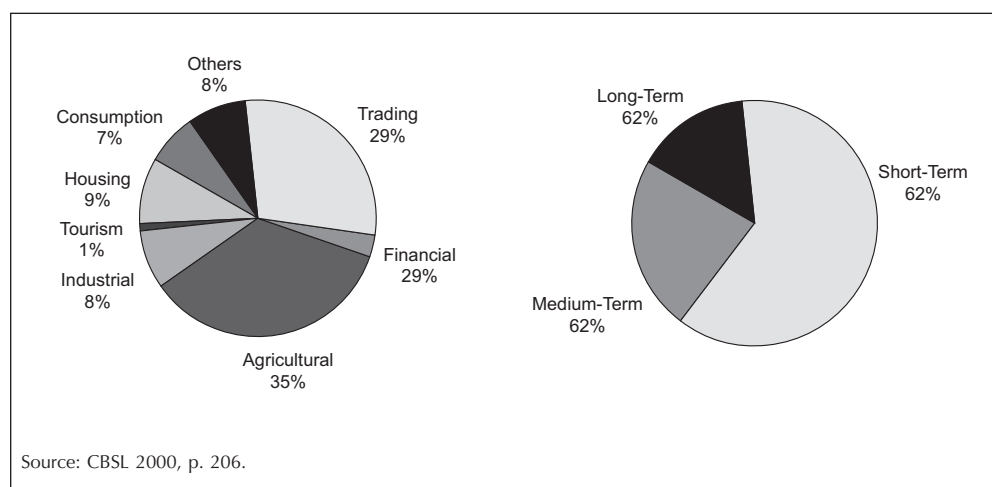


Table 1.2: Interest Rates (%)

	End-1999	End-2000
Commercial bank average weighted deposit rate	9.10	9.90
3-month Treasury bills	11.79	17.77
Commercial bank average weighted prime lending rate	15.90	21.46

Source: CBSL 2000, p. 28, 200.

financial intermediation and increased financial deepening in the economy, i.e., reaching lower-income clients. Further steps were taken to improve rural banking and credit facilities and expand private forward sales contract facilities for agricultural products, introduced in 1999. However, the extremely high interest rate spreads by commercial banks call for further improvements in efficiency and reforms in the financial sector.

As part of financial sector reform, action has been taken to restructure the Ministry of Finance and to modernize CBSL. In addition, the two state banks were restructured, including the introduction of a few expatriate senior managers.

The consensus built between employees and employers on the bank restructuring program was a positive step, but implementation may take more time than expected. The Government has signed performance agreements with the state banks, but effectiveness has been limited by challenges in directing credit in these institutions. These banks have twice been assisted by taxpayers to meet their deficits, which arose largely from directed lending. Further strengthening of the two state banks by increasing their capital bases is necessary to reduce intermediation costs and improve financial sector stability.

2 Progress Toward Microfinance Commercialization

Microfinance in Sri Lanka has existed since the establishment of the thrift and credit cooperatives in 1911 with the enactment of the Cooperative Credit Societies Ordinance. The sector grew most rapidly during the last 20 years when microfinance, as an instrument to reduce poverty, gained the attention and support of both the Government and funding agencies. Today the market is pluralistic and approaching saturation. Many different types of institutions are providing microfinance using a wide range of microfinance models and methods.

Organizations based on the cooperative model remain the dominant providers and the cooperative movement continues to influence how major microfinance NGOs deliver microfinance. As a result, savings mobilization has enabled substantial outreach. However, social mobilization programs and government interventions hinder the commercialization and sustainability of microfinance. This chapter discusses the historical development of the microfinance industry in Sri Lanka and evaluates its performance in terms of outreach and application of commercial principles.

DEVELOPMENT OF THE INDUSTRY

Importance of the Cooperative Movement

The credit cooperative movement is represented by two networks of cooperatives that serve low-income clients: the CRBs and the TCCSs, described below.

The cooperative rural banking movement was initially closely linked to the People's Bank. The CRBs were an important source of liquidity for the People's Bank, which was the state bank that acted as their handling institution for many

years.²³ This link ceased in late 1992 and the CRBs now operate under the Cooperative Development Department. The first CRB began in Kandy in 1964. By end of 2000, there were 1,476 CRBs operating throughout the country.

The CRBs, which are the banking arms of multipurpose cooperative societies (306 at present), continued their financial functions and other activities under the Cooperative Development Department. The main functions of CRBs are mobilization of savings; extension of credit to member borrowers for agriculture-related activities, fisheries, animal husbandry, trade and commerce; pawning activities; collection of utility bills; and payment of pensions to farmers.²⁴

The TCCSs are village-level cooperatives specializing in microfinance; they are not linked to the multipurpose cooperative societies. Although both TCCSs and CRBs are offshoots of the cooperative banking movement that began in 1911, the TCCSs (known collectively as SANASA—the Sinhala acronym for the TCCS movement), really began to expand only after 1980.

The CRBs and TCCSs are based on a federated three-tier cooperative structure: federation, district, and primary. This three-tier model has become the dominant model for microfinance in Sri Lanka, not only for cooperatives but also for some of the major microfinance NGOs, such as Sarvodaya Economic Enterprise Development Services (SEEDS) and Janashakthi.

Strong Social Orientation

Sri Lanka has had an overdose of social mobilization programs, including village group and society formation and later, small group

formation, especially since the 1980s. Apart from the activities of cooperative groups, NGOs, such as Lanka Mahila Samithi and Sarvodaya, began to form village organizations on a large scale in the 1960s. Next, the integrated rural development programs started forming village societies and groups. Large numbers of NGOs also began forming such groups. The more activist NGOs thought of groups as a medium to empower the people. Now virtually every village has such groups.

Since the 1980s, these groups have become popular tools for microcredit delivery and savings mobilization. However, there is a perception among the purists of the social movement that too much focus on microfinance commercialization would result in loss of social empowerment goals, such as raising awareness of human rights and fighting for peace and democracy. Little is yet understood about how both financial and nonfinancial services can be complementary. The benefits of separating the administrative and financial costs entailed in each have yet to be understood by many Sri Lankans.

Pervasive Presence of the Government

The microfinance sector has grown most rapidly during the last 20 years. During this period it gained the attention and support of both the Government and external funding agencies as an instrument to reduce poverty. The Bank of Ceylon, inaugurated in 1938, and the People's Bank, established in 1961, were set up to provide financial services to smaller borrowers and rural people. When it became apparent that the two banks were reaching only a small minority of the rural populace, regional rural development banks were established, beginning in 1985. These banks are now known as regional development banks (RDBs).

The Government's advent into the area of microfinance explicitly as a poverty reduction strategy is relatively recent. There have been two major initiatives. First, the National Development Trust Fund (NDTF—formerly known as the Janasaviya Trust Fund) was established in 1991 as an apex lending institution for MFIs to onlend

to the poor. NDTF was created in an attempt to move away from established forms of credit delivery, such as through the state-owned commercial banks. Second, in contrast, SBSs were started in 1995 by the Government to help people establish sustainable self-help groups to promote savings and disburse credit. Government microcredit or microfinance programs have entailed heavy subsidies and generated large losses because of high administration costs and, in the case of almost all agricultural microcredit projects, poor repayment.

EVIDENCE OF MICROCREDIT MARKET SATURATION

Microcredit market saturation is high. Based on household data and the current average outstanding microloan amount of SLRs17,339 (\$193), the maximum potential demand among low-income households and their micro-enterprises is estimated to be around SLRs22.9 billion²⁵ (\$254.9 million), equivalent to 2.3 million microloans. At the end of 2000, MFIs in Sri Lanka had approximately SLRs18.2 billion (\$202.3 million) outstanding in 1.65 million microloans. Current supply represents about 80% of the maximum potential demand for microcredit, in terms of overall amount and number of microloans, as calculated in Annex 4.

COMMERCIALIZATION OF MICROFINANCE PROVIDERS

Despite its broad outreach and level of market saturation, the microfinance industry is at a fairly early stage of commercialization. Cooperatives have made the most progress toward commercialization, although the performance of individual institutions within each of these categories has been highly mixed. The most commercial providers, in terms of achievements in financial self-sufficiency and access to commercial sources of funds, such as savings, are together estimated to provide only about one

third of the microfinance services. The noncommercial providers of microfinance include numerous unsustainable government microfinance programs, several hundred poorly performing CRBs and TCCSs, and around 200 weak, small, and medium-sized microfinance NGOs.

The current landscape of microfinance is cluttered with a vast array of government interventions and donor-funded projects that impede commercialization, while private sector initiatives and grassroots organizations provide microfinance as a way of encouraging poor rural households to commercialize agriculture, start small businesses, and create savings groups (Table 2.1 summarizes each of the major microfinance suppliers). MFIs in Sri Lanka have played a valuable role in broadening access to development financing to the poor and landless while contributing to village savings and group formation, particularly among poor, rural women.²⁶ However, most MFIs continue to be plagued by high costs as well as weak administrative and financial controls. Many of these shortcomings can be attributed to weak governance and widespread incorporation of social mobilization (group formation and meetings, in large part to prepare clients for microfinance services) as well as “credit plus” services (business training, etc., mainly to ensure microcredit repayment).

Cooperatives Dominate the Market, but Many Are Unsustainable

The 1,476 CRBs and more than 8,400 registered primary societies of the TCCSs together account for nearly half the market in terms of the number of active borrowers. Among the more commercialized microfinance providers, about 80% of the CRBs are estimated by the Cooperative Development Department to profitably supply about one third of the country’s total microcredit, funded entirely from deposits. In addition, a substantial proportion of the primary societies of the TCCSs (which collectively supply about 15% of the total outstanding microloans) provide microfinance on

a profitable basis. The bulk of their loan capital comes from savings.

While many of the larger and more established cooperatives have achieved profitability, most remain small and financially fragile. Because of the lack of standard accounting and reporting practices among CRBs, it is not known how many would be profitable after appropriately adjusting for loan loss provisions, write-offs, and subsidies. This is particularly true for the TCCSs, far fewer of which are believed to have commercially-viable operations.

Each CRB covers many villages as well as urban areas. The SLRs2.3 billion (\$26 million) in loans disbursed in 2000²⁷ is the highest volume of loans issued by any microfinance organization in the country. Total outstanding loans amounted to SLRs4.9 billion (\$55 million) by the end of 2000 (self-reported data). Average loan size was about SLRs8,500 (\$95). Loan funds are provided entirely from deposits. Savings deposits alone in the CRBs grew by 14% or SLRs1.3 billion (\$14.8 million) in 2000 from SLRs9.546 billion (\$106.1 million) to SLRs10.876 billion (\$120.8 million). The Cooperative Development Department reports that 1,174 of the 1,476 banks (79.5%) are profitable. The CRBs have never received grants or foreign aid; they are fully financially self-sufficient.

Nonetheless, the CRBs continue to suffer from a lack of adequately trained staff and effective credit disbursement, follow-up, and supervision.²⁸ The biggest constraint for CRBs as more effective microfinance providers is the fact that they are under the ownership and management of the multipurpose cooperative societies, many of which are loss-making entities.²⁹ These losses often absorb the profits of the CRBs.

The 8,400 registered TCCSs, with an estimated total membership of 905,106, are not all active and not all report or seek loans from SANASA Development Bank, the TCCS network. SANASA has village-level and district level societies and a national federation. However, at each level, societies are autonomous.

The SANASA federation accesses loan funds and other assistance from funding agencies and

Table 2.1: Supply of Microcredit as of end-2000^a

Large NGOs	No. of Active Microloans	Proportion of Total Microloans (%)	Outstanding Microloans (SLRs million)	Average Outstanding Microloan (SLRs)	Outstanding Microloans (\$ million)	Average Outstanding Microloan (\$)
Cooperatives						
CRBs	577,622	35.0	4,950	8,570	55.0	95
TCCSs	252,682	15.3	2,845	11,258	31.6	125
<i>Coops Subtotal</i>	<i>830,304</i>	<i>50.3</i>	<i>7,795</i>	<i>9,914</i>	<i>86.6</i>	<i>110</i>
Government						
SBSs	326,236	19.8	2,070	6,345	23.0	71
Bank of Ceylon	100,241	6.0	1,831	18,266	20.3	203
People's Bank	194,200	11.8	1,940	10,000	21.6	111
<i>Gov't. Subtotal</i>	<i>620,677</i>	<i>37.6</i>	<i>5,841</i>	<i>11,537</i>	<i>64.9</i>	<i>128</i>
Quasi-government						
RDBs	80,860	4.9	3,234	40,000	35.9	444
<i>Gov't. and Quasi-Gov't. Subtotal</i>	<i>701,537</i>	<i>42.5</i>	<i>9,075</i>	<i>18,653</i>	<i>100.8</i>	<i>207</i>
NGOs						
SEEDS	81,464	4.9	651	7,988	7.2	89
Janashakthi	17,654	1.1	86	4,854	1.0	54
<i>NGO Subtotal</i>	<i>99,118</i>	<i>6.0</i>	<i>737</i>	<i>6,421</i>	<i>8.2</i>	<i>71</i>
Private Sector						
Hatton Nat'l. Bank	9,237	0.6	379	41,031	4.2	456
SANASA Dev. Bank	6,270	0.4	128	20,415	1.4	227
Seylan Bank	4,500	0.3	99	22,000	1.1	244
<i>Private Subtotal</i>	<i>20,007</i>	<i>1.3</i>	<i>606</i>	<i>27,815</i>	<i>6.7</i>	<i>309</i>
Total	1,650,966	100.0	18,213	17,339	202.3	193

CRBs = cooperative rural banks; NGOs = nongovernment organizations; RDBs = regional development banks; SBSs = Samurdhi Banking Societies; SEEDS = Sarvodaya Economic Enterprise Development Services; TCCSs = thrift and credit cooperative societies.

^a Includes all microfinance providers with at least 4,500 active borrowers.

Sources: CBSL 2000, p. 215, and the following:

- 1) CRB data are based on 80% of their outstanding loan balance at end-2000 and the total number of outstanding loans provided, based on interviews with CRB and CBSL staff.
- 2) TCCS data are based on self-reported estimates by the Federation of TCCSs for number and outstanding microcredit as of 30 June 2001.
- 3) SBS, Hatton National Bank, Seylan Bank, and SANASA Development Bank data are based on self-reported estimates for number and outstanding microcredit as of 30 June 2001.
- 4) Bank of Ceylon and People's Bank figures are estimated number of active loans (SLRs5,000–100,000) and microcredit outstanding as of 30 June 2001, based on institutional interviews.
- 5) RDB data are based on 80% of their disbursed loans in 2000 being microcredit, with average loan size of SLRs40,000, based on interviews with RDB and CBSL staff.
- 6) SEEDS data are based on self-reported estimates for number and outstanding microcredit as of 30 June 2001.
- 7) Janashakthi (Women's Development Foundation) data are based on total 2000 disbursement figures and self-reported average microcredit loan size of SLRs4,854 as of 31 July 2001.

other agencies, such as the NDTF, but most cooperative loans are made from savings. Loans to clients provided by the federation at the district level range from SLRs5,000 to SLRs100,000 (\$56–1,111). In total, 252,682 loans with a total value of more than SLRs2.8 million (\$31,000) were outstanding as of the end of 2000; the average loan balance was SLRs11,258 (\$125). Women accounted for 55% of the loans. The outstanding loan portfolio does not include the large number of loans issued by individual societies from their own savings.

The SANASA federation is simply a loose network of TCCSs. It has no central management and does not act as a regulator or supervisor, or even as an effective coordinator of the TCCSs' activities. Without a central management system, the TCCSs suffer from poor accounting. Their management information systems lack standardization, transparency, and accountability, and are often incompatible across the primary, district, and national levels. These factors, combined with poor management in some of the TCCSs, keep them from achieving their full potential in terms of outreach, efficiency, and financial viability.

While not a cooperative, the SANASA Development Bank (SDB) plays a significant role in the commercialization of the cooperatives by acting as an apex institution for the SANASA TCCS network. Established in August 1997 as a savings and development bank with capital of SLRs121 million, SDB's role is "to mobilize deposits at competitive rates of interest and invest such deposits in community-based lending programs with particular focus on SANASA societies, their members and microenterprises."³⁰

Of the savings and development banks, only SDB has what can be characterized as a substantial focus on microfinance.

As a second-tier lender for primary (village)-level and district-level societies of the movement, SDB is taking over some of the lending to TCCSs from the SANASA federation. As of 30 June 2001, SDB had 6,270 outstanding microloans with a value of SLRs127.5 million (\$1.4 million), and average loan size of SLRs20,415 (\$227) (Table 2.2). SDB charges commercial interest rates of 13–16% on a declining balance basis for loans, and pays 9.5% on its savings deposits, which leaves more than enough spread to cover its operational costs. No repayment rate information was available. While SDB mainly lends to the district and primary societies, it also lends to microfinance NGOs, community-based organizations, self-help groups, and individuals who are not society members.

Government Programs Hinder Commercialization

Around one third of all outstanding microloans is supplied through the large government microfinance program that promotes the SBSs and numerous directed credit programs implemented by the CBSL's Rural Credit Department through the two state-owned commercial banks and several private sector banks. Most of these government programs are narrowly targeted, feature subsidized interest rates, have weak repayment enforcement, and entail large recurrent costs; thus, they are generally believed to be unsustainable. The microcredit supplied through the bulk of these

Table 2.2: SANASA Development Bank Microfinance Performance Highlights

Microloan Portfolio	30 June 1999	30 June 2000	30 June 2001
Number of active microcredit clients	3,851	4,877	6,270
Total microloans outstanding (SLRs million)	52.9	85.7	127.5
Average microloan per client (SLRs)	13,737	17,572	20,415

Source: Self-reported data provided in response to the country study questionnaire.

government-sponsored programs is akin to disguised grants, which provide disincentives for the private sector to develop microfinance operations on a commercial basis.

Government programs in microfinance cover a wide variety of direct interventions and indirect support mechanisms. These include some microfinance services provided through the two state-owned commercial banks and implementation of several donor-funded and government-sponsored rural credit programs (most of which are geared toward poor rural households), with the CBSL's Rural Credit Department and the SBSs as the executing agencies. Most of the Government's microcredit programs feature subsidized interest rates that have contributed to poor repayment and undermined the ability of the Government to be a cost-effective provider of microfinance. Some of them are described below.

State-owned Commercial Banks

Publicly-owned commercial banks are used by the State as tools for implementing government policy on agriculture and poverty alleviation with subsidized loans, refinancing, and periodic debt forgiveness. At the same time, the banks are also expected to make profits. This contradiction has resulted in the banks not viewing microfinance as a profitable product. In fact, the two state commercial banks have been advised by CBSL to scale back their micro and small-scale lending and to expand their portfolio of larger loans at least in the short term in order to become more financially self-sufficient.³¹ However, these banks continue limited microfinance operations, mainly because of the continuation of government rural credit programs that contain microfinance components.

The Bank of Ceylon started providing microcredit in 1973. At the same time, rural savings mobilization was also encouraged. Both activities were initiated in accordance with government directives rather than by an internal decision to explore the microfinance market for its profit potential. As of 30 June 2001, the Bank of Ceylon estimated that the outstanding loans

in the range SLRs5,000–50,000 (\$56–556) each (its definition of microcredit) numbered 100,241, with a total value of SLRs1,831 million (\$20.3 million), an average loan of SLRs18,266 (\$203). The Bank is apparently shifting away from microfinance lending. The number and amount of microfinance loans outstanding steadily declined from 1999 to 2001, while average loan sizes increased (Table 2.3).

The Bank of Ceylon estimates an average recovery rate (on a cumulative, not on-time basis) of only 70% on all loans below SLRs50,000 (\$556). By the end of 2000, the Bank had written-off microcredit amounting to SLRs271 million (\$3 million), about 27% of its total microcredit portfolio at that date. The Bank estimates that as of 31 August 2001, the net loss on microfinance activities was SLRs43.7 million (\$485,556). The Bank further estimates that it had an operational self-sufficiency ratio of 70% for its microfinance at that date, based on total revenues divided by total expenses. In other words, its microfinance operations do not generate enough revenue to cover its costs.

The People's Bank started providing microcredit and mobilizing rural savings from its inception in 1961. Like the Bank of Ceylon, it was dictated by government directives. The People's Bank estimated that as of 30 June 2001, the outstanding loans provided in the range SLRs10,00–100,000 (\$111–1,111) each (its definition of microcredit), numbered 194,200, an average microcredit loan of about SLRs10,000 (Table 2.4). The interest rate charged on loans was cited to be 10–14% per annum, on a monthly declining balance, depending on the microcredit product. No information on repayment rates or microfinance program costs was available. However, the People's Bank is increasing loan sizes and added fewer new microfinance clients in 2000/2001 than in 1999/2000 (Table 2.4), showing that it too is moving away from microfinance lending.

The key microfinance programs implemented by the two state banks during 2000 were the New Comprehensive Rural Credit Scheme and the Surathura Diriya Credit Program. Both included heavy subsidies. Evidence of the shortcomings

Table 2.3: Bank of Ceylon Microfinance Performance Highlights

Microloan Portfolio Information	30 June 1999	30 June 2000	30 June 2001
Number of active microcredit clients	330,000	176,155	100,241
Cumulative number of microcredit clients	902,000	931,540	941,077
Total microloans outstanding (SLRs million)	3,020	2,241	1,831
Average microloan per client (SLRs)	9,152	12,722	18,266

Source: Self-reported data provided in response to the country study questionnaire.

Table 2.4: People's Bank Microfinance Performance Highlights

Microloan Portfolio Information	30 June 1999	30 June 2000	30 June 2001
Number of active microcredit clients			194,200
Cumulative number of microcredit clients	553,400	610,200	642,300
Average microloan per client (SLRs)	7,800	8,500	10,000

Source: Self-reported data provided in response to the country study questionnaire.

of government subsidies emerges when some of the larger targeted credit programs, such as these, are evaluated. Despite refinance facilities, on-time recovery rates of these two largest programs implemented by the Bank of Ceylon were 76% and 67%, respectively. The on-time recovery rate of the Bank of Ceylon's Small Enterprise Development Program, which used the Bank's own funds, was slightly higher at 81%.

The Central Bank of Sri Lanka's Rural Credit Department

CBSL's Rural Credit Department has several functions: supervision of about 10 donor-funded and government-sponsored rural credit programs, implementation of the CBSL credit guarantee program, liaising with foreign lending agencies and government agencies on behalf of CBSL, coordination of the bank-financed cultivation scheme, implementation of interest subsidy programs, developing linkages with participating financial institutions and

microfinance NGOs in credit disbursement activities, and conducting credit awareness programs. The various projects, including microfinance projects, being implemented or supervised by the Rural Credit Department are listed in Box 2.1. More detailed information on some of these programs and their terms and conditions is given in Annex 3.

CBSL's rural credit programs often overlap with microfinance and hinder the commercialization of the industry by offering subsidized interest rates of 3–6% to participating financial institutions. The latter lend at subsidized rates to rural microfinance clients who might otherwise take out loans at cost-recovery or market interest rates from private MFIs. Given that CBSL is responsible for overseeing the regulation and supervision of financial institutions, its Rural Credit Department programs distract it from its main purpose, utilize its scarce resources (human and financial), and cause conflict of interest by competing with some of the very institutions it is overseeing.

Box 2.1

**CBSL Rural Credit Department
Projects, as of July 2000^a**

Donor-funded Projects

- ❖ Asian Development Bank
 - Second Perennial Crops Development Project*
 - Tea Development Project*
 - Southern Province Rural Development Project*
 - NW Province/Water Resources Development Project*
 - North Central Province/Rural Development Project*
- ❖ International Fund for Agricultural Development
 - Small Farmers and the Landless Credit Project*
 - North Central Province/Participatory Rural Development Project*
 - Matale-Regional Economic Advancement Program*
- ❖ Overseas Economic Cooperation Fund
 - Japanese U-ko Microfinance Project
- ❖ United States Agency for International Development
 - Urban Environmental Infrastructure Development Project

Government-sponsored Projects

- New Comprehensive Rural Credit Scheme*
- Self-employment Promotion through Microenterprise Project*
- Kegalle District Integrated Development (Revolving Fund) Project*
- Food and Nutrition Promotion Credit Scheme*

CBSL-sponsored Projects

- Inland Bill Scheme
- Forward Market Contract System for Agricultural Produce

Credit Guarantee Scheme

- New Comprehensive Rural Credit Scheme
- Tea Development Project/Second Perennial Crops Development Loans

^a Projects with microfinance components are denoted by an asterisk.
Source: CBSL 2000.

Samurdhi Program

The Samurdhi Program, the Government's main poverty reduction program, has two main microfinance components. The first, comprised of the Samurdhi Development Credit Scheme (SASANA), the Samurdhi Enterprise Credit Scheme (SAVANA), and the Samurdhi Leasing Scheme, is a conventional government lending program operated by state-owned banks. This program suffers from the usual weaknesses of subsidized interest and very high default rates. At the end of 2000, on-time loan recovery rates for SASANA, SAVANA, and Samurdhi Leasing were 79%, 70%, and 51%, respectively (Table 2.5). A key factor behind the high default rates has been the high degree of political influence in the credit decision-making process.

In contrast, the Samurdhi Banking Society (SBS) program, begun in March 1997, has achieved tremendous growth in terms of both savings mobilization and microcredit disbursement, and with better repayment rates. At the end of 2000, there were 940 SBSs under the Samurdhi Act, an increase of 75 societies during the year.³² Membership in the SBS program is limited to those who are recipients of Samurdhi program welfare benefits from the Government. However, with more than 2 million families as current recipients from the program, the captive market is quite large—families that qualify for benefits from the Samurdhi program based on income criteria represent about 50% of all Sri Lankan households—indicating an absence of effective targeting and exit systems.³³

Membership in the SBSs grew by 21.5% in 2000 to a total of 1.57 million people (an increase of 22% from the previous year); 65% of the shareholders were women. The value of paid-up capital of SBSs amounted to SLRs983 million (\$10.9 million) while member and nonmember savings (including compulsory savings of Samurdhi clients) amounted to SLRs3.011 billion (\$33.3 million), of which 61% was invested and the balance loaned to members (maximum loan is SLRs50,000 [\$556]).

Outstanding loans as of 30 June 2001 totaled SLRs2,070 million (\$23.0 million) with 326,236

Table 2.5: Samurdhi Credit Programs, Cumulative to the End of 2000

Program	No. of Loans Disbursed	Amount of Loans Disbursed (SLRs, million)	On-Time Recovery Rate
Building Societies	480,643	2,783	107
Development Credit Scheme (SASANA)	84,160	513	79
Enterprise Development Scheme (SAVANA)	13,112	321	70
Leasing	721	167	51
Associated Samurdhi Animators Credit Programs	180,572	159	99
PANA	175	52	99
SABADA	71	9	92
Total	759,454	4,004	

Source: CBSL 2000, p. 220.

active loans. The on-time loan recovery rate was an impressive 104%, as members in some districts paid in advance of their repayment schedules (due in part to the use of future welfare payments as quasi-collateral).³⁴ Nearly all the loans are issued for self-employment and cultivation, as reported by the borrowers. Most SBS loans charge 3% interest per month on a declining balance, on 3-month to 2-year terms, and pay 9% annual interest on member deposits, which should be enough spread to more than cover all operating costs.³⁵ However, while the recovery rate for the SBSs as a whole is good, recovery rates are uneven among the SBSs and had sunk below 50% in distressed regions, such as Ampara, at the end of 1999.³⁶ The system also has in place one credit guarantee scheme and two insurance schemes to secure its operations.

In areas where SBSs have been established and the poor have managed to purchase their shares, the system is an important source of emergency credit for small loans (about SLRs300 [\$3.34]).³⁷ Around one third of shareholders stated that the SBS would be their principal source of emergency credit, while 40% said they still relied on friends and relatives. SBSs are also useful sources of credit for larger loans (SLRs1,000–3,000 [\$11–33]) that are not required immediately. One third of SBS members regard them as the principal source for such loans,

whereas only 20% continue to depend on friends and relatives. But shopkeepers and moneylenders retained a large share of this market: approximately 40% of SBS members regarded them as their principle source of credit.³⁸ Despite the success of the SBSs in terms of outreach, their expansion continues to discourage commercial entrants in microfinance, as do other government programs.

Regional Development Banks: Quasi-Governmental MFIs

The RDBs began in 1986, based on a 1985 Act, mainly to expand the rural outreach that the two state-owned commercial banks were unable to accomplish. In other words, the RDBs were created to function as one of the primary disbursement windows for numerous government microcredit programs. The Government gave these banks greater autonomy in 1998, but maintained ownership. The main shareholder remains CBSL. Other major shareholders include the Bank of Ceylon, the People's Bank, and the National Savings Bank. As a result of this ownership structure, the RDBs are in a category of their own as quasi-government microfinance providers.

CBSL notes that the RDBs are profitable, with approximately 80% of their loan portfolio made

up of microcredit loans under SLRs100,000 or \$1,111 (Table 2.6). It is not clear, however, whether these profits are adjusted for the direct and indirect subsidies that the RDBs receive. Total disbursement of microcredit by the RDBs in 2000 was estimated to be SLRs4,043 million (\$44.9 million). Self-reported data indicated that total loans outstanding as of the end of 2000 were SLRs5,244 million (\$58.3 million). The total loan portfolio of the RDBs grew by SLRs697 million (\$7.7 million), an increase of 21% in 2000. Savings grew by a massive SLRs1,427 million (\$15.9 million) to SLRs3,937 (\$43.7 million), a growth rate of 40% in one year.

Table 2.6: Reported Annual Profits of RDBs for 2001

RDB	Profit (SLRs million)
Ruhunu	73.6
Wayamba	35.5
Rajarata	18.7
Sabaragamuwa	14.2
Kandurata	13.2
Uva	2.2

Source: CBSL Research Division.

Plethora of Small, Weak Microfinance NGOs

A few microfinance NGOs are attempting to commercialize their operations but most remain unsustainable. The largest NGO, SEEDS, provides 10% of the total number of microloans, and has been progressing steadily toward financial self-sufficiency while providing microloans of only SLRs8,000 (\$89) on average. Self-reported data suggest that several other leading microfinance NGOs, such as Janashakthi, may also be approaching financial self-sufficiency, although a substantial portion of the latter's income is from interest earned on fixed deposits.

The vast majority of smaller and less-established microfinance NGOs, which number around 200, are not operating on a very sound basis.³⁹ Fewer than five are said to have profitable

microfinance operations, although lack of transparency and standardized financial reporting impede a detailed assessment of their financial soundness.

Only four NGOs with an organizational budget of more than SLRs20 million (\$222,222) consider microfinance as their core activity. They are SEEDS, Janashakthi, Social Mobilization Foundation (SMF), and Arthachariya Foundation.

Even these four agencies, especially SEEDS and the SMF, conduct a considerable amount of "credit plus" activities. SEEDS and Janashakthi have been the most focused on their own sustainability, and as a result have captured almost one quarter of the microcredit market (see Table 2.1). World Vision, an international NGO, and Agromart, a local NGO, are at the initial stages of moving toward commercialization. However, these institutions have very small revolving funds.

SEEDS originated in the 1950s' Sarvodaya movement of Sri Lanka, which empowered poor communities through a philosophy of sharing and mutual support. By the mid-1980s there was a feeling that the Sarvodaya societies should play a more active role in the economic lives of their members, and this led to the birth of SEEDS in 1987. SEEDS was the first centrally-managed, specialized microfinance NGO in Sri Lanka. Today, it is by far the largest NGO-managed microfinance program. Registered under the Companies Act as a private, nonprofit limited company, SEEDS plans to transform itself into a formal bank by 2003.

SEEDS provides loans in the range SLRs10,000–50,000 (\$111–556) with a very few loans of amounts close to SLRs500,000 (\$5,556). As of the end of 2000, SEEDS had 81,464 active loan clients and an outstanding loan portfolio of SLRs650.8 million (\$7.2 million). SEEDS' performance must be seen in the light of its massive "credit plus" operations, through which 55,698 people have received training in social mobilization, credit management, leadership management, accounting, entrepreneurship, and a range of technical subjects. If SEEDS were to separate its financial service activities from its

nonfinancial service activities, it would likely be able to report full financial self-sufficiency. SEEDS societies measure profitability closely, because this is one of the criteria for graduation to a SEEDS Bank. All the SEEDS societies that become banks (507) are profitable and are audited by external accountants.

Janashakthi commenced operations in 1989 as an offshoot of the previous government's poverty reduction program. Janashakthi is a member-based microfinance NGO for poor rural women (Box 2.2). It was formed as an apex body of 124 women's societies. In March 1990, the members of the societies organized themselves into Janashakthi bank societies to pool individual and group savings and to extend small loans to members. The mission of the organization is to eradicate poverty by empowering women to develop individual and collective self-reliance through mass mobilization and working through the family unit and low-income groups in villages and hamlets.

Janashakthi has 67 banking societies (comprising 28,168 members) and 464 village societies. Loans outstanding from the Janashakthi banks as of 30 June 2001 amounted to SLRs85.7 million (\$952,222) and savings amounted to SLRs29 million (\$322,222), comprised of normal, special, and fixed deposits.⁴⁰ Most of the Janashakthi bank societies were profitable in 2000. However, Janashakthi has not grown in size during the last few years, mostly because of the need to consolidate and the lack of funds to invest in new areas. Although 75% of Janashakthi's budget goes toward the credit and savings program, it also offers some nonfinancial services to its members, such as business training, a "barefoot library," nutrition and education program, and environmental training.

The Social Mobilization Foundation is an offshoot of the government-implemented, donor-funded Integrated Rural Development Project. It also works in Hambantota, concentrating more in divisions where Janashakthi does not work. The Social Mobilization Foundation has around 10,000 clients with a revolving fund of SLRs20 million (\$222,222) in addition to savings. It has a small business and agriculture development

Box 2.2

Gender Issues

Unemployment in Sri Lanka, at 7.6% for 2000, is predominantly a female phenomenon. Whereas 5.8% of economically active (age 10 years and above) males were unemployed, the figure for women was almost double at 11.1% (CBSL 2001, p. 22). This proportion has remained steady over the last 10 years at least and is common to all districts. Perhaps in part because of this, women are heavily represented in the microenterprise sector. A Mahaweli survey of 10,000 microenterprises in 1992 showed that 75% of employees of microenterprises were women (Lucock et al. 1995, p. 22). Most microenterprises are family-run businesses and women play an active role in these businesses. Because the vast majority of home-based microenterprises are run by women, they form a significant portion of demand for microfinance services. Their demand is most likely to be satisfied by semiformal MFIs that do not require traditional collateral and by the pawning departments of formal microfinance institutions that accept gold jewelry as collateral. Of the recent lending by the SANASA Development Bank and the thrift and credit cooperative societies, women's participation was just over 50% and for the Janashakthi program it was 100%.

assistance program to support its microcredit lending and to link the groups with government services.

Founded in 1992, the Arthachariya Foundation has a strong poverty focus, working only with the poorest in villages. It has activities other than microfinance, such as environmental work, but only as an entry point for the social mobilization and savings and credit that follow. It has a revolving fund of approximately SLRs20 million (\$222,222), with a client base of around 3,000. The Foundation works in 12 projects in 6 districts. One link to commercialization is that the Arthachariya Foundation is one of the few microfinance NGOs that has sought and received credit funds from banks. It has received loans

totaling SLRs10 million (\$111,111) from SDB, Seylan Merchant Bank, and NDTF, based on the credit guarantee fund and fixed deposits. Its loans are disbursed at an annual rate of 30% interest on a declining balance basis. This microfinance NGO has a 100% loan recovery record, which it attributes to good social mobilization.

In addition to these NGOs, there are around 120 NGOs and community-based organizations with microfinance programs in the range SLRs1 million–40 million (\$11,111–444,444). This excludes village societies registered under the main programs discussed in this report. Most of these small NGOs focus excessively on social objectives and do not apply commercial principles adequately in their operations. Many suffer from operational inefficiencies and weak institutional capacities, especially in the areas of financial analysis, strategic planning, and governance. Of these, 4 NGOs have funds of SLRs20 million–60 million (\$222,222–666,667) for microfinance: FORUT, Sewa Lanka, South Asia Partnership, and All Ceylon Community Development Foundation.

Limited Involvement of Private Commercial Banks in Microfinance

Most senior managers of private commercial banks believe that the high costs involved in small transactions, especially microcredit, do not permit direct commercial bank microfinance operations to be profitable. Private commercial bankers also perceive that the market for microfinance is saturated because of the existence of so many government programs and institutions. The numerous subsidized microcredit programs of the Government “crowd out” commercial microfinance providers. There are no foreign-owned commercial banks and few private domestic banks that target micro-enterprise clients. Private commercial banks largely concentrate on short-term lending mainly to medium- and large-sized enterprises and salaried employees in the formal sector.

A few notable exceptions exist. Some private domestic banks—Seylan Bank, Hatton National Bank (HNB), and Sampath Bank—together with the two state-owned commercial banks

participate in the Government’s New Comprehensive Rural Credit Scheme to provide subsidized loans to farmers, nearly all smallholders, requiring microcredit. However, apart from the limited role of Sampath Bank in the New Comprehensive Rural Credit Scheme, only HNB and Seylan Bank have shown any significant interest in microfinance. Nonetheless, the outreach of these two banks still represents just over 1% of the microfinance market (see Table 2.1).

Both HNB and Seylan Bank have ventured into microfinance on their own accord, although mainly for social reasons. Both have found it difficult to deliver microfinance services in a sustainable manner, although HNB has had more success in running its programs at only a minimal annual loss. The main constraint has been the Government’s subsidized microcredit programs and frequent debt-relief packages in the microfinance market, which they say makes it difficult for them to compete for clients and damages the general repayment culture.

In the current environment, these banks see two options to operate their microfinance programs sustainably. The first option is to develop linkages with NGOs and village-level organizations with a track record of good repayment in order to refinance funds to them for onlending. The second option is to target what some may consider the tier of loans just above those considered microfinance: loans in the range SLRs150,000–500,000 (\$1,667–5,556), mainly aimed at small businesses. HNB is actively pursuing both options, while Seylan Bank is exploring NGO linkages to maintain its focus on microfinance.

HNB pioneered work in this sector with its own funds, in a program called *Gami Pubudu* that began in April 1989. It was one of the first times that a commercial bank had engaged in microfinance.⁴¹ Under the *Gami Pubudu* program, small loans were issued for self-employment, small business including services, and small industry, based on project feasibility and two guarantors who were account holders (Box 2.3).

By 2001, HNB had shifted its focus from the poor to rural entrepreneurs, who may not

Box 2.3

Hatton National Bank's Barefoot Banking Model

While the formal banking sector mainly follows traditional banking procedures in lending, HNB's *Gami Pubudu* scheme takes banking to the community in the form of the loan agent or *Gami Pubudu Upadeshaka*. The loan agent also acts as general adviser to his or her clients on a range of financial and nonfinancial issues, and acts as a source of information to clients on how to access nonfinancial services from other government and nongovernment agencies. Much of the success of the scheme depends on engendering trust and establishing relationship banking, accompanied by an aggressive drive for savings deposits. Moreover, it has simplified financial transactions, disburses loans quickly and operates a graduated system of loans (maximum loan size SLRs20,000 or \$222).

HNB has also developed a linkage program for microfinance outreach by working with 15 microfinance partners from the NGO sector. The partners are selected after a critical appraisal of their management, field structure, sustainability of operations, and legal status. In this partnership, the NGOs provide the social mobilization component and assess project proposals while HNB disburses loans directly to the clients and remains responsible for their repayment.

The experience of HNB in microfinance demonstrates that commercial banks with the appropriate program design, pertinent loan products, and human resources, can make microfinance profitable and be client responsive. Moreover, while *Gami Pubudu* banking units are initially subsidized by the HNB's conventional operations, the scheme has offered HNB substantial positive externalities. Not only has it enabled the bank to extend its outreach in personnel banking and increase its deposits, it has added to the organization's image as a bank with a social conscience.

Source: UNDP 2000a, p. 13–14.

necessarily be poor. One senior manager remarked that HNB's current involvement in microfinance is a good (albeit loss-leading) opportunity to develop mainstream clients for the future. This shift in emphasis is also largely the result of the influx of subsidized actors in microfinance, including Samurdhi and other government programs. HNB's shift is in line with the Rural Economic Advancement Program, which also focused on this segment, leaving poverty reduction to Samurdhi and other programs. Another motive for increasing loan size was the need to make the scheme profitable after experiencing 12 years of marginal losses. Table 2.7 contains selected HNB highlights for its microcredit and microsavings activities only, although no repayment data are available.

The actions taken by HNB to make its *Gami Pubudu* program profitable include

- amalgamation of village-level microfinance units to urban centers and limiting the program coverage to a geographic area near the branch;
- restricting the number of projects per field officer as a means to enhance repayment (average recovery rate of 97%);⁴²
- increasing the loan size to SLRs5,000–500,000 (\$56–5,556) where loans of SLRs100,000–500,000 (\$1,111–5,556) represent a market niche not well covered by other banks and programs; and
- steadily increasing the annual interest rate from 18% in 1999 to 22% as of 30 June 2001 (both on a declining basis).

Seylan Bank

Seylan Bank started work in this field only in July 1997 after the bank's chairperson developed a greater interest in poverty reduction and other social causes. Seylan Bank's microfinance operations focus on loan sizes of SLRs10,000–250,000 (\$111–2,778). Management estimates that the average loan size is around

Table 2.7: HNB Microfinance Performance Highlights

	30 June 1999	30 June 2000	30 June 2001
Loan and Deposit Portfolio Information			
Number of active loan clients	10,347	9,526	9,237
Cumulative number of loan clients	30,605	34,604	38,490
Amount of loans outstanding (SLRs million)	274	310	379
Average loan amount per client (SLRs)	26,000	32,000	40,000
Total amount of deposits (SLRs million)	698	747	905
Average deposit amount per client (SLRs)	10,000	10,000	11,000
Total Sources of Funds (SLRs million)			
Subsidized loan funds from NDTF - SMILE	55.6	55.0	39.6
Subsidized loan funds from NDTF - Surathura	28.1	13.9	10.0
Own Funds	190.7	241.7	328.9
Total	274.4	310.6	378.5

Source: Self-reported data provided in response to the country study questionnaire.

SLRs22,000 (\$244). The target market is concentrated in a few projects in remote rural areas, primarily in agriculture. Seylan Bank combines its microfinance activities with “credit plus” and combines its lending with the forward sales contract system for agriculture produce derived from the loans provided. It has also done some innovative work in developing a credit card for farmers to purchase inputs (Box 2.4). Over time, Seylan Bank has built up its equity (i.e., own funds) and savings deposits, which has reduced its need for soft loans from NDTF (Table 2.8). This reduced reliance on subsidized loan funds indicates Seylan Bank’s positive progress toward microfinance commercialization.

However, Seylan Bank’s (cumulative) repayment rate dropped sharply from 95% in June 2000 to 76% in June 2001, because its main projects are in drought-affected areas and its loans are mainly for agriculture. Also, periodic government debt relief packages (including the write-off of agriculture loans) have a direct negative impact on repayment performance. Seylan Bank is now taking stock of its work in order to move toward a more sustainable approach. The commitment of the Bank’s chairperson to poverty reduction and the

Box 2.4

Seylan Bank’s *Govisarupatha* Credit Card for Farmers

The *Govisarupatha* credit card enables farmers to buy basic supplies, such as seeds, fertilizers, and pesticides, without going to the Bank to obtain a loan. It is important that farmers meet deadlines during the cultivation season. Delays caused by the traditional system of applying for once-off cultivation loans inconvenience both the farmer and the Bank.

As a result of *Govisarupatha*, the farmer does not physically have to go to the Bank for a loan, has to complete forms only once, gets automatic rescheduling in case of a natural calamity, and receives life and hospitalization insurance as an added benefit. Farmers’ organizations are assured of trading volumes and benefit from being identified as the recognized merchandisers for their community. The Bank saves on documentation and staff time and also develops loyal clients who are gradually improving their income and standards of living.

Source: Asian Banking Digest, August 2001, p. 40.

Table 2.8: Seylan Bank's Performance Highlights

	30 June 1999	30 June 2000	30 June 2001
Loand and Deposit Portfolio Information			
Number of active loan clients	2,100	2,500	4,500
Amount of loans outstanding (SLRs million)	46	46	99
Average loan amount per client (SLRs)	20,000	20,000	22,000
Total amount of deposits (SLRs million)	13	15	20
Average deposit amount per client (SLRs)	1,666	1,870	2,000
Other Sources of Funds (SLRs million)			
Subsidized loan funds (from NDTF)	30	28	25
Own funds	16	18	78
Total	46	46	103

NDTF = National Development Trust Fund.

Source: Self-reported data provided in response to the country study questionnaire.

innovative attitude of several of its senior managers could lead to a shift toward developing more sustainable microfinance products for the poor.

ACCESS TO COMMERCIAL SOURCES OF FUNDS

Heavy Reliance on Savings Mobilization

Most MFIs rely heavily on savings mobilization to fund their loan portfolios, indicating a fairly high level of commercialization in terms of access to market-based sources of funds (Table 2.9). Not surprisingly, cooperatives are the largest mobilizers of small savings, accepting almost SLRs20 billion from members of the CRB and TCCS networks. The SBSs and RDBs also collect a significant amount of savings; they and the cooperative networks all mobilize more savings than they can use for their lending operations. The balance of these savings resources flows into the traditional financial sector and acts as an additional source of liquidity and loan capital for larger loans in the formal financial system.

With more than SLRs14.8 billion of deposits in 5.3 million-plus individual accounts, the CRBs

are the most active organizations in mobilizing deposits, receiving in excess of four times the amount that the system lends out (see Table 2.1). In fact, according to CBSL, the total deposits mobilized by the CRBs are 26% of the total deposits mobilized by the entire commercial banking system of SLRs56 billion as of the end of 2000. The low share of lending by the CRBs in relation to their deposits indicates that despite having a wide bank network (1,476 banks at the end of 2000), the system is less effective in lending than in savings mobilization. This is not surprising given its historical purpose of creating liquidity for the People's Bank, its former handling agency. The TCCSs are also active savings mobilizers and together with the SDB, the cooperatives' apex institution, they lend over half of the deposits mobilized by the SANASA network.

Membership in the SBSs at the end of 2000 was 1,571,200. Deposits of SBS members and nonmembers amounted to SLRs3.0 billion; however, all the SBS operations are not subject to CBSL regulation and supervision. In an effort to manage risk to savings, the loan portfolio of an SBS is restricted to 80% of the combined value of deposits held, plus share capital issued (ratio is currently only 34%). In addition, SBSs

Table 2.9: Deposits at end-2000 (provisional)
(SLRs million)

	CRBs	TCCSs	SANASA Development Bank	SBSs	RDBs	SEEDS NGO	Janashakthi NGO	TOTAL
Savings	10,870	1,757	194	3,011	2,731	488	21	19,072
Special Savings	0	902	12	0	305	138	7	1,364
Fixed Deposits	3,937	739	810	0	899	0	1	6,386
Shares	0	841	161	983	1,060	0	17	3,062
Total	14,807	4,239	1,177	3,994	4,995	626	46	29,884

CRBs = cooperative rural banks; NGO = nongovernment organization; RDBs = regional development banks; SBSs = Samurdhi Banking Societies; SEEDS = Sarvodaya Economic Enterprise Development Services; TCCSs = thrift credit cooperative societies.

Source: CBSL 2000, p. 215, based on data submissions from the Cooperative Development Department, SANASA Federation, SEEDS, and Janashakthi.

Note: All TCCSs figures are based on 1999 CBSL data because the equivalent 2000 CBSL data for them did not appear consistent with history or trend. SBS "Savings" reflects "member and nonmember savings" as well as "compulsory savings of Samurdhi beneficiaries." SBS "Shares" reflect paid-up capital.

contribute 1% of each loan to an insurance fund, covering the potential for default.⁴³ Despite being a government program, such large-scale savings mobilization, especially relative to total loans outstanding of only SLRs2,070 million, represents a substantial risk to the Government and ultimately to participants' savings.

The RDBs also mobilize substantial volumes of savings, virtually all for lending. Created under their own Act in 1997, the eight RDBs are allowed to mobilize savings and term deposits but cannot accept demand deposits or provide checking accounts and, therefore, are not subject to reserve requirements by CBSL.⁴⁴

Many microfinance NGOs, although they are not legally allowed to accept deposits in any form, are active in savings mobilization. CBSL has generally ignored to the practice, mainly because the funds deposited with microfinance NGOs have been largely compulsory in nature, used to guarantee or access a microloan. As the largest and oldest of the NGOs, SEEDS has been the most successful in mobilizing deposits and the bulk of these are deposited with HNB in return for a commercial bank loan for onlending through SEEDS. In fact, SEEDS has been able to fund about 96% of its loan portfolio in this manner. Smaller microfinance NGOs, as well as

Agromart and Janashakthi, rely less on deposits and guaranteed loan funds from commercial banks and more on subsidized sources or grant funds.

National Development Trust Fund

In addition to relying on savings mobilization to fund the loan portfolio, many MFIs have also accessed low-cost loans (i.e., at subsidized interest rates) from NDTF. Most of the funds used for microfinance lending by the two state commercial banks, People's Bank and Bank of Ceylon, as well as a portion of loan portfolios of almost all other MFIs, are funded by NDTF. NDTF wholesales funds at 7% per annum to its participating organizations and these funds are onlent to the final borrowers at a minimum interest rate of 19% per annum (on a declining balance basis).⁴⁵ Given that NDTF lends at subsidized interest rates, easy access to its loan funds discourages MFIs from accessing commercial sources of loan funds, such as from commercial banks.

Originally established to support the Government's income transfer program—Janasaviya Program—NDTF began in 1992, through a \$35 million revolving fund provided

by the International Development Association of the World Bank (\$20 million), *Kreditanstalt für Wiederaufbau* (German Development Bank) (\$10 million), and the Government (\$5 million). Funds are lent to participating organizations, such as microfinance NGOs and financial institutions, to onlend to the poor.

Although NDTF was established with the needs of the poor in mind, its performance in poverty reduction and meeting the credit needs of the poor has been largely disappointing. The main reasons for this disappointment include design failures that worked against an integrated approach (including overestimating the loan absorptive capacity of clients and loan management capabilities of the partner organizations) and poor management of the program by both the Government and the World Bank. By 1995, the financial viability of NDTF's operations was in doubt as the interest rate spread covered only 30% of the expenses of the credit division, excluding overhead charges. NDTF's poor performance in credit provision was also linked to the difficulties encountered in promoting viable microenterprises in an environment of sluggish macroeconomic growth, segmented markets, and serious infrastructure bottlenecks.⁴⁶

Most of NDTF's operations were wound down in 1998, but its credit and microenterprise

development component is now being run by the People's Bank. Current activities include lending to participating organizations with good repayment histories and recovering funds from those that have defaulted. As of 30 June 2001, NDTF had 120 participating organizations and outstanding loans totaling SLRs540.8 million (\$6.0 million). NDTF estimates that its current on-time loan repayment rate is about 88%, based on the amount paid as a percentage of the amount payable for the month.

NDTF is the main lender for microfinance NGOs, providing subsidized loans to 56 of them. However, despite its efforts to have a capacity-building focus, NDTF's main attention is on loan recovery from its borrowers. Most microfinance NGOs repay loans from NDTF from their other funds even when clients do not pay on time. NDTF is managed by traditional bankers seconded from the People's Bank, who lack exposure to best practices in microfinance. However, management is doing well what it is entrusted to do, which is to provide and recover loans.

Other microfinance programs, such as RDBs, TCCS, SDB, and CRBs also receive funds from NDTF. In total SLRs263.7 million (\$2.9 million) in loans were disbursed by NDTF in 2000. This amount of lending is low, considering that NDTF's budget for the year ended 31 December 2000 was SLRs361 million (\$4.0 million).

3 Challenges to Microfinance Commercialization

Negative perceptions of microfinance commercialization pose perhaps the biggest challenge to microfinance commercialization. Government policies and interventions also discourage new entrants into microfinance and hinder the commercialization of existing MFIs.

The underdeveloped legal and regulatory framework further impedes commercialization in a variety of ways. It fails to enforce laws against microfinance NGOs mobilizing savings deposits and offers no clear legal path for those institutions to become formal financial institutions subject to prudent supervision. The cooperatives, which are the largest suppliers of microcredit as well as significant savings mobilizers, are not adequately regulated and supervised. The lack of a sound legal and regulatory framework for microfinance NGOs and cooperatives places clients' savings at risk. If one of these key institutions were to become insolvent, this lack would put the reputation of the entire microfinance industry at risk. In addition, there are several internal constraints to MFI commercialization, such as weak ownership and governance and low institutional capacity. Lack of several key support institutions, such as microfinance training institutions, a strong microfinance network, and a functioning credit information bureau also hamper commercialization of the microfinance industry.

NEGATIVE PERCEPTIONS OF COMMERCIALIZATION

Concerns of Practitioners and Funding Agencies for the Poor

Many of the key stakeholders in microfinance in Sri Lanka including government officials, microfinance practitioners, and funding agencies,

have somewhat negative perceptions of microfinance commercialization. While many are beginning to see the importance of MFIs becoming sustainable, most are concerned that microfinance commercialization would neglect the needs of the “ultra poor” and other populations groups just below the poverty line (Box 3.1). Many Sri Lankans see commercial microfinance’s dual objectives of profitability and poverty reduction as conflicting rather than mutually supportive. While an increasing number of microfinance NGOs are charging cost-recovery interest rates and are moving toward sustainability in their programs, some microfinance NGO managers perceive that commercialization would lead to a shift away from targeting the poorer clients.

It is widely believed that for the poorest clients, social intermediation and “credit plus” services are necessary for microenterprise development, which implies continued subsidization. Discussions around microfinance commercialization tend to focus primarily on microcredit and lump the ultra poor together with other poor and near-poor groups. The poor do not seem to be segregated by strata (such as those identified in Figure 4.1, Chapter 4). Many of these negative perceptions of commercial microfinance have been translated into policies, laws, and regulations that are adverse to the commercialization of microfinance, as discussed next.

IMPEDIMENTS IN THE POLICY ENVIRONMENT

The Government’s commitment to economic development and poverty reduction has had a significant positive impact on the development of the microfinance industry in terms of outreach

Box 3.1

Perceptions of Microfinance Commercialization by Selected Government Officials

The researchers posed several questions to elicit perceptions of senior managers on major government programs on microfinance and its commercialization. Two are listed below along with selected responses:

1) What is your definition or understanding of microfinance and the commercialization of microfinance?

Small-scale loans for income-generating activities, sized SLRs5,000–40,000 (\$56–444). Commercialization entails serving enterprises being economically viable and sustainable with future potential; interest rates should be at market, and lending operations should be on a viable basis.

2) Do you believe that microfinance commercialization will increase or decrease the services of your organization extended to the poor?

It will increase the services. However, there will be a tendency to neglect the ultra poor. As such, they need some sort of subsidy until they become "potential poor" (near poor).

Increased microfinance commercialization without supporting services will decrease services to the poor.

Source: Responses to country study questionnaire.

to low-income borrowers and savers. The two state banks (People's Bank and Bank of Ceylon), combined with the SBSs, serve 37.6% of the total microcredit market, with 620,477 active microloans at the end of 2000. In addition, CBSL implements or supervises 18 different rural credit programs that overlap with the microfinance market. This active engagement by the Government and CBSL discourages commercial entrants to microfinance and hinders the commercialization of existing MFIs, creating market distortions via ad hoc debt relief and subsidized microfinance programs.

Debt Relief

Many private MFI practitioners cited recurrent debt forgiveness as the chief impediment to their achieving and sustaining high repayment rates. In the most recent instance, cultivation loans of less than SLRs20,000 granted for paddy and banana cultivation during 1999/2000 (*maha* season, October–January) and 2001 (*yala* season, March–July) were written-off by a government decision to provide relief to farmers whose cultivation was adversely affected by drought. Accordingly, the two state banks, the six RDBs, CRBs, and TCCSs in Badulla District wrote-off approximately SLRs187 million (\$2.1 million) of debt.

The last major debt forgiveness was in 1995. However, practitioners noted that the Government had also waived loan repayments for small loans by state commercial banks and some loans under its microfinance programs from time to time. The Farmer's Relief Scheme, introduced by the Government in 1994, had its termination date extended by 6 months from June 1999 to December 1999, and participatory credit institutions were requested to submit their claims on or before 31 March 2000. Under the scheme, banks write-off 25% of the loans on which farmers have defaulted, including both the principal and accumulated interest. The remaining 75% are shared by CBSL (37.5%), lending banks (18.75%), and the Government (18.75%). Further, this package allows farmers to obtain fresh loans as borrowers in good standing.

The Government's relief package required CBSL to relax its credit guarantee rules by waiving requirements that a lending bank should institute legal action against a defaulter in order to be eligible for the full amount of the credit guarantee. In terms of this waiver, CBSL agreed to pay half of the principal amount in loss less the original down payment of 25% by the farmer. The total liability of CBSL under this scheme up to the end of 2000 was SLRs333 million, while the liability of the Government was SLRs235 million.⁴⁷ In addition to debt forgiveness, the Government also introduced other relief packages, such as the forced rescheduling of loans

to small-scale potato farmers in Nuwara Eliya and Badulla districts during the 1995/96 *maha* to 1997/98 *maha* seasons. In this case, the Government again absorbed a large portion of the debt. These findings suggest that debt forgiveness is not only costly to the Government, but also damaging to the enabling environment in which MFIs operate because it communicates to clients that not all loans have to be repaid.

All instances of debt forgiveness, both large and small, affect not only the repayments of clients growing the affected crops, but also general client attitudes toward loan repayment.

Government Credit Programs

The government microfinance programs, and specifically the largest of them—the SBS program—do not operate on a sustainable basis. SBS loans carry an interest rate of 3% per month (on a declining balance basis) over loan terms of 3 months to 2 years. Emergency loans via the SBS program carry an interest rate of half that rate. Neither rate covers the cost of administering the program. Through other Samurdhi loan programs, the Government provides loan capital that is onlent through the state commercial banks and other financial institutions to the final borrowers at highly concessional interest rates (under many programs, the channeling institutions are subsidized to hold the final lending rate down to 10% per annum), which would be insufficient for them were they using their own funds.⁴⁸

Despite the positive perception of microfinance commercialization by several senior managers at the two state-owned commercial banks, these banks have historically been subject to constant political interference and have had little to no autonomy in their management and operations (Box 3.2). Over the years, both banks have even tried to initiate their own microfinance products but had to abandon them under pressure to devote manpower and other resources to implement various government projects.

Despite the positive strides that some funding agencies, such as *Deutsche Gesellschaft für Technische*

Box 3.2

Perceptions of Microfinance Commercialization by Selected Government Officials

Several senior managers from each of the two state-owned commercial banks conceded that microfinance can be profitable, but that they currently do not have a plan or strategy to initiate it. One of the managers remarked, “We would like to introduce suitable microcredit products, apply commercial interest rates, lower our administrative costs, properly appraise projects, identify potential microdepositors, and link deposit schemes to microcredit schemes.” The same manager noted that the binding constraints to acting on these desires were, “lack of awareness of best practices and lack of trained and experienced staff.”

Because of the constraints faced by the state-owned commercial banks, many managers concede that it may not be feasible for them, and for commercial banks in general, to be direct providers of microfinance. Thus, they may need to focus on wholesaling funds. One senior manager commented, “For commercial banks, establishing linkages with self-help groups of microentrepreneurs or NGOs will pave the way for the bank to commercialize its microfinance activities.”

Source: Responses to country study questionnaire..

Zusammenarbeit (German Agency for Technical Cooperation, GTZ) and the United Nations Development Programme (UNDP), have been recently taking to make their microfinance programs more sustainable, there is widespread belief that substantial donor support of MFIs has been one of the main causes for the overriding poverty focus of most donor-supported MFIs. The poverty focus of most donor-supported microfinance projects has come at the expense of financial self-sufficiency. There is clear evidence of this today. Many of the microfinance components of rural credit projects being

implemented through CBSL's Rural Credit Department incorporate the features of subsidized interest rates on loans that carry with them the perception of soft repayment enforcement. The availability of cheap credit through many of the government programs crowds out private MFIs and other microfinance providers that do not have access to such large subsidies.

WEAKNESSES IN THE LEGAL AND REGULATORY FRAMEWORK

Legal Ambiguity Concerning Microfinance NGO Deposit Mobilization

Savings mobilization by microfinance NGOs places clients' savings at risk and threatens to damage the credibility of the microfinance industry. According to law, NGOs are not allowed to mobilize deposits, but many require mandatory deposits and some accept voluntary savings from members. Under the Banking Act and the Finance Companies Act of 1988, an institution must be licensed as a bank or a finance company to collect deposits. This applies to all deposits, whether from members or nonmembers, and includes compulsory savings that may be a precondition for obtaining microcredit. In practice, the prohibition on savings mobilization has generally not been enforced. Indeed, major government programs, such as the NDTF and the Small Farmers and Landless Credit Project, have required microfinance NGOs borrowing from them to establish savings programs.

Lack of Institutional Options for Transformation

Lack of a supportive legal and regulatory framework for MFIs discourages commercial entrants. Legal options are limited for semiformal MFIs (for example, microfinance NGOs) that want to transform themselves into formal institutions. The most commercial of the microfinance NGOs—SEEDS—sees its best option to formalize in becoming a bank. But this

is likely to be a difficult and inappropriate legal form for transformed microfinance NGOs, because of banks' high minimum capital requirements. Commercial banks require minimum initial capital of SLRs500 million (\$5.6 million), the RDBs were launched with initial capital of SLRs150 million (\$1.7 million), and savings and development banks require SLRs100 million (\$1.1 million). The RDBs have their own statute, the 1997 Regional Development Banks Act. Given that the legal status granted to the RDBs was a special case designed to amalgamate the 17 state-dominated regional rural development banks into more independent RDBs, it is unlikely to be a viable institutional form for microfinance NGOs desiring formal status.

The savings and development bank category for regulated financial institutions may be the most appropriate legal form because of its lower initial minimum capitalization. However, exceptions and adaptations to the regulations would need to be made to accommodate the specific needs of microfinance institutions. Standard international prudential guidelines that apply to each of these types of regulated entities are not appropriate to the specialized operations of microfinance providers. For example, reporting requirements, limits on unsecured loans, requirements concerning loan documentation, supervision methods, and branching restrictions are incompatible with successful MFI operations that are based on acceptance of alternative forms of collateral, the use of simplified applications, and other nontraditional lending practices.

Most of these guidelines would need to be less stringent for MFIs, but others, such as provisioning standards, would need to be stricter for MFIs in view of the shorter maturity of their loans. A 60-day delinquency of a 90-day microfinance loan may represent a greater risk than a 90-day delinquency of a 5-year loan.⁴⁹ Currently, CBSL does not require 100% provisioning until loans are more than 18 months past due, whereas most microfinance loans should probably be written-off within a year of the date of their default.

Inadequate Regulation and Supervision of Cooperative Networks

An inadequate regulatory framework for cooperatives puts their clients' savings at risk and hampers commercialization of the cooperative networks. The 1,476 individual CRBs are organized under 306 government-dominated multipurpose cooperative societies and are only loosely supervised by the Cooperative Development Department. Despite the lack of strict supervision, the CRBs collectively had mobilized SLRs 14.8 billion in deposits in over 5.3 million accounts by the end of 2000. A few are regulated by CBSL by virtue of their participation in the national deposit insurance program; however, this regulation is only loosely applied to the participating CRBs.

As with the CRBs, the TCCSs are governed by the Cooperative Societies Law of 1972 and are subject to minimal supervision by the Cooperative Development Department. As a whole, the TCCSs mobilized over SLRs 1.8 billion in savings by the end of 2000. Both the TCCSs and CRBs have federations that are only loose networks, with the success of individual banks (of the CRB network) and primary societies (of the TCCS network) largely dependent on the expertise of their local managers. While the federations are able to provide some leadership, they have no legal means of enforcing standards. The scale of deposit mobilization by cooperatives places substantial savings at risk. Unfortunately, the Cooperative Development Department is not currently equipped to provide prudent regulatory oversight to the thousands of cooperatives under its supervision.

The TCCS Federation is exploring other ways to improve management and enforce standards. The opening of SDB is a step in this direction. The agency relationship that SDB is currently attempting to develop with the primary societies will strengthen their financial position by improving operational and managerial professionalism. CBSL and SDB have agreed upon minimum financial and risk management criteria in order for a primary society to have an agency. Society managers will need to achieve

individual accreditation through the SANASA Education Campus. To qualify as an agent for SDB, a primary society must follow sound business practices in the areas of staffing and training, accounting, record-keeping, financial performance, security, facilities, and hours of operation.⁵⁰

Inadequate Secured Transactions Framework

An inadequate secured transactions framework curtails opportunities for MFIs to diversify their microcredit products and impedes MFI progress toward commercialization. Lenders need a system wherein claims against property can be created (legally defined), perfected (publicly registered), and enforced. The more uncertain and expensive the process, the less willing may be MFIs to lend.⁵¹ State ownership of more than 80% of all land limits its use as a potentially valuable form of collateral. Use of movable property as collateral is blocked by the absence of a legal basis to support it. The lack of a secured transactions framework limits MFIs from using collateral to secure a loan, thereby hindering MFIs from scaling-up and offering larger, individual loans, especially in rural areas.

INTERNAL CONSTRAINTS TO MICROFINANCE INSTITUTION COMMERCIALIZATION

Weak institutional capacity and overemphasis on social mission curtails MFI progress toward commercialization. At least half the current provision of microfinance is by MFIs that have weak institutional capacity and an aversion to commercial principles. In particular, many MFIs suffer from lack of clarity in their mission, weak governance, low levels of technical understanding of banking and finance, inappropriate accounting practices, and inadequate management information systems. Negative perceptions of commercialization prevent much of the industry from striking a balance between their commercial and social missions and becoming more sustainable. Institutional weaknesses and negative

perceptions of commercialization are two of the main challenges to commercialization of the microfinance industry.

Lack of awareness of best practices in microfinance and the need for staff training were given as the key constraints to commercialization of microfinance by five of the eight institutions that responded to the questionnaire used to elicit data for this study. This remains a major issue because very few institutions undertake microfinance training or capacity building. For example, management ability within the SANASA movement (TCCSs, SDB, etc.) varies widely. The autonomy of primary societies is a strong factor in this inconsistency. While the federation is able to provide leadership, it has no legal means of enforcing standards.

Some district unions have been able to bring a level of discipline to their primary societies by using loan conditions to impose standards. For example, a district union may impose management standards as a condition for a primary society to receive a loan. In such a case, the district union is able to intervene directly with the management of the primary society by requesting that a part of the manager's salary be withheld by the district union if the manager fails to achieve certain performance standards agreed upon by the manager and a district field officer.

For the TCCSs at the primary society level, a main reason for not focusing on profitability has been a cultural one: the cooperatives are seen by its leaders as community development organizations to assist members to access credit and to deposit savings and not as profit-making bodies. Very few of the profitable societies distribute profits among members. The attitude of office bearers is also an issue. Most of them consider this to be a social position derived from community service. Most office bearers do not come from the business community and even if they do, they see their role in the societies as providing a social service.

However, the TCCS movement has recently shifted its perceptions, giving much greater emphasis to profitability because of the creation of SDB and the need to make it viable. This has sharply changed operational focus from a mere

growth orientation to a profit orientation. SDB and the TCCSs are now increasingly focusing on ways to make societies more profitable. This may lead to increased centralization of management of primary societies and a more profit orientation at primary society level in the future.

Microfinance NGOs have also progressed greatly since the 1980s when savings and credit work commenced in this sector and most NGOs (as well as their funding agencies) were advocating subsidized interest rates. They also felt that serious action against defaulters was not to be taken for social reasons. The Janasaviya Trust Fund (now NDTF) helped to make the biggest changes by providing funds at interest rates that made it necessary for the recipient microfinance NGOs to charge cost-recovery interest rates.

Reduced grants funds from funding agencies to the NGO sector especially in southern Sri Lanka has also helped microfinance NGOs to move away from a noncommercialized approach to microfinance. Increasing numbers of microfinance NGOs are moving toward creating sustainable programs, or at least wanting to do so. Charging cost-recovery interest rates or higher has become more common and many even try to take legal action against defaulters to instill repayment discipline, especially in the face of frequent government debt relief programs. This is not yet widespread, however. Most microfinance NGOs remain lax on taking legal action against defaulters.

LACK OF SUPPORT INSTITUTIONS

Credit Bureau

Lack of MFI access to a credit bureau impedes credit risk minimization and increases clients' costs of borrowing. Sri Lanka's credit bureau currently does not serve the needs of MFIs. The bureau only reports on loans over SLRs100,000 (\$1,111) and it is accessible only by its shareholders, such as commercial banks, licensed specialized banks, and the RDBs. Lack of a centralized credit information source keeps the

search, monitoring, and enforcement costs incurred by providers of microcredit unnecessarily inflated. It also increases the cost of microcredit to clients. MFI access to a credit bureau could reduce MFIs' lending to bad borrowers and minimize excess debt and default by clients.

Microfinance Networks

Microfinance networks and support programs have several important roles to play to promote sustainable microfinance systems. They can spread awareness of key features of the "financial systems" approach to microfinance among policymakers, the development community, and microfinance practitioners, integrating microfinance more with the general financial sector and ensuring that complementary approaches are considered. In addition, they can collect and disseminate microfinance "best practices" to accelerate the outreach and financial self-sufficiency of their member MFIs in terms of cost-saving technological developments, creation of linkages to expand outreach, and lessons learned from microfinance NGO transformation and other experiences.

There is one microfinance network, the Sri Lanka Microfinance Network, which started in the early 1990s under the initiative of the Swiss Inter Corporation. In 1996, UNDP took over support for this initiative and broadened its membership base to include CBSL, donor organizations, international NGOs, commercial and development banks, cooperatives, and a few prominent consultants and representatives from several major government programs. However, it is still a loose network with no formal mem-

bership and anyone interested is invited for meetings. The members meet monthly and carry out some activities, such as an annual microenterprise fair to promote the marketing of products produced by MFI clients, giving comment on studies done in the microfinance field, and meetings and studies of relevance to the sector. The Microfinance Network suffers from a lack of focus and institutionalization with formal membership and activities.

Microenterprise and Microfinance Training

The limited capacity within Sri Lanka for training in microenterprise development and microfinance is a major issue. The main training institutions are CBSL Centre for Banking Studies, International Center for Training of Rural Leaders (ICRTL), SEEDS Management Training Institute, Rural Development Training Institute (RDTI), and SANASA Training Institute.

Two of these five institutions were established by SEEDS and TCCSs, respectively, to train their own staff and have little capacity to train other persons. Of the three government training institutions active in this field, the Rural Development Training Institute's main strength is social mobilization training. This leaves only CBSL's Centre for Banking Studies and the International Center for Training of Rural Leaders as facilities that could offer microfinance capacity-building training. While the latter is strong at training management and accounting for microfinance at the community-based organization level, both have weak capacity to offer training on local and international microfinance best practices.

4 Implications of Microfinance Commercialization

This chapter examines the implications of microfinance commercialization in terms of outreach, competition, and “mission drift.” While this report mainly discusses microfinance commercialization from the perspective that commercialization would have a positive impact on microfinance outreach, some MFIs fear that it could lead to greater competition and make it harder for them to survive in the future. In addition, many Sri Lankans are concerned that increased commercialization could have negative social impact or result in mission drift, such as a reduced focus on reaching the poorest sectors of society, and lead to increased loan sizes. The findings show that while some of these implications are possible, the negative impact on the poor is probably less than some might think.

POTENTIAL FOR GREATER SUPPLY OF DEMAND-DRIVEN PRODUCTS

The basic premise behind microfinance commercialization is that commercial MFIs are more likely to be sustainable and more efficient in the long-run than noncommercial MFIs. Advocates believe that increased commercialization will yield greater outreach, including to the poor, and more product diversity, resulting in more clients served and their diverse needs met over time. This theory has proved true in such countries as Bolivia, where commercial MFIs dominate the market and as a result, low-income clients have multiple choices of financial service providers and products at lower cost than when only noncommercial MFIs dominated the market.⁵² While it is difficult to demonstrate this concept in Sri Lanka, which is at a fairly early stage of commercialization, there are already signs that

indicate the positive effect of commercialization on microfinance outreach.

The MFIs that have achieved the greatest outreach are the cooperatives: the CRBs and the TCCSs. Together these two cooperative networks have reached more than 830,000 clients, representing approximately 46% of the total market, with a combined outstanding loan portfolio of almost SLRs7.8 million (\$87 million) (Table 2.1). They have achieved this level of commercialization and outreach while maintaining a commitment to the poor, as demonstrated by their low average loan size, SLRs9,914 (\$110). The cooperatives that have achieved profitability are the larger and more established ones, with the greatest outreach.

Another manner in which the positive effect of commercialization is demonstrated is the link between savings mobilization and outreach. Some of the MFIs that mobilize the greatest amount of savings—CRBs (SLRs14.8 million), TCCSs (SLRs4.2 million), SBSs (SLRs4.0 million), and SEEDS (SLRs626,000)—have achieved the greatest outreach in terms of number of clients served. While the SBSs and SEEDS are structured to be noncommercial, their role as savings mobilizers and financial intermediaries (i.e., they onlend the savings) represents a commercial approach to microfinance and a commitment to achieving sustainability. One could argue that if these MFIs were commercially structured, with true owners and effective boards to oversee them, they could operate more effectively and efficiently and achieve even greater levels of outreach.

Much of the remaining unmet demand for microcredit in Sri Lanka is a result of both lack of potential clients’ awareness of their options and the need for MFIs to gain a better understanding of client needs and to adopt

products and services to meet those needs. Because microfinance commercialization is still fairly undeveloped, clients largely remain uninformed about potential opportunities for microfinance services. Public awareness and marketing campaigns, such as through radio announcements or billboards, could help to increase the number of microfinance clients. In addition, MFIs should strive to improve their understanding of client needs and preferences and adapt products and services to better respond to clients' requests.

Client perceptions of microfinance commercialization vary widely. All clients and potential clients interviewed in the present study needed clarification on what microfinance commercialization meant, especially what it would potentially mean for them. Most were in favor of lower interest rates being charged. However, if greater and more dependable access meant nonsubsidized interest rates, they were generally willing to pay them. On the savings side, this was even more prominent, with preferences for safety of deposits and liquidity being their chief concerns rather than earning the maximum interest possible. So, while some might argue that commercialization could result in increased interest rates, these and other findings suggest that even poor clients are willing to pay the price required to ensure access, product diversity, and safety of deposits (Box 4.1).

Empirical evidence shows that interest rate increases do not result in decreased demand for loans.⁵³ Information gathered from participant MFIs in the MicroBanking Standards Project⁵⁴ supports this view. Further, "even if below-cost recovery interest rates for borrowers were the most efficient means to reduce poverty, such an approach would create problems for MFIs not participating in donor-funded poverty reduction."⁵⁵

Box 4.1:

Clients Think Commercialization Improves Access

A primary issue for most clients is access to finance, rather than cost or other factors. Clients of the Saravodaya Economic Enterprise Development Services (SEEDS) believe the commercialization process has resulted in an overall improvement in service delivery as well as a wider range of products. There is also growing opinion that commercialization has changed SEEDS' approach, in terms of greater professionalism and more business oriented attitudes. This has also led to greater confidence among clients to invest in SEEDS. Previously, there was some reluctance to invest because SEEDS' traditional NGO image did not instill the confidence required, but its new focus on commercialization has facilitated increased savings mobilization.

LACK OF CLEAR PROFIT POTENTIAL CURTAILS COMPETITION

Some MFI directors are concerned that increased commercialization could lead to more MFIs entering the market, making it more difficult for existing MFIs to expand their markets and increase revenues. They fear that increased competition from commercial microfinance providers could put a financial strain on them, making it more difficult for them to cover their costs over the long term. The success of microfinance commercialization in Bolivia did indeed cause new commercial microfinance providers to enter the market, which squeezed profit margins for other providers and ultimately resulted in the collapse of some MFIs there. However, despite the fact that its microcredit market is fairly saturated, Sri Lanka is far from facing that level of competition.

High liquidity and wide interest rate margins among the commercial banks and licensed, specialized financial institutions indicate that Sri

Lanka's financial market, while largely liberalized, is not yet developed enough (because of lack of technological advances, limited professional commercial banking skills, and other factors) to spur intense competition. Thus, there is little incentive for formal financial institutions to scale down their product offerings based on competitive pressures. There are, however, social concerns and the desire to be a good corporate citizen that have prompted some commercial banks to become more involved in microfinance activities.

Highly significant in terms of total numbers of microcredit loans and total volumes are the semiformal MFIs. True competition has probably not yet arrived in the microfinance market provided by this sector. This view is supported by the continued rapid growth of programs like SBSs, RDBs, SEEDS, and other semiformal MFIs, although several microfinance NGOs complain that the Government's expansion of the SBSs eroded their potential client base. Competitive pressures are further eased in that most semiformal MFIs provide microfinance to different tiers of the microfinance market or in only localized areas. For example, the CRBs and TCCSs can be seen as serving a slightly better-off clientele than the SBSs, SEEDS, or Janashakthi. However, the medium-term prospect (2–3 years) is that competition will begin in at least a few locations if the growth of these types of MFIs continues on the same path.

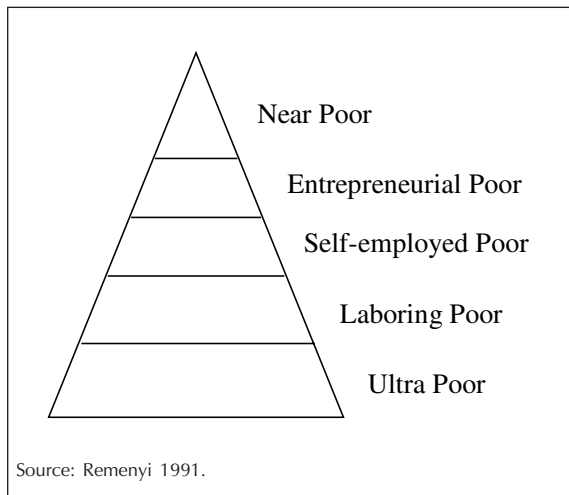
Nonetheless, until the microfinance industry demonstrates more profit potential, new commercial market entrants are unlikely. Profit potential will be difficult to demonstrate until the Government stops promoting its subsidized microfinance and targeted credit programs. Given that a third of microfinance is currently supplied by the Government, this exit from the market would open up a large market for existing MFIs and would encourage new commercial entrants. Only after this market is recaptured would true competition emerge.

POTENTIAL FOR MISSION DRIFT

Increased competition will likely force most, if not all, of the semiformal MFIs to reevaluate their missions in relation to their comparative advantages in serving their target group. Decline in donor support (in all but the North East Region) can also be expected to bring about such introspection. Some of the more poverty-oriented institutions will inevitably leave the microfinance market when their financially unsustainable programs run out of funds; others may shift their focus to nonfinancial activities deemed more directly beneficial to their target group. The institutions that remain in the microfinance business might find that serving the ultra poor is too costly for them to continue on a sustainable basis and that targeting the poverty tiers immediately above that group may afford them the desired balance between outreach and financial self-sufficiency.

Remenyi's poverty pyramid (Figure 4.1) is often used to conceptualize these tiers or gradations of poverty. In Remenyi's classification there are five strata. At the bottom layer are the ultra poor who depend on the earnings of others. Next up, the laboring poor are employed full-time in low-paid, unskilled labor positions. The upper three strata consist of the self-employed poor who work for themselves and may employ up to five others; the entrepreneurial poor whose enterprises employ more than five people; and the near poor who have stable, albeit low wage employment.⁵⁶

Many Sri Lankans are concerned that increased microfinance commercialization could result in mission drift, implying that MFIs will reduce their emphasis on targeting the poorest sectors of society and will gradually increase their loan sizes. In fact, average loan sizes for both HNB and Seylan Bank have drifted higher in recent years. The average loan size for HNB in 1999 was about SLRs26,000 (\$289). By 30 June 2001, it had almost doubled to SLRs40,000 (\$444). Over the same period, Seylan Bank's average outstanding loan size was estimated to grow from SLRs20,000 to SLRs25,000 (from \$222 to \$278). While HNB's average loan size is

Figure 4.1: Poverty Pyramid

expected to continue rising, that of Seylan Bank is likely to remain relatively steady as it keeps its original focus. This trend can be expected to continue until the Government curtails its direct interventions in the microfinance market, because these banks are simply targeting the markets where they see the least competition and the most profit potential.

How much mission drift this entails for various semiformal MFIs and the microfinance market as a whole depends on a variety of factors. One is the extent to which semiformal MFIs seek to become regulated entities, which is a prerequisite to mobilizing significant voluntary savings (to facilitate their substantially increasing outreach on a sustainable basis). SEEDS, the largest NGO, is considering taking this step in the near future. Becoming a formal, regulated financial institution

can result in targeting higher-income clients with larger loans, as a result of profit-seeking pressures from equity shareholders. However, the industry will have to wait for at least one such transformation to take place in order to gather the empirical evidence to support or contradict this potentiality.

Mission drift will also depend on the nature of the prevailing regulatory and supervisory framework. For example, certain prudential standards applied to commercial banks are not appropriate for formal MFIs (such as reporting requirements, limits on unsecured loans, requirements concerning loan documentation, supervision methods, and branching restrictions), and might cause the institutions to shift focus up market to ensure compliance. No regulatory and supervisory framework for microfinance exists yet and this represents a great opportunity to learn from successful experiences elsewhere, such as in Bolivia, in designing a framework that will minimize mission drift.

Mission drift may remain low in those semiformal MFIs that are content with serving a localized market on a competitive basis (i.e., the majority of small NGOs, such as Janashakthi). Such institutions will likely enjoy fewer opportunities to diversify their risks and will not be able to take advantage of economies of scale in their operations. Despite the advantage of proximity to their target market, these institutions can be expected to remain weaker than formal MFIs. In other words, some diversification of target markets can be beneficial to MFIs to minimize risks and improve their ability to recover costs.

5

Positive Approaches to Microfinance Commercialization

Commercialization of microfinance holds the promise of capitalizing on the achievements in outreach that MFIs have made to date. General improvements in MFIs' financial self-sufficiency are promising, but the industry is far from reaching all the potential benefits of microfinance commercialization. Many stakeholders including the Government, funding agencies, MFIs themselves, and support institutions have a role in moving microfinance commercialization further. In the following sections are conclusions and recommendations for each of these key stakeholders, based on information gathered in the present study and the literature.

ROLES OF THE GOVERNMENT

The main roles that the Government should play in commercialization of microfinance are to create and maintain an enabling macroeconomic and sectoral policy environment and an adequate legal, regulatory, and supervisory framework for microfinance. There is a need for the Government to undertake a private-public sector partnership to produce a cohesive national framework for microfinance development and rationalize its pervasive presence in the microfinance market. This entails phasing out several, major, direct government microfinance interventions in favor of more indirect support of the microfinance sector.

Direct financial sector interventions should be minimized to prevent market distortions and to allow the private sector to provide microfinance services using proven methodologies for sustainable microfinance delivery. The Government should also consider complementary, grant-based approaches to reach certain sections of the traditional microfinance market (for example, the

lowest rung of the working poor) when the net benefits of offering microfinance directly are exceeded by alternative interventions (for example, investments in training or social services and physical infrastructure). Specific recommendations are provided below that relate to the policy environment, the legal framework, and regulation and supervision.

Create and Maintain an Enabling Policy Environment

Ensure macroeconomic growth and stability

Several measures should be undertaken to ensure positive, stable economic growth that will enable the microfinance industry to expand in a sustainable manner. These include ending the secessionist conflict, which continues to destabilize the population and dampen economic growth by necessitating increased defense expenditures; and curtailing ad hoc policy changes including tax relief measures that cause significant decreases in national income or increased government expenditures related to public sector wage increases, and various smallholder debt relief packages. Such policies may worsen inflationary pressures and dampen economic growth. This would have an adverse impact on effective demand for microfinance and harm efforts of MFIs to progress toward financial sustainability.

Promote agriculture sector growth

Tariff policies should be rationalized and ad hoc changes in them minimized. Poorly targeted agriculture subsidies would be better directed to improvements in agriculture inputs, processing, and marketing facilities. Given that agriculture

production supports more than one third of the Sri Lanka's labor force, these and other measures aimed at increasing the agriculture productivity might go a long way toward providing a large, economically-viable client base for MFIs seeking to commercialize their operations and expand in rural areas.

Strengthen the financial sector

Further efforts to restructure the two state-owned commercial banks are needed to improve their performance. This should be undertaken with an eye toward eventual privatization. Many of the government-sponsored agriculture credit programs currently being implemented by the banks undermine their ability to achieve sustainable outreach, especially in terms of their microfinance portfolios. Consideration should be given at least to allowing the banks more autonomy coupled with accountability, similar to the RDBs. The reported profitability of the RDBs (with an estimated 80% of their portfolio in microfinance) may be a testament to the potential for sustainable microfinance outreach that such changes may bring. However, it is uncertain how profitable the RDBs would be after appropriate adjustments for loan loss provisions, write-offs, and subsidies.

Stop ad hoc debt forgiveness

Many private MFI practitioners cited recurrent debt forgiveness as the chief impediment to their achieving high repayment rates. In the most recent instance, cultivation loans of less than SLRs20,000, granted for paddy and banana cultivation during the 1999/2000 *maha* season and 2001 *yala* season) were written-off by a government decision to provide relief to farmers whose cultivation was adversely affected by drought. Accordingly, the two state banks, the six RDBs, CRBs, and TCCSs in Badulla District wrote-off approximately SLRs187 million (\$2.1 million). The last major debt forgiveness program, the Farmers' Relief Scheme, began in 1994 (and was extended through December 1999). However, practitioners noted that the

Government had also waived loan repayments for small loans by state commercial banks and some loans under its microfinance programs from time to time.

Provide quality social services and adequate physical infrastructure

Thus far, macroeconomic growth has boosted the effective demand for microfinance, especially in the service sector. Weaknesses, however, in physical infrastructure (power, telecommunications, water, etc.) and basic health and education services will continue to constrain effective demand for microfinance until there are substantial improvements in these areas.

Minimize Direct Interventions

Phase out government programs

At the end of 2000, some 940 Samurdhi banks had been established, an increase of 75 societies in that year. This significant presence and growth requires a rethinking of their management and operations. Presently, the banks have boards made up primarily of clients, but the staff (about 20,000 total) are from the Samurdhi Authority and, as such, wield great power within the organization. The savings portfolios are entirely client funded and include no government or donor deposits. There is a need to consolidate the gains in outreach achieved under the program and to ensure its sustainability by changing the SBS from public to private, local ownership. In addition, because the Samurdhi Program has been so successful at reaching the bottom end of the market, other government interventions, such as the directed CBSL projects and the state-owned commercial banks, are not needed in the microfinance sector.

Redirect the CBSL Rural Credit Department programs

The implementation of at least a dozen rural credit projects is currently being supervised by CBSL's Rural Credit Department (with at least

two being directly implemented by it). Many of these projects have targeted, subsidized microcredit components. CBSL should not be engaged in direct lending, which conflicts with its ability to provide impartial regulation and supervision of the financial sector. In addition, it uses scarce resources (human and financial) in a way that would be better served by the private sector. Such direct financial sector intervention by the Government undermines the ability of the private sector to provide microfinance. Also, it is not a cost-effective means of microcredit delivery because, as mentioned, repayment under the government projects is not strongly enforced. Indeed, the repayment culture is eroded by debt relief and debt forgiveness programs announced frequently by the Government. The project features of targeting, subsidized onlending interest rates, and weak repayment enforcement should be phased out as soon as possible, because they conflict with efforts to encourage private sector MFIs and MFI sustainability. In addition, responsibility for the provision of microfinance should be shifted from the public sector to private sector MFIs with a strong focus on, and a track record toward achieving, financial self-sufficiency.

Reduce government ownership and control of the RDBs

Although the RDBs were given greater autonomy in 1998, the main shareholder remains CBSL; shares are also held by other government agencies. To minimize adverse political interference in the RDBs and to strengthen their market orientation, CBSL and other government shareholders should progressively reduce their ownership control in these banks. Promotion of private investment in the banks through privatization should be strongly considered in the near future. The RDBs appear to be ripe for privatization: each of them has reported profits in serving their respective rural financial markets in recent years.

Strengthen the Legal Framework

Resolve legal ambiguity regarding microfinance NGO savings mobilization

Savings mobilization by microfinance NGOs without legal authority is placing clients' savings at risk, which in turn places the microfinance industry at risk. There are a number of options that can be considered to resolve this issue. The Government could require that all microfinance NGO savings deposits either be deposited into a formal financial institution and not onlent to microfinance clients, or that all such deposits be covered under the national deposit insurance program. In addition, CBSL could create a new legal structure to accommodate the transformation of informal MFIs into regulated financial institutions subject to its regulation and supervision, or allow exceptions to be made under one of its current regulatory structures, such as for savings and development banks. Regardless, CBSL should enforce its law under the Banking Act and the Finance Companies Act of 1988, requiring all institutions that mobilize savings and use them for onlending to be licensed as formal financial institutions.

Create a new legal structure for microfinance institutions

Consideration should be given to developing a new tier of financial regulation for financial intermediaries specializing in microfinance operations, including voluntary deposit mobilization from the general public. Such regulation and supervision should be tailored to the specialized microfinance operations and reinforce sustainable growth, drawing from recent positive experiences in Africa (e.g., in Uganda⁵⁷) and Latin America (such as in Bolivia). Initial applicants might include a few of the best performing CRBs, TCCSs, and microfinance NGOs. Introduction of such a tier could improve accountability and transparency of MFI operations. It is commonly acknowledged that these are necessary ingredients both for obtaining recognition as financial partners of the formal

financial sector and for ensuring the security of the savings. The ability of these institutions to mobilize deposits and to obtain deposit insurance is crucial for their enhanced financial self-sufficiency and the commercialization of the microfinance industry. Strengthening CBSL to be able to undertake regulation and supervision of the few MFIs that may be suited to such a transformation would be a necessary prerequisite and should be a priority of the Government and donor community.

Improve Regulation and Supervision

Build the capacity of the Central Bank of Sri Lanka

The types of institutions regulated by CBSL should be expanded according to the growth in recent years of several nonbank financial institutions, especially in terms of savings mobilization. It is important that the regulation and supervision practices, as well as the capacity, of CBSL evolve with the growth of these nonbank financial institutions because most of them take part in financial inter-mediation. CBSL has a supervision force of only about 75 persons and they appear to be fully occupied supervising the entities currently subject to its regulation. CBSL personnel should be shifted from direct implementation of microcredit projects to supporting the development of market-friendly and effective microfinance regulation and supervision.

Adopt appropriate regulation and supervision for microfinance

To protect deposits, savings-mobilizing MFIs should be subject to some form of prudential regulation and supervision. Given that CBSL does not currently have the capacity to regulate and supervise all MFIs, alternative forms of oversight should be considered, such as the strengthening of the federation for the TCCSs or the development of self-regulatory bodies. Regardless of structure, the regulatory framework should ensure that deposit-mobilizing MFIs have

strong governance structures, with qualified, active board members; effective internal control and risk management systems; and thoroughly auditing by an independent third party at least once per year. In addition, the regulatory framework should adopt strict risk classification criteria, requiring higher levels of loan provisioning and quicker write-offs than are required of traditional financial institutions. Minimum standards for performance should be set and key indicators monitored, such as for capital adequacy, asset quality, and liquidity. Box 5.1 offers several common adaptations to traditional bank regulatory and supervisory practices that could be applied.

ROLES OF FUNDING AGENCIES

Support an enabling policy, legal, and regulatory environment

Funding agencies should work with the Government to ensure an enabling environment for microfinance conducive to MFI progress toward commercialization. This includes advising on macroeconomic and sectoral policies, as well as the legal, regulatory, and supervisory framework (specific areas of emphasis are mentioned above). It also entails encouraging the Government to stop granting broad debt relief and supporting refinancing loan programs with subsidized interest rates.

Build MFI Institutional Capacity

Funding agencies should help to build institutional capacity by providing exposure to and training in microfinance best practices, along with performance-based support for capacity building so that MFIs can expand their outreach and develop cost-effective, sustainable operations (through the use of so-called “smart subsidies”). In other words, funding agencies should use technical assistance more than direct subsidies to MFIs to ensure a level playing field for interest rate setting and to avoid creating distortions in the market. If onlending funds are provided at

Box 5.1

Common Adaptations of Traditional Bank Regulations and Supervision

- **Lower capital requirements.** Minimum capital requirements should be low enough to attract new entrants into microfinance, but high enough to ensure the creation of a sound financial intermediary.
- **Risk weighting of assets for unsecured loans.** The type of lending (unsecured or secured and, if secured, by what type of collateral) a bank engages in affects its risk weighting of assets, capital adequacy, and provisioning. Regulators should assess the level of risk of an MFI based on overall portfolio quality and repayment history rather than on the value of traditional guarantees. Historical performance of portfolios, statistical sampling of arrears, the adequacy of management information systems, and the MFI's own policies for dealing with arrears should also be taken into account (CGAP 1996).
- **Higher capital adequacy ratios.** A weighted capital adequacy ratio of 8% of risk-weighted assets is currently recommended by the Basle Accord. Because of their generally lower ability to diversify their risks, MFIs should be subject to even higher capital adequacy ratios as a means to safeguard investor funds. Consideration should be given to application of initial MFI capital adequacy ratios approaching 20%, with potential lowering to the range of 12–15%, based on good performance over time.
- **Stricter provisioning.** Provisioning requirements should be based on the average loan maturity of the portfolio. MFI portfolios tend to have shorter average maturities and, therefore, require more aggressive provisioning. Basle Accord requirements suggest that banks be subject to loan provisioning requirements of 25% for substandard loans, 50% for nonperforming loans, and 100% for loss loans. Stricter provision loan loss requirements for MFIs should be at least:

10% of the unpaid balance	0–30 days in arrears;
25% of the unpaid balance	31–90 days in arrears;
50% of the unpaid balance	91–180 days in arrears; and
100% of the unpaid balance	in arrears more than 180 days.

- **Higher operational costs allowed.** MFIs manage small loans and deposits; thus, they tend to have higher operational costs than traditional banks. Allowing MFIs to offer incentive-based payments to staff; to have flexible hours of operation convenient for clients; and to engage in mobile banking, permitting them to disburse funds and collect payments outside branches, can help MFIs to minimize their operational costs. Permitting incentive-based payments to staff can help MFIs reduce portfolio risk. Regulators should not penalize MFIs for higher operating costs if they can demonstrate a reasonable average return on assets.
- **Customized reporting requirements.** Not all the reporting requirements of traditional banks are applicable to MFIs and microentrepreneurs usually cannot produce the same level of documentation as required of traditional lending. Portfolio reporting formats should take into account the volume, loan size, and term of microfinance loans.

Source: Berenbach and Churchill 1997, p. 43.

all, they should be coupled with time-bound, quantitative performance indicators, the achievement of which determines the timing and amount of subsequent funding within a maximum 2–3 year time horizon on continued funding access.

It will be important for funding agencies to focus also on increasing the domestic availability of microfinance training courses and programs. In addition, opportunities for senior managers of MFIs to be exposed to successful microfinance programs in other countries, such as Indonesia and the Philippines, should be supported. An integral part of this second major role for the donor community is assistance in the development of commonly accepted microfinance industry organizational, operating, financial, and reporting standards.

Support Innovation

Funding agencies should promote the development of innovative microfinance methodologies and products as well as complementary, grant-based social service programs. The responsibility for (pre-microcredit) social mobilization efforts and (post-microcredit) business development services or “credit plus” activities (e.g., business training, setting product standards, and marketing assistance) can be passed to purely socially-oriented NGOs. This will allow microfinance NGOs reaching for sustainability to concentrate on satisfying the financial needs of their clients. In addition, assistance from the donor community will be vital in developing and piloting new or adapted delivery methods and products that can be used to increase access by underserved groups to financial services.

Promote Linkages between the Formal and Semiformal Financial Sectors

Finally, funding agencies should promote linkages between commercial banks and MFIs as a means to increase the latter’s access to commercial sources of funds. Greater transparency of MFI performance would help in this regard. The donor community should assist

in the development of commonly accepted accounting, performance, and reporting standards with a wide range of stakeholders, drawing on international experience in this field. Donor efforts toward establishing standards and promoting linkages may build and reinforce trust and confidence of banks in MFIs, so that mutually beneficial business relationships can develop between them.

ROLES OF MICROFINANCE INSTITUTIONS

Balance Commercial and Social Objectives

MFIs are vulnerable to social mission risk if they do not have a clearly defined target market and monitoring mechanisms to ensure that they are providing appropriate financial services to the intended clients. MFIs are exposed to commercial mission risk if they do not set interest rates (and fees) high enough to cover costs and if they are not managed as a business. MFIs have pursued their social missions but need to balance these with commercial objectives. In order to expand outreach commensurate with demand in a sustainable manner, it is imperative that Sri Lankan MFIs move toward financial self-sufficiency through a combination of strategic and business planning and adoption of cost-recovery interest rates. The success of SEEDS, the most financially self-sufficient and largest microfinance NGO in Sri Lanka, demonstrates that only through achievements in financial sustainability can outreach be expanded in a substantial and sustainable manner.

Become More Responsive to Clients

To become more client responsive, MFIs need to learn how to collect and analyze data on client preferences and know when to make changes. MFIs should work with skilled and independent market researchers who can help clients identify and articulate their microfinance needs without swaying client responses to survey or focus group questions. As these clients express their interests, new product ideas will undoubtedly emerge.

Microfinance providers should also work to understand the reasons behind client desertion. A few MFIs track client retention, but none have a systematic method for collecting reasons why clients desert. Exit interviews and surveys can help an MFI to understand client desertion and avoid it through client recovery strategies.⁵⁹

Increase Cost Efficiency

In addition to bringing their commercial and social objectives into balance, MFIs should strive for cost-efficient operations. The emphasis on cost efficiency is in line with their social objectives, because increases in cost efficiency allow commensurate reduction in the interest rates. SEEDS' achievements in this regard are proof that cost efficiency can be attained even when serving poor clients. All MFIs have a responsibility to reduce costs in order to provide their clients with the most affordable, demand-driven microfinance services possible.

Improve Institutional Capacity

Institutional and management capacity in the vast majority of MFIs is extremely weak and improvements in several areas should take top priority. Missions should be clarified to incorporate a sustainable view of microfinance provision. Efficiency in operations should be made an institutional priority. Weaknesses in ownership and governance should be acknowledged and minimized through the establishment of clear lines of responsibility, staff incentives that promote sustainable outreach, and adequate systems to monitor progress toward commercialization. Increased attention should be given to building human resource strength in financial analysis and banking—at least to the extent that strategic planning and ways to operationalize such planning can take place. Improving boards of directors by including members who have understanding of business and finance is crucial.

Charging unsubsidized interest rates linked to cost recovery is also necessary. Interest rates should sustain the MFI operation. The

administration of many small loans, including processing and tracking services, is a costly operation. Consequently, MFIs need to charge higher interest rates than those charged by commercial banks but lower than those offered by money lenders. Properly prepared and audited standard income statements and balance sheets will increase the transparency of MFI operations, enable performance improvements, and ultimately lead to access to commercial sources of capital. Following are specific MFI recommendations.

Strengthen the ownership and governance of the CRBs

The ownership and management of the CRBs need to be improved, possibly consolidating the banks at the national or provincial levels and partnering them with other financial institutions. This recommendation is likely to be viable only if the multipurpose credit societies can see that they can have a greater profit potential from such a restructuring. The RDBs or a major commercial bank are the best candidates to partner with the CRBs.

Strengthen the management and information systems of the TCCSs

Lack of central management is a key constraint in shifting either the CRBs or the TCCSs as a whole into sustainable operations. The TCCS movement should consider moving toward greater central management not only at the national level—with SDB serving as an apex body—but also at the district level. For this, a first step should be to strengthen the technical skills of TCCS management at the national and district levels. The TCCS accounting system and management information systems need to be streamlined so that they are compatible at the primary, district, and national levels. Greater computerization must accompany the process. This could start in few districts as a pilot project with a few willing primary societies. Centralization would be a major task and the TCCS movement would likely need the

assistance of funding agencies. The auditing process must also be revamped. TCCS has come a long way since the 1970s under the new management. Millions of people now have their life savings in the movement, and it needs consolidation at this stage to avoid a major crisis because of lack of a central management and appropriate oversight.

Microfinance NGOs should improve transparency of their operations and accounts

Microfinance NGOs should separate their nonfinancial activities from their financial services and work toward defining a generally accepted chart of accounts. Once the chart of accounts is accepted, MFIs should also agree to have their annual financial accounts independently audited. Then, the process of developing financial and reporting standards can gain momentum with a view to eventual (reliable) ratings of microfinance NGOs. Such ratings are prerequisite for access to increasingly commercial sources of funds, “soft” loans from NDTF, loans with deposit collateral or other forms of guarantees from private commercial banks (such as HNB) at “commercial” interest rates, and eventually, loans without guarantees from commercial banks at “market” interest rates.

ROLES OF SUPPORT INSTITUTIONS

Second-tier Lender

NDTF is the main supplier of loan funds to microfinance NGOs, providing loans to 56 of them. However, despite its efforts to have a capacity-building focus, its main attention has been on loan recovery. Although NDTF appears successful at refinancing funds, it is managed by traditional commercial bankers seconded from the People’s Bank, who need greater exposure to best practices in microfinance. NDTF should be reorganized to become a strong second-tier and capacity-building agency for MFIs.

Credit Information Bureau

Credit information coverage and quality should be increased to allow MFIs to use this valuable tool in their efforts to commercialize. Thought should be given to expanding coverage to loan amounts less than SLRs100,000 (\$1,111), including more information (such as client past delinquencies and defaults, current outstanding balances [with information on guarantees and collateral], and the credit histories of guarantors and co-signers), and making such information more accessible to a greater range of semiformal financial institutions, such as the CRBs and TCCSs.

The Microfinance Network

The Sri Lanka Microfinance Network needs to be more focused on its prime task of developing the country’s microfinance market. For this purpose, it needs to concentrate more on the core subject than on “credit plus” work. The Network needs to be institutionalized and have its membership base expanded and categorized by groups such as practitioners, funding agencies, etc. The Network should also require regular statistics from its members (based on a common accounting format) on their financial and nonfinancial programs. This could be a start to establishing standards and a rating system of MFIs. The Network should also organize a working group on appropriate legal and regulatory reforms, especially regarding mobilizing savings by MFIs. In addition, the Network could possibly provide microfinance training and other capacity-building assistance.

The Network should introduce a policy for cost sharing for certain activities as well as a strategy for sustainability, graduating over time from subsidized training to full payment for certain activities, especially technical training. Membership fees from all members and participants in network activities should cover essential costs of learning and sharing seminars. Other funding agencies should support UNDP to strengthen and institutionalize the Network so that it can work toward becoming less donor

dependent. The Network should develop links with strong networks, such as those in the Philippines. The Network could play a significant role in creating a forum for learning and sharing by identifying and promoting examples of good practices from Sri Lanka and abroad.

Training Institutions

There is a dearth of training programs and marketing and technology services in entrepreneurship and small business development. The most common service providers to date have been microfinance NGOs that offer integrated social services; however, the supply is well below the potential demand for business development services. In addition, there are no organizations that specialize in microfinance training; no domestic universities or other training institutions offer courses specific to microfinance on a regular basis. The lack of affordable, high-quality microfinance training prevents MFIs from improving their capacity to move toward commercialization. Donor organizations need to develop the capacity and range of skills of one or two existing training institutions if MFIs are to make any headway in microfinance commercialization. The training hubs in India and the Philippines of the Consultative Group to Assist the Poorest may be helpful in this regard until sufficient domestic training capacity is developed.

CONCLUSION

The microfinance industry in Sri Lanka is at an early stage of commercialization, with at most one third of the industry operating on a commercial basis. The industry is characterized by pockets of microfinance commercialization, owing primarily to the personal vision and capability of a few bank managers who are providing microfinance in more economically active communities.

The pervasive presence of the Government in microfinance has hindered the entry of commercial microfinance providers and will continue to do so until its subsidized programs

are phased out. This will require a major shift in mindset on the part of government and funding agencies from seeing microfinance primarily as a poverty reduction tool to adoption of the financial systems view. To advance microfinance commercialization, this change in perception will also need to be adopted by the microfinance practitioners themselves.

Cooperatives have strong potential to make significant contributions to microfinance but are constrained by weak administrative and regulatory structures. The cooperatives need to be disconnected from nonfinancial service activities and should be allowed to become licensed banks. Alternatively, their federations should be strengthened and given the authority to truly supervise them. Efforts must be made to ensure the safety of the vast amount of savings deposits mobilized by the CRBs and TCCSs, through improved regulation and supervision or by allowing their deposits to be covered by the national deposit insurance program.

Given the limited supply of donor funds, the majority of microfinance NGOs would likely collapse if they were no longer able to mobilize savings deposits for onlending (i.e., conduct financial intermediation). Nonetheless, the Government needs to reduce its ambiguity toward the situation and begin enforcing the laws that prohibit microfinance NGOs from engaging in financial intermediation. However, it should simultaneously offer alternatives to microfinance NGOs, such as linkages with commercial banks to safeguard the deposits and provide loan capital, and create a regulatory structure for microfinance NGOs. This will enable them to transform into formal financial institutions, such as savings and development banks, with regulatory adaptations to accommodate the distinctive characteristics of microfinance operations.

Implementation of these recommendations will move Sri Lanka even further along the commercialization continuum, which should result in expanding access to microfinance by the poor as well as by higher-income clients. Clients would be offered a greater variety of products more customized to their specific needs and preferences, resulting in greater customer satisfaction. In turn,

clients' businesses should be able to grow and yield more income. This is a model that is likely to lead to economic growth for Sri Lanka as a

whole and create more wealth from which to pay for necessary social services, including those that reach the poorest segments of society.

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Annexes

ANNEX 1: SOCIAL INDICATORS

Item	Reference Year(s)		Reference Year(s)	
Population Indicators				
Total Population (million)	17.6	1993	20.0	2000
Annual Population Growth Rate (% change)	1.2		1.7	
Social Indicators				
Total Fertility Rate (births per woman)	2.4	1993	2.1	1998
Contraceptive Prevalence Rate	62.0	1990	66.0	1990–99
Maternal Mortality Rate (no. per 100,000 live births)	80.0	1980–92	30.0	1990–97
Infant Mortality Rate (below one year; per 1,000 live births)	17.0	1993	17.0	1998
Life Expectancy at Birth (years)	72.0	1993	73.3	1998
Adult Literacy (%)	89.0	1990	91.1	1998
Primary School Enrollment (% of school-age population)	108.0	1987–92	109.0	1997
Secondary School Enrollment (% of school-age population)	74.0	1987–92	75.0	1997
Child Malnutrition (% of under-fives)	36.6	1987–92	37.0	1990–98
Population with Access to Safe Water (%) ^a			70.0	1996
Rural	29.0	1985–87	65.0	1995
Urban	82.0	1985–87	88.0	1995
Population with Access to Safe Sanitation (%) ^b			75.0	1995
Rural	39.0	1985–87	60.0	1990–95
Urban	65.0	1985–87	67.0	1990–95
Public Education Expenditure as % of GDP	3.3	1992	2.6	1998
Public Health Expenditure as % of GDP	1.7	1990	1.4	1998
Human Development Index	0.704	1992	.733	1998
Human Development Ranking			84/174	1998

^a Percentage of households with either tap or tubewell source.

^b Percentage of households.

ANNEX 2: ECONOMIC INDICATORS

Item	1996	1997	1998	1999	2000 ^a
Income and Growth					
GNP per Capita (\$, current prices)	748	804	823	813	841
GDP Growth (%)	3.8	6.3	4.7	4.3	6.0
Agriculture	4.6	-3.0	2.5	4.5	1.2
Industry	5.6	7.7	5.9	4.8	8.2
Services	6.0	7.1	5.1	4.0	6.9
Savings and Investment (% of GDP)					
National Savings	19.0	21.5	23.4	23.9	21.7
Domestic Investment	24.2	24.4	25.1	27.1	29.1
Money and Inflation (Annual % change)					
Consumer Prices	15.9	9.6	9.4	4.7	6.2
Money Supply (M2b) ^b	11.3	15.6	13.2	13.4	12.9
Government Finance (% of GDP)					
Total Revenue	19.0	18.5	17.2	17.6	16.7
Total Expenditure	28.5	26.4	26.3	25.1	26.6
Overall Budget Surplus/Deficit (-) ^c	-9.4	-7.9	-9.2	-7.5	-9.9
Balance of Payments (% of GDP)					
Merchandise Trade Balance	-9.7	-8.1	-6.9	-8.7	-10.8
Current Account Balance	-4.9	-2.6	-1.4	-3.6	-6.4
External Payments Indicators					
Total Official Assets (\$ million)	1,937	2,029	1,984	1,639	1,043
Months of Imports	4.3	4.2	4.0	3.3	1.5
Debt Service Ratio	15.3	13.3	13.3	15.2	14.7
Total External Debts and Liabilities ^d	68.6	62.3	61.6	63.5	60.0
Memorandum Items					
GDP (current prices, \$ million)	13,898	15,092	15,760	15,779	16,570
Exchange Rate (SLRs/\$)	55.3	59.0	64.6	70.4	75.8

^a Provisional.

^b M2b includes the operations of foreign currency banking units.

^c Before grants and without privatization.

^d Percentage of GDP.

GDP = gross domestic product; GNP = gross national product.

Source: ADB. 2001. Sri Lanka: Country Strategy and Program Update 2002–2004. Available: <http://www.adb.org/Documents/CSPs/SR1/2001/default.asp>.

ANNEX 3: CENTRAL BANK RURAL CREDIT DEPARTMENT PROGRAMS

The various projects being implemented or supervised by the Central Bank of Sri Lanka's (CBSL) Rural Credit Department are listed in Box 2.1 (Chapter 2). Those understood to include microcredit components were noted by an asterisk. These microfinance projects are further described in Table A3.1.

In addition, the CBSL Rural Credit Department administers the Govi Sahanaya Scheme for forward sale contracts for agriculture produce. The main objective of the scheme is to ensure a stable price for farmers without affecting the sharp fluctuations in prices of agriculture produce during and between seasons. The scheme operates by the participation of farmers and farmers' organizations on the one hand, and the produce purchasers and processors on the other, while banks function as facilitators and financiers. It enables farmers to sell their produce in advance at an agreed price and encourages them to increase yield and improve quality. As a result, prices are stabilized at the forward contract price, assuring participating farmers of a stable market together with assured supplies. This promotes the growth of an efficient agro-processing industry, which enables consumers to enjoy an uninterrupted supply of quality products throughout the year. The forward contract prices enable participating financial institutions to minimize credit risks associated with agriculture lending and to enhance the recovery rates of cultivation loans. The total number of forward sales contracts in 2000 was 443, with a participation of about 17,000, including some 15,000 farmers as well as bankers and agents from government and nongovernment agencies.⁵⁹

Inaugurated in January 1990, with funds from the International Fund for Agricultural Development, the Canadian International Development Agency, and the Government of Sri Lanka, the activities of the Small Farmers and the Landless Credit Project continued in four districts (Kandy, Puttalam, Galle, and Matara), creating opportunities for the rural poor to organize themselves into people-based societies by building social capital as a safety net for development. Although the project terminated in 1997, the project operates currently by using funds from the revolving fund managed by the CBSL's Rural Credit Department (\$17.9 million in total funds). The formation of self-help groups is the most important strategy adopted by the project. The participants of the identified needy households (those with annual per capita income of less than SLRs5,600 (\$62), the income estimated as the minimum necessary to obtain at least 2,240 calories per day) are required to form themselves into groups of 4–10 persons (at least 40% should be women) and begin a savings plan in order to qualify for project benefits (for example, skills training and microcredit loans of SLRs5,000–40,000 [\$56–444]).

Table A3.1: Selected CBSL Rural Credit Department Project Lending Terms

Program	Interest Rate CBSL Lends to PFI per Annum (%)	Interest Rate PFI Lends to Client per Annum (%)	Credit Guarantee Available (%)	Max. Loan Maturity	Max. Grace Period (year)
Second Perennial Crop Development Project	6 (below AWDR)	2 (below AWDR)	60	12 years	6
Tea Development Project	6 (below AWDR)	2 (below AWDR)	60	17 years	7
Southern Province Rural Development Project	6	14		10 years	2
NW Province/Water Resources Development Project	6	14		5–10 years	1–2
North Central Province/Rural Development Project	PFI uses own funds	At market			
North Central Province/Participatory Rural Development Project	PFI uses own funds	7.5 to POs, then 17 to clients			
Matale-Regional Economic Advancement Program	3	7 to NGOs, then 16 to clients		3–5 years	
New Comprehensive Rural Credit Scheme	PFI uses own funds	12, but PFI receives 10 gov't. subsidy*	60	270 days	
Self-Employment Promotion through Microenterprise Project	PFI uses own funds	10 for regular loans, 12 for irregular, but PFI receives 10 gov't. subsidy	3	1	
Kegalle District Integrated Development (Revolving Fund) Project	4	10		3 months–4 years.	
Food and Nutrition Promotion Credit Scheme	3	6 to cooperatives then 10 to clients		5	2

AWDR = average weighted deposit rate; PFI = participating financial institution; PO = participating organization; RF = revolving fund.

* PFIs are permitted to charge the borrowers a penal rate of interest of 4% per annum in the event of delay in repayment within 270 days.

Source: CBSL 2000.

ANNEX 4: MICROCREDIT DEMAND CALCULATIONS

A popular method for inferring potential demand for microenterprise loans is to use the results from household surveys and basic assumptions about percentage of the population working in microenterprises, average number of employees per microenterprise, and average ability and willingness of microentrepreneurs to borrow funds. A shortfall of this method is that it does not take into account potential demand for consumption loans (noted as an important use of microcredit above) and it gives no indication for potential demand for other types of microfinance services, such as saving, payments, and transfers. Nevertheless, the potential demand estimated by following the steps outlined below provides some indication of the size of the microcredit market, depending on one's acceptance of the assumptions.

The steps are as follows:

- Take the size of the economically active population from census data.
- Determine the percentage of the population that is self-employed or working in enterprises with fewer than five employees and apply it to the economically active population to derive the number of people working in microenterprises.
- Make an assumption about the average number of employees per enterprise, to derive the number of potential microenterprises.
- Apply a discount factor (often 50%) to take into account that not all microenterprises qualify for or wish to have a loan at any given time.⁶⁰

Applying this method, the values of the parameters are as follows:

- The economically active population as of 2000 was estimated to be 6,828,000.⁶¹
- The Government of Sri Lanka does not have an official single definition of a microenterprise. Many agencies consider a microenterprise as one employing up to five persons, whereas a small enterprise employs from 6 to 25 people.⁶² Commonly, microenterprises are responsible for around 30% of employment in an economy. A survey in Kurunegala District indicated that 37% of sample firms employed up to four employees while a further 46% employed 5–24 workers.⁶³ This suggests that microenterprises provide at least 30% of total employment in Sri Lanka. If 30% is used, then the estimated number of people who are self-employed or working in a microenterprise is about 2,048,400.
- A survey of household activities in 1984/85 showed that there were 341,069 nonagriculture own-account entrepreneurs.⁶⁴ These employed 165,502 unpaid family workers and averaged 1.5 workers (full-time or part-time) per enterprise. Assuming a current average of 1.5 employees per enterprise, the number of potential microenterprises derived is 1,365,600. This appears to be consistent with other estimates that suggest that Sri Lanka's private sector had 1.5 million self-employed (during the early 1990s), which includes farmers, and that the majority of businesses are the micro and small-scale categories.⁶⁵

- Using a discount factor of 50% to take into account that only about half of microenterprises at any given time would qualify for or wish to have a loan, yields a potential microenterprise credit demand of 682,800. This is just slightly higher than the number (520,000) estimated in the early 1990s,⁶⁶ using a potential demand estimation technique based on household and labor force surveys.

This result for potential demand for microcredit by microentrepreneurs appears to be generally in line with the estimate of current supply of microcredit. Assuming the 70–30 percentage breakdown between microcredit for consumption purposes and microenterprise purposes, then 682,800 microcredit loans would be demanded for microenterprise use and 1.593 million microcredit loans would be demanded for consumption purposes; a total potential demand of 2.276 million microcredit loans.

In terms of the potential demand for microcredit by amount, the same logic suggests that approximately SLRs6.9 billion (\$76.5 million) is demanded by microenterprises for working capital or investment purposes and that approximately SLRs16.1 billion (\$178.4 million) is desired for household consumption purposes: an estimated total of SLRs22.9 billion (\$254.9 million) potential microcredit demand. Comparison of the total potential demand with the current supply of about SLRs18.2 billion (\$202.3 million) indicates that as much as 80% of the potential demand for microcredit may be currently satisfied.

ENDNOTES

- i The country studies adopt ADB's definition of microfinance provided in its Microfinance Development Strategy, "Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to the poor and low-income households and their microenterprises." Microcredit in the context of Sri Lanka generally refers to loans up to SLRs40,000 (about \$444)—although the industry's average microcredit amount is much lower, at around SLRs10,000 (\$111)—and other similarly small-scale financial services as described above.
- ii An MFI is defined here as a single organization (for example, a nongovernment organization providing microfinance) or a unit whose primary business is microfinance within a diversified institution (a microfinance unit within a commercial bank, for example).
- iii Based on the assumption that 75% of the CRBs, 25% of TCCSs and the Sarvodaya Economic Enterprise Development Services (SEEDS) are financially self-sufficient, the calculation uses a conservative estimate that assumes they provide an equal proportion of microfinance services. Using the figures in Table II.1 yields 433,217 CRB loans + 63,171 TCCS loans + 81,464 SEEDS loans = 577,851, divided by total number of outstanding loans (1,650,766) equals 35% of the total market.
- iv Also incorporates the assumption of a 70% use of microcredit for consumption and 30% use of microcredit for funding microenterprise activities.
- v McGuire et al. 1998, p. 264-266.
- vi McGuire et al. 1998, p. 266.
- vii The Central Bank of Sri Lanka has been restructured since this report was prepared. A new regional development department has been formed to handle rural finance and microfinance.
- viii Rhyne 2001.
- ix Similar to Christen's (2000, p. 5) use of the term, *mission drift* in this country study refers to the shift in MFI focus from targeting their provision of microfinance services to the poor or poorest to relatively higher-income clients.
- 1 The country studies adopt ADB's definition of microfinance provided in its Microfinance Development Strategy: "Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to the poor and low-income households and their microenterprises." Microcredit in the context of Sri Lanka generally refers to loans up to Sri Lanka rupees (SLRs)40,000 (about \$444), although the industry's average microcredit amount is much lower at around SLRs10,000 (\$111), and other similar small-scale financial services targeted as described above.
- 2 The financial systems approach to microfinance considers microfinance as part of a country's general financial services market, focuses on the development of sustainable financial institutions, and recognizes that microfinance clients are willing to pay the full cost of these services if they are designed and delivered consistent with their specific needs (Von Pischke 1988; Otero and Rhyne 1994).
- 3 The Central Bank of Sri Lanka has been restructured since this report was prepared. A new regional development department has been formed to handle rural finance and microfinance.
- 4 A microfinance institution is defined herein as a single organization (for example, an NGO

providing microfinance) or a unit whose primary business is microfinance within a diversified institution (a microfinance unit within a commercial bank is an example).

5 Similar to Christen's (2000, p. 5) use of the term, *mission drift* in this country study refers to the shift in MFI focus from targeting provision of microfinance services to the poor or poorest to relatively higher-income clients.

6 For example, Poyo and Young 1999, Christen 2000.

7 "*Formal institutions* are defined as those that are subject not only to general laws and regulations, but also to banking regulation and supervision. *Semiformal institutions* are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial laws, but informal insofar as they are, with few exceptions, not under banking regulation and supervision. *Informal providers* (generally not referred to as institutions) are those to which neither special banking law nor general commercial law applies and whose operations are such that disputes arising from contact with them often cannot be settled by recourse to the legal system" (Ledgerwood 1999, p. 12–13).

8 Fleisig 1996, p. 45; Lyman 2000, p. 39–41.

9 CBSL 2001, p. 22.

10 The 2000 GNP (at market prices) per capita in US dollars is a provisional estimate by CBSL (CBSL 2001, p. 1).

11 World Bank 2000, p. i.

12 World Bank 2000, p. i. The Termination of Employment Act and the Employee Provident Fund and Employee Trust Fund are examples of constraints to private sector development. There is a series of legal and regulatory barriers, such as needing the approval of the Labor Commissioner to release an employee under the former act, that come into force as soon as a microenterprise is officially registered. This discourages growth-oriented firms from registering and disqualifies the unregistered microenterprises from receiving certain types of assistance or receiving formal bank loans (Lucock et al. 1995, p. 15).

13 UNDP 2000b, p. 1.

14 The Department of Census and Statistics uses three sectors—urban, estate, and rural—based on their different socioeconomic characteristics. It defines urban areas as being governed under Municipal or Urban Councils. The estate sector comprises plantation areas having more than 20 acres (8 hectares) and more than 10 residential laborers with a single administration body. Rural areas are considered all areas not belonging to urban or estate sectors. In the early 1990s, the area under town councils was reclassified from urban to rural. The urban population in Sri Lanka is only 22% of the total population based on this categorization.

15 UNDP 2000b, p. vii.

16 CBSL 2001, p. 17.

17 CBSL 2000, p. 24.

18 Daily News, 18 October 2001, p. 16.

19 ADB 2002, p. 1.

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- 20 The repurchase rate is the rate at which commercial banks and primary dealers can invest their surplus funds in Treasury bills and bonds held by CBSL. The reverse repurchase rate is the rate at which commercial banks and primary dealers can obtain funds from CBSL against the collateral of Treasury bills and bonds. These two rates are the leading indicative rates in the money market. The statutory reserve requirement is the proportion of deposit liabilities that commercial banks are required to keep with CBSL.
- 21 At the end of 2000 there were 13 licensed specialized banks: 6 regional development banks, National Savings Bank, State Mortgage and Investment Bank, two long-term lending institutions, and three private savings and development banks (CBSL 2000, p. 210).
- 22 ADB 2000b, p. 297.
- 23 Conroy 1998.
- 24 CBSL 2000, p. 222.
- 25 This figure incorporates the assumption that 70% of microcredit is used for consumption and 30% for funding microenterprise activities.
- 26 GTZ/Sri Lanka 1999, cited in UNDP 2000b, p. 36–37.
- 27 Based on 80% of total disbursed amount (SLRs3,612 million) qualifying as microcredit, with an average balance of SLRs9,000 (based on self-reported data and CBSL 2000, p. 215).
- 28 Attanayake 1997, p. 24.
- 29 The CRBs attribute their receipt of training and systems introduced by People’s Bank at the time the latter was managing the CRBs as one of the main reasons for their profitability; another is having about 21% of the microcredit portfolio in pawning loans, which are highly profitable.
- 30 ADB 2001, p.42.
- 31 Information provided to the authors during interviews with bank officials.
- 32 CBSL 2000, p. 220.
- 33 CBSL 2000, p. 113.
- 34 Sharif (2000) points out importantly that even though the recovery rate of SBS loans is reported to be greater than 100%, it is not clear whether this is indicative of the quality of loan performance or other idiosyncrasies of the program itself. For example, access to Samurdhi food stamps is conditional on loan repayment. Given that money is fungible, one could argue that what is being observed is simply a net re-transfer of Samurdhi food stamps in the form of loan repayments.
- 35 Conroy 1998, p. 290.
- 36 UNDP 2000a.
- 37 Gunatilaka and Salih 1999.
- 38 UNDP 2000a, p. 24.
- 39 McGuire et al. 1998, p. 264–266.
- 40 CBSL 2000, p. 222.

- 41 According to a World Bank study in 1995 conducted by Gallardo, Randhawa, and Sacay (1997).
- 42 CBSL 2000, p. 221.
- 43 ADB 2000b, p. 291.
- 44 ADB 2000b, p. 286.
- 45 McGuire et al. 1998, p. 267.
- 46 UNDP 2000a, p. 22-23.
- 47 CBSL 2000, p. 219.
- 48 McGuire et al. 1998, p. 266.
- 49 Berenbach and Churchill 1997, p. 72.
- 50 Ish et al. 1999, p. 43.
- 51 Fleisig 1996.
- 52 Rhyne 2001.
- 53 Cited in Rosenberg 1998.
- 54 MBB 1997.
- 55 World Bank 1999, p. 19.
- 56 Remenyi 1991.
- 57 Katimbo-Mugwanya 2000.
- 58 Churchill and Halpern 2001.
- 59 CBSL 2000, p. 216.
- 60 Christen 2000, p. 22-23.
- 61 CBSL 2001.
- 62 Lucock et al. 1995, p. 7.
- 63 Ibid., p. 9.
- 64 Department of Statistics and Census 1986.
- 65 Lucock et al. 1995, p. 7.
- 66 Lucock et al. 1995, p. 9.