



Ministry of
Finance and
Planning

Key Principles of Microfinance

Explained by Microfinance Practitioners and Promoters



gtz

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This Brochure is...

An attempt to provide a common understanding of the principles of microfinance endorsed by the Consultative Group to Assist the Poor (CGAP).

A voice for practitioners and promoters from the sector who explain how these principles can be seen in the local, regional and international contexts.

A picture of the Sri Lankan microfinance sector, which is on the threshold of a major transformation. Many factors contribute to the fact that microfinance in Sri Lanka is now highly debated in public. Many actors provide financial services for the poor for various different reasons and with different methodologies. This brochure will help to understand the sector and to define a set of criteria which are necessary for a sustainable microfinance sector that can help poor people to get out of poverty.

We hope that you will find this brochure interesting and informative and would like to thank all those who have contributed to this brochure.



Dr. Dagmar Lumm
Senior Advisor
GTZ—ProMiS
(Promotion of the Microfinance
Sector)



Dr. Damitha de Zoysa
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Microfinance means building financial systems that serve the poor





Microfinance means building financial systems that serve the poor

How do financial systems help the poor to get out of poverty?

Experience shows that financial systems serve the poor best when they are inclusive. In an inclusive financial system, as many people of a country as possible are reached and accepted as customers by financial institutions. This also includes the poor strata of society, however not as recipients of charity or welfare but as clients who use financial services and pay for them. An inclusive financial system offers a wide range of products including products specifically tailored for the needs of the rural and urban poor. These products such as savings, different types of loans, payment and remittance services, insurance, and leasing should be offered at a cost which is as low as possible but still allows the financial institution to remain profitable and sustainable.

Sustainable financial institutions are reliable partners for the poor in achieving their economic objectives and helping in emergency situations. They are also more stable, reliable and less expensive than the traditional informal sources of financial services used by the poor such as money lenders, traders, neighbors, family or friends. Just like anybody else, poor people need these services on a permanent, low cost and trustworthy basis backed by a legal system that protects all clients, including the ones with only small amounts of money.

It is *permanent* access to financial services that helps poor people to get out of poverty. How does this happen? In financial terms, permanent access to financial services allows poor people to better allo-

cate their resources and to better manage their cash flow. Translated into easier terms, this means that poor people can much better use their own talents and skills, which we should not underestimate. Offering them a wide range of products, including insurance, can then help to keep people out of poverty.

Under which conditions can a financial system for the poor be integrated into the country's mainstream financial system?

One precondition is the existence of a conducive and country-specific legal and regulatory framework for microfinance providers in order to protect customers, to keep the sector transparent and promote good governance and the use of best practices as well as to foster access to capital from national and international sources. Additionally, a good infrastructure for training & consultancy, auditing, rating, and information technology (IT) needs to be in place to support MFIs in improving their efficiency and effectiveness. The integration of microfinance providers into credit bureaus can improve transparency and reduce the risk of over-indebtedness of the clients. Local and international professional networks improve exchange of ideas, advocacy, and the dialogue between microfinance providers and government authorities.



Dr. Dagmar Lumm
Senior Advisor
GTZ—ProMiS

Microfinance is a powerful tool to fight poverty





**Chandula
Abeywickrama**
Deputy General
Manager
Hatton National Bank
and Chairman of
Banking with the Poor
Network

Has microfinance contributed to reducing poverty in Sri Lanka?

There is no simple answer to the question. Sri Lanka's poverty level, which was around 22% has come down to 15% in the recent past. The poor in Sri Lanka has been indentified in three categories: Urban poor, Rural poor & Estate poor. The many initiatives during the last four decades in the areas of social upliftment, poverty alleviation and microfinance have contributed to the establishment of many organizations, albeit lacking a cohesive approach. These have targeted the urban and rural sectors. These two sectors have experienced a poverty reduction and the microfinance industry can claim that it has contributed towards this. However, amongst the estate poor, the poverty levels have actually increased and there are no visible involvements of microfinance Institutions initiating sustainable programs to reduce poverty in the estate areas.

What other impact does microfinance have? For instance, can microfinance empower people and reduce vulnerability to external shocks?

In Sri Lanka and also in the Asian region, we have experienced nearly four decades of initiatives in the area of social upliftment, poverty alleviation and microfinance. The microfinance industry having reached a certain maturity level in our region, has now gone beyond the area of micro credit more into financial inclusion, which covers micro savings, micro credit, micro insurance and migrant worker remittances. Creating access to financial services for the people at the bottom of the pyramid has taken many forms. Firstly, savings

have enabled people to build up capital and create a habit among people with the opportunity, to save in little amounts by putting their earnings in a program with a very clear accessibility to the savings products and services. This has indeed reduced the vulnerability to external shocks. Secondly, in the area of identifying micro level entrepreneurial talents and skills and by supporting them with the necessary micro capital through micro credit, hundreds of thousands of people in Sri Lanka, and also millions in the Asian region have become promising micro entrepreneurs who are on the path to becoming successful entrepreneurs. Thirdly, insurance services, which were enjoyed by the advantaged sector have now been made available for those at the bottom of the pyramid. This in turn has empowered the people of this sector and reduced their vulnerability to many external shocks. Fourthly, in Sri Lanka, nearly 10% of the population as migrant workers contribute about \$ 3.0 Bn annually in foreign exchange. Linking them to a sustainable micro savings program can open up many opportunities in the area of microfinance to be a Micro Entrepreneur. Also an area of great empowerment is being undertaken by a few Banks.

Microfinance is a powerful tool to fight poverty

Where and when did microfinance originate?

The concept of microfinance originated in the mid-1970s in Bangladesh through a pioneering experiment by Dr Muhammad Yunus, then a Professor of Economics. Since then it has become instrumental in helping the poor to improve their livelihood. It has been evident that microfinance helps in creating employment and empowering the poor in their own socio-economic arena. Microfinance refers to the provision of financial services to poor or low-income clients, including consumers and the self-employed. It is a credit system, where the loan size is small and the loan duration short. In broader terms, it refers to a movement that envisions “a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers”.

Why did microfinance originate?

Traditionally, the formal banking institutions have been serving only the needs of the commercial sector and providing loans for middle and upper income groups. These banks failed to extend their services to the informal sector and low income earners due to non-availability of collateral for the banks to use in case of default. It is against this background that micro finance was introduced as a way of providing uncollateralized loans to borrowers who have no constant income. Poor people rarely access services through the formal financial sector. Instead they address their need for financial services through a variety of financial relationships, mostly informal. In addition, money lenders from the informal credit market charge very high rates restricting poor people’s access to credit earnings.

Can microfinance empower people and reduce vulnerability to external shocks?

Different studies show that microfinance helps very poor households to meet basic needs and protect against risks. The use of financial services by low-income households is associated with improvements in household economic welfare and enterprise stability or growth. By supporting women's economic participation, microfinance helps to empower women, thus promoting gender-equity and improving household well-being. Microfinance has two distinct advantages over charitable giving. Firstly, it is sustainable and creates independence from aid, not dependence on it. By giving a small loan to an individual, we hope to give them the ability to work their own way out of poverty. Secondly, it means that the money goes directly to the people who need it - bypassing the bureaucracy and corruption that can compromise traditional methods of charitable giving. A GTZ study on outreach of financial services in Sri Lanka states that “a considerable proportion of households feel that their utilization of financial services has a positive impact on factors such as household income, housing conditions, employment opportunities, overall standard of living and the ability to cope with vulnerability and risks.” The Oxfam-Novib evaluation report in 2009 certifies “a very high level of women’s participation in economic activity”. This shows that most women microfinance clients are not just a conduit for their husbands to take loans but active micro business managers, thus empowering them significantly.



Muhammed Faridur Rahman
Former Country
Manager
BRAC Sri Lanka

Microfinance is about building permanent local financial institutions





Roshini Fernando
Senior Microfinance
Specialist
GTZ—ProMiS

Why can money not simply be channeled through banks to the poor? Why do we need permanent microfinance institutions?

Banks usually impose collateral requirements and other conditions which low-income individuals and micro enterprises generally find difficult to meet. Furthermore, the operating model of microfinance institutions which usually relies on delivery of services through a network of field officers (the concept of “door-step banking”), is more convenient for less mobile customers living in remote areas who could not afford the transport and time cost of travelling to banks which are mostly located in urban areas. For banks, their high cost structure makes the small transaction, door-step banking model of microfinance less attractive so very few of them consider microfinance as an important area of activity. Therefore, in areas which are not served by microfinance institutions, those who are considered “un-bankable” have no choice but to obtain finance from informal sources such as money lenders, whose services are provided at very high cost to the borrower.

Microfinance institutions work largely through non-collateralized lending, are present in rural locations and maintain close links with their clients. Therefore, their operating model is more suited to serving the financial needs of low-income individuals and micro enterprises. Microfinance institutions play an important role in serving these clients by providing them with a means of improving their income, reducing their vulnerability to unforeseen events and their dependence on very high cost informal sources of finance. It is im-

portant that these institutions are sustainable so that their clients can have continued access to financial services.

What does “inclusive financial sector” mean?

An inclusive financial sector is one where access to financial services is available to all segments of society and not confined only to certain groups such as the wealthy and big businesses. The United Nations estimates that only 5% of low-income households around the world have access to financial services and even this is provided mostly by informal sources rather than the formal financial sector. The degree of financial inclusion differs widely across countries, generally being much lower in developing countries; e.g. 99% of the population of Denmark has access to a bank account compared to less than 6% in Tanzania.

There are many conditions necessary to foster the development of an inclusive financial sector. These include a sound regulatory and supervisory framework, sector transparency, sustainable institutions, a broad and innovative product range which accommodates the financial needs of low income people and micro and small enterprises, strong consumer protection safeguards and financial literacy among clients and potential clients of financial institutions.

Microfinance is about building permanent local financial institutions

How should international development partners support the sector?

There are three main areas where development partners can support the sector in Sri Lanka: (1) Designing and committing to a common framework for development partnership involving all relevant development partners, in consultation with all microfinance sector stakeholders; (2) the facilitation of debt and equity to sustain and expand operational and financial sustainability of MFI partners; and, (3) direct provision and facilitation of quality technical services that contribute to institutional and human resource development from start up to successful transformation.

Success in the sector will depend on the ability of development partners to agree to a code of conduct, develop a congruence of vision with a shared commitment among partners to avoid negative competition, market distortion and the promotion of monopolies. Collaboration between development partners can reduce costs as well as avoid leakage and duplication. Collaboration in post-conflict areas where efficient social and human development initiatives have to be combined with directed microfinance to restore livelihoods is of the utmost importance. The recent refinancing by NDTF* to expand MFI portfolios has supported the increase in outreach and sustainability.

However, continued operational and financial sustainability depends on refinancing support from commercial banks. Development partners can help in forging bank-MFI partnerships through innovating new products such as loan guarantees, rating funds, and workshops

to develop the confidence of banks in MFIs. Also, MFIs will need technical support and guidance in negotiating suitable terms and conditions with commercial banks.

Development partners must envision long-term partnerships to enable successful transformation of MFI partners, either by forging long-term relationships or handing over partners to other development partners who can support the MFI. Successful transformation from start up to formalization under the new regulatory framework will involve the establishment of appropriate legal structures, governance and management structures and sustainable portfolios. Development partners can help attract new development partners especially those that can provide equity and debt to MFIs.

What can Sri Lanka learn from other countries?

Cambodia and Bangladesh have successful models for development partner consortiums that have led to the success of their MFI partners, by avoiding duplication and ensuring optimization. The sector in Cambodia has good examples of how development partners can support successful transformation and formalization of MFIs. India and Bangladesh have successful models of bank-MFI linkages that have been supported by development partners that have shared the vision of their MFI partners.

Nina Nayar
Consultant

* *National Development Trust Fund*

Financial sustainability is necessary to reach significant numbers of poor people





Charitha Ratwatte
Managing Director
Sri Lanka Business
Development Centre

How has the Sri Lankan Microfinance sector developed so far?

Microfinance has a long history in Sri Lanka. It started before independence, in the 1900's, when the Cooperative movement started. Sanasa started in 1906 as a savings and credit movement. The next development was in the 1980's when the National Youth Services Savings and Credit Cooperative (NYSCO) and Sarvodaya's SEEDS began operations. In the early 1990's the Janasaviya Trust Fund (JTF), a state driven poverty alleviation initiative supported by donors began to enroll Partner Organizations for its Savings and Credit Program. A large number of civil society organizations got into micro finance with JTF support. JTF is known as the NDTF today. The post Tsunami reconstruction program saw a large increase in microfinance which was used as a tool to re stabilize communities displaced by the Tsunami. The 2009 resettlement of post-conflict IDPs provides a unique opportunity for expanding microfinance, as it is one of the best known ways of stabilizing and resettling a displaced community.

What are the major challenges to reach sustainability in Sri Lanka?

1. A policy lacuna — The official policy could only be described as "Benign Neglect" with a few exceptions, such as periodic state loan waivers which destroy a loan culture carefully built up over the years. We need to make the sector transparent, certain and predictable. There are four possible ways of doing this, not necessarily mutually exclusive:

- State intervention- by way of i) Clear enforcement of the provisions of the Banking Law regarding taking of financial deposits from the public. ii) Removing legal obstacles for foreign investment in the sector. For-profit microfinance interventions are being seen world wide as a development tool of great promise and impact. iii) The principal regulator, the CBSL, setting up a working group of all the relevant regulating authorities under the various statutes, who agree on a generally applicable, transparent set of guiding principles developed with the participation of the microfinance players.
- Self regulation by the players, with a Code of Conduct implemented by an autonomous Ombudsman.

2. Access to Funds is still an issue for most of the MFIs.

- Presently deposits by members is a major area of fund mobilization by MFIs. The legal provisions on this in the Banking Act must be strictly enforced.
- The aid environment must be made favourable to donors seeing microfinance as an opportunity to positively affect the development process in Sri Lanka, especially in the resettlement and restabilization of displaced communities.
- The apex lender the to MFIs — NDTF — must be reformed and reorganized in terms of the CGAP recommendations for apex lenders in the sector to make the institution more autonomous and independent.

Financial sustainability is necessary to reach significant numbers of poor people

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- Some MFIs deposit their capital with Commercial Banks and borrow funds for on-lending. This must be streamlined, to improve integration of microfinance with the formal financial system with tax incentives for Commercial Banks which support MFIs in this way.

3. Taxation of MFIs and financial control must be made more microfinance friendly. There must be an accounting standard for MFIs and auditing procedures must be improved. Microfinance must be treated as a thrust sector and supported by tax incentives.

4. Foreign investment in the for-profit microfinance sector is a possibility as this has been successful in many developing countries. The legal regime for this to be facilitated must be created.

5. The role of state sector players - the Cooperatives, Samurdhi, and Gemi Diriya, must be regulated on a level playing field basis. Presently, regulation is very weak and has a potential for a crisis, if not monitored carefully. The principle of equality before the law vis-à-vis other non state MFIs is being violated, which has the potential for causing destabilization in the future. Samurdhi is exempted from the Finance Companies Act, but not the Banking Act. Gemidiriyā operates in a seemingly legal lacuna. These issues must be addressed.

Why is financial sustainability so important?

In 1970's and 1980's financial sustainability was not a key factor as grant money was the main source of capital to provide microfinance solutions to the poor. But now with loan funds being the main source of capital for MFIs, financial sustainability is of utmost importance. An MFI needs to retain and enhance its capital in order to reach out to existing clients on a continuous basis with repeat loans as well as to expand to new clients. The key tasks to achieve financial sustainability are zero tolerance for delinquencies, a culture of cost consciousness and efficiency in loan issues and recovery. Costs must be kept to what is absolutely required and a strong emphasis on controlling costs must prevail in the organization. A good MIS system is a must and internal checks as well as an internal audit should ensure that figures reported are accurate.

How can modern technology help MFIs to reach more clients and/or to be more efficient?

In the 80's nearly all microfinance documentation was done manually. Then computers came into vogue and spread sheets such as Excel were used at least for summarising data. Now most leading MFIs use tailor made or off-the-shelf software for information management. These software can handle large volumes of data fast and also generate statistics, ratios, indicators as well as accounting statements speedily. One other key modern invention which is still not prevalent in Sri Lanka but is increasingly used in India and few other countries is the mobile phone. Mobile phones as well as swipe cards can help MFIs to be more efficient in the future.

Dulan De Silva
Chairman
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interest rate ceilings hurt poor people
by making it harder for them to get credit





Dr. Nimal Fernando
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Are interest rates for microcredit high?

If we think of the full cost of providing sustainable microcredit, the rates charged by most microfinance institutions in today's markets are not high because the cost of providing microcredit on a sustainable basis is typically high. Charging prices high enough to cover costs and earn a reasonable margin to gradually expand the operations is an essential practice for any business. No business can survive in the medium to long-term without this practice.

Microcredit interest rates may not appear high if we compare with typical interest rates prevailing in most informal commercial credit markets, commonly known as informal sector money lender's credit.

Conversely, these interest rates may appear high if one compares them with the lending rates of a typical commercial bank or rates charged by most state-owned lending institutions. However, such comparisons are seriously flawed for many reasons. Commercial banks do not provide collateral free loans like MFIS. Commercial banks have lower administrative costs on a per unit basis of loans. Their average loan size is much larger than that of an MFI. Administrative cost of a Rs1.0 million loan is much lower on a per unit basis than the administrative cost of a Rs10,000 loan. On this basis, even if everything else is the same, interest rate on a microloan has to be higher. The cost of funds of commercial banks is also generally lower partly because they have access to a large pool of cheaper funds in the market including public deposits. State-owned banks may provide microcredit at lower nominal interest

rates than MFIs. This may be due to the fact they get subsidies from the government to meet part of their costs. More importantly, empirical evidence suggests that borrower transaction costs associated with subsidised credit from state-owned institutions are generally high. One must be careful to compare apples with apples, not with oranges, when comparisons are made.

Do you think that in Sri Lanka financial literacy and consumer protection are sufficiently addressed, especially for poor people?

I do not think that the issues of financial literacy and consumer protection are sufficiently addressed in Sri Lanka. The Government has just begun to take interest in these issues. But there are huge gaps in information and solid research is needed to make informed decisions and formulate effective policies and programs. Also, the subject has not yet received adequate public discourse. In my view, there is a lot to do in both financial literacy and consumer protection, particularly for the poor. However, we must not forget financial illiteracy is common among the non-poor as well. We need public-private partnerships and comprehensive programs to deal with this. We must also learn from international experience. I am pleased to learn about the Central Bank of Sri Lanka's increasing interest on these issues. Yet, in my view, the Central Bank of Sri Lanka must play a more active role in promoting financial literacy and ensuring consumer protection to build a financially democratic society.

Interest rate ceilings hurt poor people by making it harder for them to get credit

Can poor people pay high interest rates?

It is generally known that interest rates for micro loans are higher than interest rates for commercial bank loans. This is mainly due to the fact that making many small loans costs more than making a few large ones. Micro loans are very cost-intensive for MFIs since credit technology is based on a client-MFI relationship and loan amounts are very low and not collateral based. Nevertheless, poor people need to borrow money to take an active role in the economy, to build up social empowerment and to sustainably improve their living conditions.

Many poor people are excluded from formal financing and only have access to informal sources, which are much more expensive than the interest rates MFIs charge (money lenders often charge more than 100% p.a.).

But can these poor people pay such high interest rates? Our experience says: Yes, they can! Poor people generally consider that ongoing access to credit is more important than the actual costs of the loan. Offering appropriate loan products to meet the needs of the poor mitigates the impact of high interest rates. People are prepared to pay high interest rates for good services like quick loan disbursement, confidentiality and flexible repayment schedules. Besides that micro entrepreneurs normally work in the informal sector and returns on their business activities are higher per unit of capital compared to those on large businesses.

Why do interest rate ceilings hurt poor people?

Interest rate ceilings hurt poor people by making it harder for them to get access to credit. Governments defining interest rate ceilings do not consider the complex cost structure of microfinance operations in their calculation. Thus, interest rate ceilings are often set too low for sustainable microfinance.

One negative aspect of interest ceilings is that MFIs will grow more slowly and will refuse to work in cost-intensive markets such as rural areas because they cannot work on a cost covering base anymore. Commercial banks will be deterred from expanding into higher-cost rural or microcredit markets and potential investors might also be discouraged to further support the sector.

Although the overall objective of interest rate caps is to avoid excessively high interest rates, the reality experienced in many countries during the last years has shown that interest rate ceilings exclude poor people from the financial sector rather than supporting them to be part of it.



Kathrin Haerdle
Project Manager
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Poor people need a variety of financial services, not just loans

&

The main role of the government is to create an enabling environment



Poor people need a variety of financial services, not just loans



Renuka Hewage
Chief Executive Officer
Sewa Finance

Can other financial services such as savings or insurance reduce the vulnerability of poor people?

Absolutely. Mobilizing savings is a very powerful tool for reducing vulnerability of the poor people. When considering community based organizations (CBO), small groups or even individuals, we can measure their financial sustainability by observing their saving habits. In some ways the value of savings is less important than the discipline of the process. Most of the CBOs in Sri Lanka are formed for project based activities & this creates a dependent culture, however there are some CBOs who form on their own in order to meet a local financial requirement or to fulfill social obligations. Whilst a CBO or small group is a good way to create “social capital”, they also need assistance to maximize the use of this capital. At the ground level there are many simple saving methods amongst communities. When the scheme is developed locally and built up gradually there is a greater sense of ownership and there is also a stronger motivation to maintain it. At this point they need the help of others to develop a disciplined method of keeping records & maintaining the survival of the organization. At this stage microfinance institutions don't necessarily need to increase their indebtedness but instead can help to start new income generating activities & provide extra financial assistance which cannot be fulfilled on their own. By providing different kinds of services, such as livelihood training, service providers can minimize the long term vulnerability of these people and hopefully improve their status both from a social and financial perspective.

Microinsurance is another powerful tool to reduce vulnerability of poor people but it is a much misunderstood concept in many Asian

countries. Communities often have other coping mechanisms in times of crisis, such as borrowing from the extended family or neighbours, or seeking assistance from a reserve fund created at a CBO level. However it is clear that this does not always prove sufficient, especially if the whole community is affected by a similar problem. Insurance policies can therefore be used very well to reduce risk and vulnerabilities.

Could new technologies be used to offer innovative services to clients?

When considering new technologies we must consider not only those associated with the digital age but also processes and machinery that can help communities improve their revenue by capturing a larger share of the supply chain.

For example by utilising micro-leasing services, a community could buy a large grinding machine to process spices or packaging equipment to make products ready to market. These are not new technologies internationally but new to these communities and would dramatically increase their share of the end price of the goods. With regard to mobile technology there are many areas where they have been shown to support independent farmers. Giving them access to crop prices from around the region ensures that they are aware of where and when they will get the best prices for their goods. Additionally e-banking, whilst still in its infancy worldwide, could dramatically reduce transaction costs for MFIs, and therefore enable them to bring interest rates down for borrowers and hopefully increase rates for savers. The rapid increase in mobile phone ownership makes this a very real possibility in the near future.

The main role of the government is to create an enabling environment

In which ways can the government enable the sector to develop?

The role of the Government is to create an enabling environment for the sector rather than directly providing the services. In my view, this can be done by:

- Creating the right mix of macro economic fundamentals conducive for the development of the sector
- Development of infrastructure facilities especially in the rural areas, such as in Bangladesh
- Formulating a clear Government policy for the microfinance sector which should be published in the form of a white paper or any other document in the public domain. The policy should not be repressive but conducive for the development of the sector.
- The role of all Government arms in implementing the published policy should be very clear. This should include the role of the foreign investment and exchange control regimes. Subject to other statutes, this policy should be friendly towards attracting foreign funds.

How can a proper system of regulation and supervision enable the development of the sector?

Regulatory regimes should be introduced taking into account the country specificities. Such regimes should be development oriented and not repressive and they should enable the development of a sound and sustainable network of institutions with the capability of serving the industry on a long term basis. Internationally accepted recommendations are relevant to Sri Lanka. However, they should be modified to suit our environment.

A sound regulatory regime, *inter alia*, has the following advantages:

- It builds confidence in the sector, which in turn helps its development .
- It helps to build strong and sustainable institutions in the sector.
- It helps attract funds to the sector from other formal institutions by way of borrowing.
- It helps attract funds from other investors both local and abroad, thereby enabling transfer of technology know-how
- The presence of a regulator in the sector which serves a large part of the population leads to bringing them into the formal financial sector & thereby helps financial inclusion.



Rose Cooray
Former Deputy
Governor
Central Bank
of Sri Lanka

Microcredit is not always the answer



Microcredit is not always the answer



Samadanie

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Assistant General
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Can microfinance reach the poorest of the poor?

Microfinance, for some, is a comprehensive solution to the wide range of issues related to poverty; for some it is 'innovative investment', for some an effective hook to hang projects that can attract low-cost funds and for others it is simply a financial tool.

Microfinance can reach the poorest of the poor. However, it must not be forgotten that it is but a starting point and not an end in itself. To alleviate poverty, microfinance has to be informed by a comprehensive vision and tailored to realize desired development objectives.

The microfinance industry is predominantly characterized by small amounts of credit delivered to those in the low-income bracket to strengthen them economically and empower them to start their own enterprises. However, not all poor people are entrepreneurs or able to absorb credit. The poorest of the poor in many countries have long histories of depending on state subsidy schemes or charity funds from non governmental organizations or both. The experiences of many microfinance institutions that adopt minimalist strategies and limit their operation to only credit (and that also only for business purposes) and to a limited segment of the community (low income women or economically active poor), are structurally destined to run into problems when addressing the issue of poverty. This is because poverty is not simply a problem of 'economics'. Addressing poverty, therefore, is always a 'finance plus' issue.

Addressing the diverse needs of the poor through unconventional (sometimes untested) and innovative methodologies that can be sustained in a high risk market requires considerable investment and a scientific approach.

If microfinance initiatives seek to empower the poor and secure for them a degree of freedom from being dependent on outside credit, then all relevant strategies have to be taken into account and be placed in the context of larger social and economic growth. A piecemeal approach will reach individuals and even free them from endemic cycles of poverty for a temporary period, but will remain unsustainable and ineffective when it comes to aggregate poverty alleviation.



The key bottleneck is the shortage of strong institutions and managers





Anura Attapatu
Chief Executive Officer
Development
Facilitators

What kind of knowledge is necessary to run an MFI?

Microfinance means providing financial services to the poor in a long term sustainable manner. In relation to the microfinance sector in Sri Lanka which is very vibrant at present and also has over 50 years of known history, the following specific areas can be identified as key areas of requirement of knowledge.

- Methodologies and approaches that provide adequate efficiency and thus sustainability for MFIs while maintaining a poverty focus
- Technical aspects such as accounting, loan appraisal, loan tracking, delinquency management, costing and pricing and social performance management
- Soft aspects mainly human resource management and development.

Will continuous monitoring and analysis of financial performance of an MFI support the sustainability of its service delivery? If yes, how?

The answer to the question is “yes”, but it should be noted that the continuous monitoring and analysis of financial performance alone are insufficient to gain improved financial sustainability. One of the dual objectives of microfinance is sustainability or profitability. Financial performance of the MFI indicates the sustainability aspect of an MFI’s operations. Usually the accounting systems, whether

computerized or manual, generate standard accounting statements such as the Profit & Loss, Balance Sheet and Cash Flow Statements on a monthly or yearly basis. These statements alone do not help understand the financial performance of the MFI. From these statements we can derive financial performance indicators such as Operational Self-Sufficiency (OSS), Financial Self-Sufficiency (FSS), Return on Assets (ROA), Return on Equity (ROE), Debt-Equity, cost related ratios, liquidity ratios etc. These parameters indicate the healthiness and hence sustainability of an MFI. Such an analysis should be done in reasonable intervals, for example ratios like OSS and FSS should be tracked monthly whereas ratios like ROA and ROI can be tracked in longer intervals such as quarterly or annually. As the loan portfolio is the main and most important asset of an MFI, the continuous tracking and monitoring of the quality as well as quantity of the portfolio is also an important aspect for the sustainability of the MFI. Such a frequent tracking will provide the MFI with trend information about their sustainability indicators which can then be compared with projections and timely corrective actions can be taken to rectify any variations. The continuous analysis will help understand the effectiveness of rectification strategies and further improve on those. The MFI may improve on projections if they turn out to be unrealistic for the MFI.

The key bottleneck is the shortage of strong institutions and managers

Which kinds of support can government and donors provide in this regard?

In microfinance, the institutional set up which supports the industry will be classified under the meso level. Meso level includes the basic financial infrastructure and range of services required to reduce transaction costs, increase outreach, build competency levels and foster sustainable development of the sector. The institutions include audit firms, credit bureaus, rating agencies, professional networks ,trade associations, transfer and payments systems, Information technology and other technical service providers, training and consulting firms.

Lack of human and institutional capacity in microfinance institutions remains the key constraint to extending access to financial services and enabling vibrant growth of the industry. The lack of capacities may manifest in the areas of technical skills, general management skills structures and procedures and transparency and efficiency at institutional levels. Therefore it is imperative to ensure that an adequate supply of technical services and advice is there to remedy this. Hence this can be a coordinated activity of both government and donors. In this effort, there should be a coherent and syndicated approach by both parties otherwise the results would be less effective and result in a waste of resources.

As the overall policy maker and guiding body of any country, the predominant responsibility for prioritizing & optimizing resources and directing them to the needed segments lies with the government. Establishment of transparent and equitable systems

for allocation of resources and creating an enabling environment for such interventions is therefore very important. In such a situation, donors should work in close collaboration with the Government to fulfill their mandates and development goals. Providing assistance in introducing best practices, improving management and specific technical skills could be some of the identified areas of possible support. Building on new technology, standardizing procedures and protocols could be introduced as a means of institutional support. In addition, building linkages with appropriate international bodies and representatives at institutional level can have a significant impact in improving the existing institutional set up.



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Microfinance works best when it measures and discloses its performance



Are there any standards on how to measure performance?

Performance measurement is always linked with trend analysis to get an overview of the performance of an MFI over time. This needs to be combined with local and regional standards based on best practices.

Best Practice Standards: CGAP, Im-Pact, AMFIU(PMT) follow the best practice standards based on measurement tools for both financial and social performance. MIX Market's MicroBanking Bulletin analyzes and discloses regional standards periodically. In Bangladesh PKSF sets standards for MFIs in terms of performance indicators through reporting systems and providing off-site consultancies. Sri Lanka needs to adopt such focal points to address some of the technical issues and provide such information to microfinance operators, promoters, donors and investors. MFIs should follow the standards based on the country context.

Microfinance Rating: Microfinance rating gives value addition on the overall performance of MFIs for global recognition. These are accepted standard practices applied to measure performance. The Key Performance Indicators (KPIs) are many but the following indicators are very important considering the minimum requirement for measuring portfolio quality:

- **Risk Performance:** Portfolio at Risk (PAR), Loan at Risk (LAR), and On time Recovery Rate (ORR)

- **Profitability:** Average return on equity, Portfolio yield, Total asset yield
- **Efficiency:** Operating Expenses Ratio, Cost per loan, Personnel productivity, Gross portfolio per staff, Liquid Assets/Total Assets
- **Sustainability:** Operating Self Sufficiency (OSS), and Financial Self Sufficiency (FSS)

The above indicators provide adequate information on the quality of the portfolio, enabling the management to make accurate decisions.

Do Sri Lankan MFIs disclose their performance?

MFIs are expected to disclose their performance with a view to improve the quality of the portfolio and to achieve overall results. Many MFIs in Sri Lanka do not disclose the actual status of their portfolios due to various reasons while very few professional MFIs follow best practices in disclosing their performance.

Transparency is a vital requirement for growth and improvement. Many MFIs in Sri Lanka find it difficult to maintain these best practices due to lack of capacity and skills in terms of portfolio management in their own MFIs. This needs to be addressed by providing quality training and introducing tools and systems for portfolio management and monitoring.

Microfinance works best when it measures—and discloses—its performance

In the absence of actual information on the portfolio, it would be nearly impossible for the management to make accurate decisions to provide directions for growth and improvement. Unfortunately, many MFIs do not consider this as a vital component for transparent operations.

The advantages of disclosing performance are as follows:

- Opportunity for improvement
- Ability to gain recognition at all levels, both national and international
- Ability to attract Donors, Lenders and Investors
- Possibility of adopting new tools, systems and technologies
- Ability to establish much needed good governance and accountability
- Opportunity for image building within the sector

How is the performance of Sri Lankan MFIs?

The performance of Sri Lankan MFIs can be determined only by analysing their portfolio reports. Even though Sri Lanka has a historical background of a strong savings and credit culture, it is only a few MFIs that have demonstrated professionalism in implementing microfinance programmes. Many are waiting for

opportunities to upgrade their capacity and skills to become professional and to operate as efficient microfinance institutions.

However, in the absence of a legal framework for microfinance in the country it is rather difficult to promote best practices as the operators do not have the much needed conducive environment to promote microfinance in Sri Lanka in a sustainable manner.

Microfinance has the power to combat poverty and if we really focus and maintain quality portfolios we will be able to reach our social mission of poverty eradication. Providing financial services to the poor will become a reality if we could develop MFIs that could operate and provide services on a sustainable basis with creativity to meet the needs of the poor people.



Nimal Martinus
Regional Director Asia
Strome Foundation

Donor funds should complement private capital, not compete with it



Donor funds should complement private capital, not compete with it



Ravi Tissera
Director /
Chief Executive Officer
LOLC Micro Credit Ltd.

Is there enough private sector capital to meet the demand for funding by local MFIs in Sri Lanka?

At present MFIs in Sri Lanka meet their funding needs mainly through NDTF (National Development Trust Fund) or through government sponsored microfinance credit programmes such as the Poverty Alleviation Microfinance Project (PAMP). Then there are microfinance lending institutions such as Stromme Foundation, Etimos Lanka & Rabo Bank Foundation who have disbursed debt to some of the smaller MFIs. Some of the better managed small MFIs have been able to attract funds from these institutions at less than market rates.

According to a recent study, Sri Lanka has an unmet microfinance market estimated at approximately Rs 250Bn. The study was done excluding the Northern province. To bridge this gap private sector capital is needed & currently local private commercial banks have been reluctant to lend to this sector.

This is quite the opposite in India where microfinance is a very dynamic industry. The private sector commercial banks lend to the microfinance sector as it is considered priority sector lending by the Reserve Bank of India. Institutes such as National Bank for Agriculture & Rural Development (NABARD) play a key role in the development of the sector through linkage banking. This has resulted in a very active private sector involvement with some MFIs having recently raised 70 Million US Dollars in syndicate loans from the private sector. Private sector has also initiated microfinance funds in India.

Lets look at the overseas private sector funding available for microfinance. The top 5 funds who have among themselves microfinance assets in excess of 3 Billion US Dollars are looking out for more opportunities for microfinance lending in Sri Lanka. Their lending is hassle free, requires no collateral and is commercially attractive.

However its is a challenge for the many unregulated MFIs to access these funds from overseas. Further, many smaller MFIs are still weak in up-to-date financial reporting, governance, business planning & financial ratings. Therefore smaller MFIs need to invest in people and develop their capacities to qualify to access these funds. In other parts of the world, banks have created mezzanine funds to invest in smaller MFIs and these funds have experienced good results. BRAC Bank Bangladesh, one of the leading sustainable banks in Bangladesh committed to microfinance, has created the BRAC Bank Africa loans fund and lends in local currency in Africa.

Local private banks interested in promoting microfinance should be encouraged to take up equity participation in MFIs which would be mutually beneficial for both the MFI & the bank.

Are donor subsidies a problem for the microfinance sector in Sri Lanka?

This would be a yes & no answer. There are many examples where NGOs have started with donor funds and transformed themselves into successful MFIs & even Commercial Banks. The ability to trans-



form into a sustainable MFI is based on the vision & management capabilities of the promoters and donor expectations.

Many MFIs in Sri Lanka still depend on donor funds many of which were received in the aftermath of the tsunami. However accessing new donor funds has become a challenge for these MFIs since the growth in microfinance funding has come from commercial lenders. Whatever available is moving to Africa or is limited to technical assistance & capacity building. It will become increasingly difficult for Sri Lankan MFIs to attract donor funding as Sri Lanka is moving towards becoming a middle income earning country.

Donor funding can also have negative effects on the microfinance industry reaching sustainability. Subsidized funding backed by poor follow-up methods can have an adverse impact on genuine MFIs promoting sustainable microfinance and can corrupt the discipline of a microfinance borrower to repay.



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