Sri Lankan – German Development Cooperation

PROMIS - Promotion of the Microfinance Sector

MICROFINANCE INSTITUTIONS IN SRI LANKA

Ministry of Finance and Planning

gtz

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Impressum

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Acknowledgments

Microfinance in Sri Lanka has a long history and providers of microfinance services are numerous and diverse. It is perhaps this very diversity that has resulted in there being no single source of information on the entire sector. With different types of microfinance providers being under the purview of different authorities no comprehensive picture of the sector has so far been available.

It is in response to this information vacuum that the GTZ ProMiS (Promotion of the Microfinance Sector) programme in collaboration with the Ministry of Finance & Planning commissioned an islandwide survey of microfinance providers. The study was funded by the German government through the German Federal Ministry for Economic Cooperation and Development (BMZ).

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Acronyms & Abbreviations

AGM	Annual General Meeting
BOC	Bank of Ceylon
BoD	Board of Directors
CBO	Community Based Organization
CBSL	Central Bank of Sri Lanka
CRB	Cooperative Rural Bank
CRIB	Credit Information Bureau
FC	Finance Company
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation)
HNB	Hatton National Bank
IBSL	Institute of Bankers of Sri Lanka
IC	Insurance company
ILO	International Labour Organization
IT	Information technology
KYC	Know Your Client
LKR	Sri Lanka Rupees
LOLC	Lanka Orix Leasing Company
MFI	Microfinance Institution
MIS	Management Information Systems
MPCS	Multi-Purpose Cooperative Society
NGO	Non Governmental Organization
NPL	Non Performing Loan
OFI	Other financial institution
PaR	Portfolio at Risk
PBPL	Persons Below the Poverty Line
ProMiS	Promotion of the Microfinance Sector
RDB	Regional Development Bank
ROA	Return on Assets
ROE	Return on Equity
RRDB	Regional Rural Development Bank
SBS	Samurdhi Bank Society
SDO	Samurdhi Development Officer
SEEDS	Sarvodaya Economic Enterprise Development Services
SU	Secondary Union
TCCS	Thrift and Credit Cooperative Society
WDC	Women's Development Cooperative

Executive Summary

This study endeavours to present a comprehensive picture of the microfinance sector in Sri Lanka, a complex sector, yet characterised by significant fragmentation. The outreach of microfinance services, especially savings and deposit products is considerable, and financial services are often accompanied by non-financial facilities. Access to loans remains below its potential, with barriers still existing for the lower income groups. However, despite a fairly high degree of outreach, the microfinance market seems to be characterised by a proliferation of traditional products (savings, loans) with few products and services beyond these (e.g. insurance and money transfer services). The growth of the microfinance sector is hampered by the lack of a coherent regulatory and supervisory framework, governance issues, the lack of technology and staff related issues.

Governance

Regulation and supervision

The rapid development of microfinance in the last decades, characterised by increasing value of assets and extensive outreach raises significant regulation, ownership and governance issues. The sustainable development of the microfinance sector and its inclusion in the financial system depend on the efforts to adopt best practices and to implement a regulatory environment conducive to growth.

The absence of a coherent regulatory and supervisory framework for the microfinance sector represents a barrier to its development. Different authorities are responsible for the supervision of the different types of microfinance institutions: the Samurdhi Bank Societies (SBSs) are regulated by the Samurdhi Authority of Sri Lanka; the Co-operative Rural Banks (CRBs) and SANASA Thrift and Credit Cooperative Societies (TCCSs) are regulated by the Department of Co-operative Development; the Regional Development Banks (RDBs), as well as commercial banks and finance companies fall under the responsibility of the Central Bank of Sri Lanka; insurance companies come under the scrutiny of the Insurance Board of Sri Lanka. Thus the regulatory and supervisory framework lacks uniformity, as different authorities employ different methods and standards of supervision. Furthermore, a considerable group of microfinance providers (NGOs) escapes financial regulation and supervision. Since most of the NGOs mobilise savings either directly as deposits or disguised as member shares, there is a pressing need for them to be monitored by an external independent authority in order to protect the interests of depositors.

Audit

Although CRBs and SANASA TCCSs are supposed to be audited by the Department of Co-operative Development, a significant number of them are in fact reported to be audited only internally. SBSs, which are supposed to be audited by the accountants of Divisional Secretariat offices, also lack a meaningful external audit. Even when audit is performed in the case of these institutions, resource constraints have a bearing on its quality and on its timely release. Furthermore, most auditors lack microfinance specific knowledge, which has an impact on the quality of the analysis.

A high percentage of NGOs are audited both externally and internally, while a further significant number is subjected to external audit only. This has to be positively acknowledged since most of the NGOs are not legally required to do so. According to our survey, only 24% of NGOs are registered under the Companies Act, being thus required by law to be audited annually. The fact that such a large number of NGOs are audited externally can be attributed to the influence of donors, who often link their support to the availability of meaningful audited information and offer funding to support the costs thus incurred.

Decision making process

The organisational structure of a microfinance institution impacts its efficiency and its potential to reach its objectives. The majority of institutions seem to operate with a highly centralized decision making structure, even up to the level of the Board of Directors. The highest degree of centralisation is found in the case of SBSs, where all operating policy decisions are reported to be taken at the level of the Board of Directors of the Samurdhi Authority.

Political interference in appointments of personnel and in the day to day management of MFIs can endanger their viability. In the case of a large number of institutions, microfinance activities are intertwined with other types of activities (CRBs with the activities of Multi-Purpose Cooperative Societies, SBSs with the Samurdhi welfare schemes, NGOs with social activities), which can result in conflict of interests and objectives.

Clients

Outreach

Microfinance providers have an extensive outreach reaching out to over 7 million clients, excluding the number of clients of the CRBs for which an estimate was impossible to obtain. Despite the fact that most microfinance providers do not gather client information and the consequent impossibility of accurately estimating the overall outreach of microfinance services in Sri Lanka, its breadth seems to be considerable. Member-based MFIs appear to have the broadest outreach, with CRBs, SBSs and TCCSs reaching a large number of clients.

Target group

Among the different types of microfinance providers, NGO MFIs seem to be the group with a most focused approach, with 93% of them setting themselves target groups (e.g. women, low income individuals) for their microfinance business. Considering their social mission and their stronger focus on development, this is not surprising. At the other end of the spectrum, insurance companies which provide micro insurance seem to be the group with the weakest target group orientation. Only 29% of the respondents from this group have a focus on specific groups.

Based on the reported information, the RDBs and CRBs seem to have a greater focus on lower-income households, while banks involved in microfinance focus more on micro-entrepreneurs, and SANASA TCCSs and NGOs have a greater focus on women clients.

Gender focus

Since the modern microfinance movement is characterised by a special focus on women, we asked respondents to estimate the percentage of female customers among their overall microfinance clientele. Based on the responses received, NGOs seem to have the largest share of female customers. At the other end of the scale, formal financial institutions have the lowest share of female customers – the majority of the banks, finance and insurance companies interviewed declared their microfinance customers to be mainly male.

Income and activity profile

Although the majority of MFIs mentioned that they focus on lower income groups a closer look at the income profile of their clients reveals that a relatively small proportion of microfinance clients fall within the definition of lower income groups. Even in the case of NGO MFIs, only half of the clients have a monthly household income less than or equal to Rs. 3,000. Borrowers in this income group account for 25% of the clients of CRBs, 20% of the clients of SANASA TCCSs and 19% of the clients of RDBs. As expected, banks and other formal financial institutions involved in microfinance have the lowest outreach among the poorest layer of clients: only 7% of their customers have a monthly household income below Rs. 3,000. The same ranking in terms of outreach to the lower income group is maintained even if the threshold level for this group is raised to Rs. 5,000.

With the exception of banks and other formal financial institutions, other institutional groups have clients with a similar profile in terms of economic activity: the highest proportion of clients is involved in agriculture (between 38% and 45%), followed by similar proportions of clients (between 9% and 20%) involved in fisheries and animal husbandry, manufacturing and trading. The highest heterogeneity is displayed by the proportion of clients involved in the service sector: their share in the total client base varies from 3% in the case of NGOs to 54% for banks and other financial institutions.

Outlet network

Microfinance providers have an extensive network in the country with over 10,800 outlets covered by our survey. The SANASA movement has the largest number of active outlets, followed by NGOs (with over 2,000 CBOs affiliated to SEEDS). In terms of regional distribution, the largest share of these outlets is found in the Southern Province and in the rural sector.

All groups of institutions with the exception of banks and other financial institutions display strong correlations between the sectoral (i.e rural, urban and estate sectors) distribution of their outlets and poverty distribution. The tightest correlation between the regional distribution of outlets and poverty distribution is displayed by CRBs, followed closely by SBSs and TCCSs. Therefore it seems the outlet network of the co-operative sector, as well as that of the Samurdhi programme is well positioned to reach the country's poor. A surprisingly low degree of correlation is displayed by NGO MFIs, a situation which can be explained by 1) the over-proportionate concentration of this group in the Southern and North-Central provinces relative to the corresponding proportion of Persons Below the Poverty Line (PBPL), and 2) the low presence in provinces with high poverty incidence such as Uva and Sabaragamuwa.

Operations

Client relations

Presence in the field is utilised by most institutions to identify and screen potential clients. This is an advantage that many grass-root level NGO MFIs have over formal financial institutions. Closeness to clients is especially important in microfinance to prevent moral hazard issues which could arise in the absence of collateral.

The survey reveals that microfinance providers rely strongly on guarantees (group or personal) to secure the loans granted to their clients. A worrying finding of the survey is that, with the exception of NGOs and SBSs, a large number of microfinance providers require various forms of collateral. This suggests that a considerable number of people from the lowest layer of the income distribution may still face significant barriers to accessing credit. It may well be that collateral requirements are reduced as compared to traditional finance, but the requirements in place among microfinance providers may still exclude some of the most vulnerable clients.

The provision of microfinance services in Sri Lanka seems to be mainly oriented towards individual clients and to rely less on group lending mechanisms. The latter seem to be used on a wider scale in the provision of insurance services to microfinance clients. Wholesale lending to other institutions is a marginal activity, with the exception of secondary TCCS unions belonging to the SANASA movement and some NGOs.

Processing time and approval procedure

It is interesting to notice that for loans, both the shortest and the longest average processing times are found among formal providers of financial services. Finance companies with an average of two days and commercial banks with an average of eight days seem to be the quickest in processing loans, while RDBs require 26 days for the same. The lack of computerisation of operations of most microfinance providers (with the exception of those belonging to the formal financial sector) has a negative impact on the processing time of loan applications.

The loan approval procedures involve several steps in most cases (with the exception of banks and finance companies), with applications having to be referred to credit committees and/or regional level bodies for approval. This can also explain the long average processing time for loans.

Access to technology

Member-based societies such as SANASA TCCSs and CRBs almost entirely lack access to modern communication technologies (email, internet facilities). Combined with the lack of language skills among staff this represents a significant barrier to the dissemination of international best practices within the sector.

In over two thirds of the institutions surveyed, operations and processes are performed manually, especially in member-based microfinance institutions such as SBSs, SANASA TCCSs and CRBs. Over half of NGOs and banks and other financial institutions, as well as all RDBs, employ a mix of manual and computerised operations. Fully computerised operations are present only in the group of banks and other formal financial institutions.

Defaulting clients

With the exception of NGO MFIs, engaging in legal action was cited by over 80% of the respondents as a means of dealing with defaulting clients. This is a rather surprising finding, as microfinance loans are mostly so small in value that it seems hardly probable that the cost of legal action is justified. From this perspective, arbitration seems to be under-utilised. It could be that engaging in legal action is considered by MFIs as a deterrent to other clients who would otherwise be tempted to default, thus offering a justification for such a costly and lengthy course of action.

NGO MFIs adopt a different approach to other microfinance providers, with more emphasis placed on group or social pressure, arbitration and recovery from guarantors. This approach seems more appropriate in the case of microfinance loans, as it functions also in the case of low-income clients from whom little compensation can be obtained through legal action, seizing of property and other forms of physical collateral.

Portfolio management

The survey reveals a widespread lack of understanding of principles and best practices with respect to portfolio management. In view of the fact that the interviews were conducted at high management levels, this is a worrying fact. A large number of respondents could not distinguish between portfolio management measures and activities employed in dealing with defaulting clients.

The majority of respondents claim to measure Portfolio-at-Risk as a means of monitoring portfolio quality. However, it is clear that the understanding of this concept varies considerably. Only a minority of respondents could provide a correct definition of this concept. Adequate monitoring of the loan portfolio is also made difficult due to the lack of technology which forces many MFIs to rely extensively on a manual system of record keeping.

The concept of non-performing loans seems to be better understood. The majority of respondents associated this concept with an age classification of overdue loans, but there were large differences in the classification. Most of the classifications adopted are similar to those of banks and not tailored to take into account the specific nature of microfinance operations. With regard to provisioning for doubtful and non-performing loans, with the exception of RDBs, banks and finance companies which are regulated by the CBSL, the number of institutions which have provisioning policies in place is quite modest. The survey also reveals that provisioning is more often associated with the total loan portfolio or revenue, than with non-performing loans or portfolio-at-risk.

Operational challenges

With the exception of the group of banks and other financial institutions, where the operational challenges identified were quite diverse and less marked, which is not surprising considering that these are strong institutions with experience in the provision of financial services, for the other groups there seems to be a large degree of consensus as to the challenges faced. Difficulties in ensuring repayment of loans, strong competition, and difficulties in obtaining funding for their microfinance operations, as well as inadequate technology and equipment are the operational challenges mentioned most often by the respondents across the different groups of institutions.

Products and markets

The Sri Lankan microfinance market seems to be to a certain extent conservative, focusing more on the proliferation of variations of the same traditional products, and lacking innovative approaches which could overcome the inherent barriers in access to microfinance. Increasing competition in the sector might provide the necessary incentive for MFIs to innovate more in terms of products offered, as well as in their marketing strategies.

Products

The most common products offered by microfinance providers in Sri Lanka are savings and deposits, loans and pawning. All SBSs, TCCSs, CRBs, RDBs and banks, as well as 89% and 60% respectively of the NGO MFIs and finance companies surveyed, offer savings and deposit products. All SBSs, TCCSs, RDBs and banks, as well as 99% of CRBs, NGOs and 80% of finance companies offer a wide range of loan products. Pawning is offered by all RDBs, 82% of CRBs and 71% of banks and 40% of finance companies. Leasing and insurance represent niche products which are largely offered by specialised leasing and insurance companies. The microfinance market seems to be characterised by a high degree of competition, especially on the savings and deposits segment.

Product development

Product development is mostly carried out at a central level utilising inputs provided by the branches. In the case of all groups of institutions, considerably more products have been introduced than withdrawn from the market within the last two years. SBSs and RDBs seem to have been most active in introducing new products to the market, while at the same time keeping all existing products as well. This shows a tendency towards product proliferation, without perhaps little attention given to the profitability of individual products.

Around 80% of the respondents from each type of microfinance provider state that they plan to introduce new microfinance products. However, when asked to elaborate, the majority cite traditional products, with only a minority quoting money transfer services, pension products or leasing. This suggests a low level of innovation among most microfinance providers.

Product delivery and marketing strategies

Microfinance products are mainly delivered through the outlet network of the MFIs although a considerable share also relies on their field officer network for product delivery. The latter system has the advantage of reducing barriers to access for low-income groups, which might be less mobile and unable to bear the transport costs of visiting the MFI. However, the cost to the institution is higher with this system. Links with other institutions play an important role in product delivery for NGOs and RDBs.

The marketing instruments most widely employed by microfinance providers are promotional material in the form of leaflets and banners, posters or hoardings. The most preferred marketing strategy depends on the type of institution. NGO MFIs and SANASA TCCSs rely mostly on promotion through clients or members while CRBs utilise the non-microfinance activities of MPCSs.

Human resources

The microfinance institutions covered in the survey report that they employ a total of 67,909 staff. Banks and other financial institutions are by far the group with the most numerous staff. However, when considering the number of staff involved in microfinance activities (a total of 45,752), CRBs have the lead, followed by NGOs. As CRBs have the largest reported number of microfinance accounts (both savings and loans) the large number of staff may be justifiable. The large number of staff in NGO MFIs may be explained in part by the focus given by this group of institutions to non-financial, 'credit plus' services which are generally staff intensive. It is also noteworthy that only a minority of the respondents (between 12 and 28%) who provided this information report that their microfinance staff is exclusively involved in microfinance activities.

There are significant differences in the type of employment offered to microfinance staff across the different groups of institutions. While in the more traditional finance institutions, such as banks, finance companies and RDBs, the majority of microfinance staff is employed on a permanent basis, member-owned institutions rely more on temporary staff and on volunteers. The percentage of volunteer staff is highest in the SANASA TCCSs – representing 94% of their microfinance staff, according to the survey.

With the exception of SANASA TCCSs, between a fifth and a third of the microfinance staff holds managerial positions. The case of SANASA is a special one, with 69% of the microfinance staff being reported to occupy managerial positions. This could be explained by the small size of the majority of TCCSs, which suggests that managerial staff is involved in a broader range of operational activities, which are traditionally performed by non-managerial staff in larger organisations. Another explanation could be linked to the large number of volunteer staff to whom these positions are awarded more liberally, having also the function of a non-pecuniary reward.

The share of credit and field officers varies significantly across institutions (from 7% to 47%), depending on the particular mechanisms of product delivery and on the procedures in place for appraisal and approval of loan applications.

Challenges

The respondents identify similar recruitment challenges for all three types of positions – managerial, clerical and credit / field officer. The absence of retirement benefits, the difficulty of finding people with the necessary skills and with microfinance experience, as well as operating in unattractive locations have been identified by most of the respondents as major challenges in the recruitment of staff for their microfinance operations.

Inadequate remuneration and incentives, together with the lack of technology were the main challenges mentioned by TCCSs, CRBs and NGOs when it comes to retaining qualified staff in the organisation. The difficulty nature of field operations was mentioned by half of the RDBs and by a quarter of banks and other financial institutions.

Almost all respondents cite training opportunities to be one of the most important incentives offered to their microfinance staff. In addition to this, the majority of respondents mention performance appraisals and performance linked rewards schemes as incentives offered to their microfinance staff. Considering the retention challenges mentioned by the respondents, the incentive structure does not seem to meet the needs of the staff.

Staff development

Managerial staff seems to receive a broad range of courses, which hints to a lack of focus on relevant issues corresponding to their activities and responsibilities. Courses such as customer care, record keeping and marketing are more relevant for other staff categories than for managers. The lack of focus on training relevant to the nature of duties is also manifested in the training offered to other staff categories (clerical, field / credit officers). Microfinance providers should strive to achieve better correlation between the training offered and the actual training needs of the staff in order to improve the capacity of their staff to address current issues and challenges.

Managers also benefit from the largest average number of training sessions a year across all microfinance institutional groups. Banks and other financial institutions have by far the highest number of training sessions per organization, while CRBs seem to offer the least training opportunities to their microfinance staff.

Financial performance

Despite efforts to gather information regarding the financial performance of microfinance providers in Sri Lanka, a clear picture in this respect could not be obtained. A series of issues, among which we mention the lack of transparency, the lack of microfinance specific financial data, poor data quality and the lack of comparability, have made it impossible to analyse the financial performance of the microfinance sector. There is certainly room for improvement in the processes of financial data collection, monitoring and disclosure in the microfinance sector in Sri Lanka. All stakeholders should commit to this objective in order to ensure the long-term viability of the sector.

Methodology

Background

There are a number of different institutional providers of microfinance in Sri Lanka. Detailed information on the operations of these institutions is difficult to obtain and not usually available from one source. Sector information is generally fragmented and the depth of information available varies according to the type of institution. In this context, the Promotion of the Microfinance Sector (ProMiS)[1] programme commissioned a survey of institutional providers of microfinance across Sri Lanka in order to obtain a comprehensive picture of microfinance institutions and their operations. This helps to identify potential economies of scale, provide scope for learning from the different organisations and their operating models and avoid duplication of services. TNS Lanka was commissioned to carry out the survey.

It was decided that the survey would cover all districts of the country except a few in the Northern Province which could not be accessed due to the then prevailing conflict. The survey focused on all institutions which provide financial services to low income individuals and micro enterprises including commercial and development banks, finance companies, leasing companies, insurance companies and NGOs engaged in microfinance activities. All institutions having a microfinance client base of at least 500 were considered eligible to participate in the survey.[2]

The following section explains the methodology which was adopted for the listing of microfinance institutions.

Identification and listing of microfinance institutions (MFIs) in Sri Lanka

Five field supervisors were allocated to the various districts to collect the relevant information on all financial institutions providing microfinance services. Three forms were prepared for the purpose of listing the MFIs. It was decided that the screening process would be carried out in three stages.

In the first stage, interviewers instructed by the supervisors created a list (Form 1) of all possible sources from which information could be obtained on institutions providing microfinance services. (eg. District/Divisional Secretariats, Provincial Councils, Business Registration Department, Registrar of Companies, etc.).

The second step was to visit all the potential sources of information identified above and complete the contact sheet (Form 2) with contact information of the institutions that were assumed to be providing microfinance services. Since the universe of microfinance providers was unknown, the process of identification of microfinance providers followed the snowball sampling method whereby the initial sources approached for information might provide further sources of information and so on. Information on microfinance institutions was also gathered through sources such as the directory of NGOs published by The Ministry of Social Development. Additional information was obtained from relevant web sites.

The completed contact sheet was more or less a list of the majority of MFIs in the country. At this stage it was helpful to identify and separate the MFIs eligible to participate in the survey from those who were considered non-eligible due to insignificant microfinance operations based on the client threshold.

In the final step of the listing exercise, Form 3 (recruitment questionnaire) was used to capture information from eligible microfinance institutions selected from the contact list. As much basic information as possible including the names, contact details of the organization, number of microfinance clients etc, was recorded in the recruitment questionnaire.

Information gathered in all 3 forms was then entered into an Excel worksheet. The end result of this process was a comprehensive list of institutions providing microfinance

1 ProMiS is implemented by the Ministry of Finance & Planning in collaboration with German Technical Cooperation (GTZ) on behalf of the German government.

2 The threshold client base was reduced to 100 for microfinance institutions in the Northern and Eastern provinces.

in the country based on the eligibility criteria developed by ProMiS which was: "having a total microfinance client base of at least 500 (100 in the North and East)".

Main Survey

The enumerators, selected from the respective districts where the survey was to be conducted, were briefed by the researchers on all aspects of the main questionnaire before being sent to the field. Best efforts were made to conduct face-to face interviews in all areas, failing which telephone interviews had to be conducted. This situation occured particularly in the North and East. The estimated time per interview was 45 minutes, but it was found that the actual time taken was 60 - 90 minutes as most of the respondents were not in a position to provide all the requested information immediately.

Prior to the survey being carried out, ProMiS advertised details of the survey in the local newspapers with the intention of creating awareness and securing the cooperation of the respondents.

The majority of the institutions identified in the listing process were interviewed successfully. However, a few institutions had to be excluded due to ineligibility for the survey, although initially captured as eligible in the listing survey.

The enumerators were instructed to investigate and contact the institutions for which incomplete information was gathered during the listing process. As the first part of the main questionnaire consisted of some screening questions the interviewer was able to decide on the eligibility of the newly added institutions to participate in the survey. When the respondent did not meet the eligibility criteria the interview has terminated after the screening questions.

Supervision and Quality Control

The normal quality checks were followed while carrying out the survey. Quality of the data was checked by accompaniment and spot checks by the field supervisors. Back checks were also carried out over the phone in most cases.

The completed questionnaires were scrutinized on the field by the supervisors and missing information re-gathered from the respective respondents; hence, any omissions were rectified before the data coding and entry stage.

Following the fieldwork the data was coded and entered and statistically analyzed using SPSS.

Part I

Profile of Microfinance Providers

Sanasa

1. SANASA Thrift and Credit Cooperative Societies

1.1 Institutional Background

The network of Thrift and Credit Cooperative Societies (TCCSs), which form the SANASA (a Sinhalese acronym for financial cooperatives) network, was established as early as 1906. TCCSs were introduced by the British colonial administration and were the first credit cooperatives to be set up in Sri Lanka. Up to the end of the 1930s, they fulfilled a wider role, being also involved in procurement of inputs and distribution of products on behalf of the cooperatives. This function was subsequently taken over by the Multi-Purpose Cooperative Societies.

During the 1970s, the TCCSs were in decline and the plan of the Department of Cooperatives at that time was to wind up operations and close remaining societies. however, under the leadership of P.A. Kiriwandeniya, the movement was revived and significantly reorganised under the SANASA banner in the late 1970s. During this period of revival and reorganisation, the mission and vision of the SANASA movement were more precisely defined and the social dimension of the program gained importance. The network orientated its focus towards poverty alleviation and started to increasingly target low-income groups at village level. The SANASA PTCCS network has thus grown from 1,500 societies at the beginning of the 1980s to 8,440 registered PTCCSs in 2007, of which about a third are active.

Organisational reforms were also needed to prepare the societies for the open economy which was established in 1977. For this purpose between 1978 and 1980 the first 7 District Unions (DUs) were established, which subsequently joined to form a National Federation, giving SANASA its present three-tier structure. By 1985 all 25 districts had a DU. Due to practical administrative reasons the number of secondary tier unions was increased after 1987 to 48 including both DUs, as well as regional unions. Currently, only 34 of them are active.

For the purpose of this survey 22 representatives of secondary unions (SUs) of Thrift and Credit Cooperative Societies and six Shakthi Officers[3] were interviewed regarding the activities of the SUs and of the respective Primary Thrift and Credit Cooperative Societies (PTCCS) under their umbrella. The following districts could not be covered during the survey: Gampaha, Killinochchi, Mullaittivu, Vavuniya, and Mannar. In addition, SANASA functions in the Puttalam and Anuradhapura districts have been taken over by SANASA Development Bank[4], therefore no secondary union is in place in these two districts.

Data concerning the other two SANASA companies offering financial services – SANASA Development Bank and SANASA Insurance Company are covered in the fifth chapter of this report "Banks and Other Financial Institutions".

The majority of SUs (64%) and PTCCS (86%) offer both financial and non-financial services. While PTCCSs provide these services to their members/ clients (i.e. individuals), SUs as district federations cater primarily to their member PTCCSs. However, 18% of SUs also provide financial services directly to customers. 14% of the PTCCSs offer financial services only.

On average, 76% of the activities of PTCCSs and 61% of SUs are considered by the respondents to be related to microfinance. The most prevalent definition of microfinance is: providing loans to low income groups and small businesses as capital investments in order to empower them. It seems that most respondents do not

3 Field staff hired for the purpose of supporting the consolidation of selected TCCSs in one area. The Shakthi Programme was initiated in 2000 with the purpose of improving the monitoring, reporting and MIS at primary society level. The programme is now in its third phase and has as mandate to strengthen 1,000 PTCCSs with a focus on three aspects: finance and accounting (setting up procedures and proper accounting systems), product development and organisational structure and community service development.

4 SANASA Development Bank was established in 1997 as a licensed special bank with the purpose of serving as a specialised apex body for the SANASA Movement, a function which it has since taken over from the SANASA Federation. SANASA Development Bank is covered in the present report under chapter 5: Banks and Other Financial Institutions.

distinguish microfinance from microcredit, despite the fact that savings mobilisation is a key activity for all SUs/PTCCSs.

In defining microcredit some SUs/PTCCSs slightly expand their definition of microfinance by broadening the purpose of lending to non-productive purposes, such as consumption, education and emergencies.

1.2 Organisational Structure and Governance

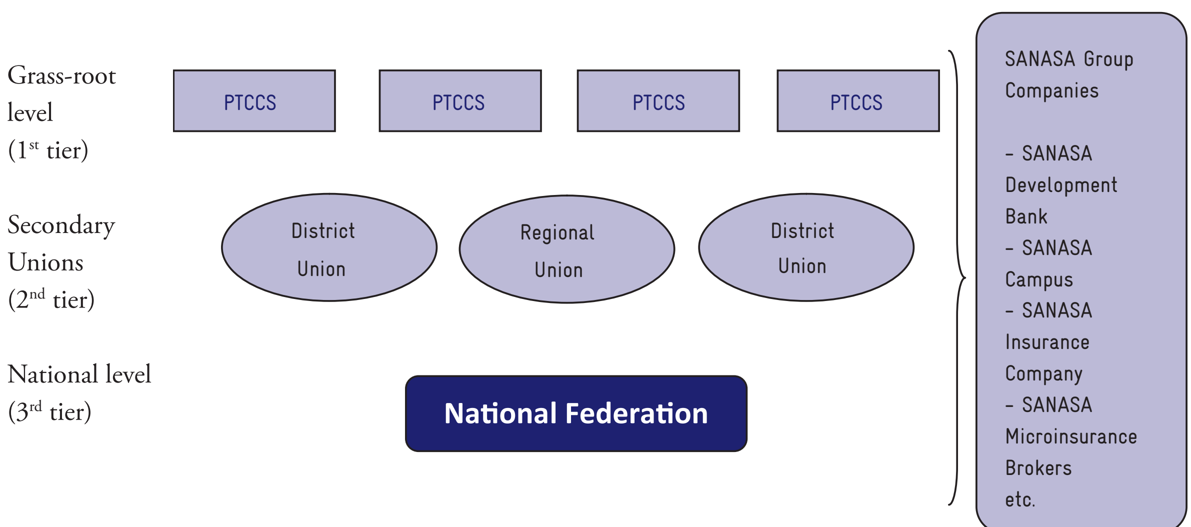
Organisational Structure

SANASA has a three-tier organisational structure, with levels which are independent, but work together to achieve the goals of the movement, as shown in Figure 1.1. The grass-root level formed of Primary Thrift and Credit Cooperative Societies (PTCCSs) is the stronghold of the movement. They are member-based financial cooperatives and are thus limited to a restricted geographical area. Each PTCCS has its own Board of Directors.

The secondary tier consists of district and regional unions of thrift and credit cooperative societies. Their traditional function as regional apex bodies and service providers for the PTCCSs has continually decreased with their roles being taken over by specialised companies of the SANASA group. These companies have a stronger market orientation and are better equipped than the SUs to fulfil the needs of PTCCSs. In two districts SUs have already disappeared (Puttalam and Anuradhapura), several other SUs being inactive, a tendency that is expected to continue in the years to come. Secondary unions (SUs) are owned by the PTCCSs of the region and their management has to be selected from the same geographical area.

The third tier is represented by the national SANASA federation. Its role has also changed from the initial mission as a national apex body for the movement to predominant representative and strategic orientation functions. While at first only secondary unions owned the national federation, more recently, PTCCSs were also allowed to acquire shares.

Figure 1.1 Organisational structure of the SANASA Group



Regulation and Supervision

Thrift and Credit Cooperative Societies are registered under the Cooperative Societies Act No. 5 of (1972) as amended in 1983 and in 1992. In order to operate, PTCCSs must register with the Commissioner of Cooperative Development. PTCCSs can choose to register as societies with limited or unlimited liability. Statistics available at national level (including both active and dormant societies) show that 88.5% are registered as unlimited liability societies.

PTCCSs and SUs are regulated and supervised by the Department of Cooperative Development. The supervision takes place at district level, through the District-level branch of the Department. The national federation is supervised by the national Department of Cooperative Development.

The survey has revealed a lack of knowledge on the part of the respondents at the secondary union level, with only 75% of them being aware that they are regulated institutions. When asked about the regulatory and supervisory authority, the picture was rather diverse. Only 62% SUs and 66% of PTCCSs which had admitted they are regulated recognised the Department of Cooperative Development as the regulatory authority. The rest of the respondents saw either the Board of Directors or SANASA Federation fulfilling this role. The percentage of those who correctly identified the Department of Cooperative Development as supervisory authority was larger – 86% of SUs and 93% of PTCCSs. The lack of a correct perception regarding the regulation and supervision of cooperatives and their unions hints at deficiencies in its implementation on the part of the Department of Cooperative Development and poor understanding on the part of the respondents.

Respondents have declared that supervision entails the following measures: regular inspection/audit of accounts (100%); representation on the management committee or the board of directors (50%) and submitting operational information on a regular basis (50%).

SUs and PTCCSs are entirely member-owned organisations. It is interesting that the perception of a significant number of respondents at secondary union level assigns ownership to either the Department of Cooperative Development (29% in the case of SUs and 21% in the case of PTCCSs) or to the Federation (14% of SUs and 11% of PTCCSs). This lack of ownership consciousness can have a negative impact on the way they relate to the microfinance business.

Audit

The Registrar of the Department of Cooperative Development is required by law to audit registered credit unions once a year. Due to insufficient resources, this provision cannot be fully implemented in practice, a situation supported by the findings of this survey. In most SUs and PTCCSs (61% and 64% respectively) accounts are audited both internally and externally. The accounts of the remaining SUs and PTCCSs are either audited internally only (18% of SUs and 25% of PTCCSs) or externally only (18% of SUs and 11% of PTCCS). With the amendments introduced to the Co-operative Societies Act in 1992, the Registrar has the authority to replace the board of a distressed credit union with an interim board, or even dissolve a credit union under certain circumstances which may come to light during the audit process.

Decision making / Strategic planning

All SUs and PTCCSs are managed as independent entities. 96% of them claim to establish business development goals, an annual business plan and strategies for their microfinance activities. In most cases (between 74% and 85%) the design of plans and strategies which include aspects such as interest rate setting, product design, human resource management, target group orientation and general policy is said to follow a participative approach: a group consisting of management, the board, members, staff and/or affiliated institutions decides through discussions. In some cases (15%-22%) the design of plans and strategies is claimed to be done at the Federation level. In fact, the national federation does not have the authority to take such decisions; it can only issue recommendations and general directions. The final decision power resides with the boards of the institutions. But, as noted above, some of the respondents do not have a sense of ownership and probably take the recommendations of the national federation to be compulsory.

1.3 Operations

Outlet distribution

The regional coverage of PTCCSs is displayed in Table 1-1. 3,794 PTCCS are grouped under the umbrella of 28 SUs (district and regional unions), displaying an average of 134 PTCCSs per SU. Needless to say, that there are significant disparities between the number of active PTCCSs under each SU, ranging from 15 (TCCS Polpithigama) to 459 (DTCCS Matara).

Table 1-1 Regional and sectoral coverage of SANASA PTCCSs

Province	PTCCSs		Sector			Population Density per PTCCS (Population / No. of PTCCS)***
	No.	%	Urban	Rural	Estate	
Western */**	376	9.9	n/a	26	n/a	8,823
Central	324	8.5	31 (9.6%)	267 (82.4%)	26 (8.0%)	7,481
Southern *	1,079	28.4	35	789	n/a	2,111
North Western **	260	6.9	1 (0.4%)	259 (99.6%)	0	5,616
North Central **	43	1.1	0	43 (100.0%)	0	8,348
Uva *	530	14.0	n/a	160	10	2,221
Sabaragamuwa	491	12.9	12 (2.4%)	479 (97.6%)	0	3,669
Northern **	173	4.6	22 (12.7%)	151 (87.3%)	0	3,712
Eastern	518	13.7	23 (4.4%)	495 (95.6%)	0	2,741
Total	3,794	100.0	124	2,669	36	4,954

n/a not available

Notes * For Western, Southern and Uva Provinces, the total number of branches does not tally with the subtotals of urban, rural and estate branches, as the breakdown for the districts of Colombo (350 PTCCSs), Galle (255 PTCCSs) and Badulla (360 PTCCSs) was not provided by the respondents.

** In the Western Province, Gampaha District could not be covered, as the DU there refused to participate in the survey. Puttalam District in the North-Western Province and Anuradhapura District in the North-Central Province could not be covered, due to the fact that the operations of the SUs were fully taken over by SANASA Development Bank. No district or regional union was operating in the area. In the Northern Province, the districts of , Mullaittivu and Vavuniya could not be covered due to the security situation.

*** The source for population per province is the Census of Population and Housing, Department of Census and Statistics – Sri Lanka, 2001. For the Northern and Eastern Provinces, 2001 estimates from the Department of Census and Statistics were used.

PTCCSs have a good nationwide coverage. According to the SUs which were interviewed, 3,794 active PTCCSs serve 19 of the 25 districts, across all nine provinces. PTCCSs are known to operate in the six remaining districts but they could not be covered during this survey. It has to be noted though, that the number of active PTCCSs could be slightly overestimated; some respondents might have included either recently closed societies or societies with plans for reactivation. At the national federation level, it was estimated that an overall number of around 2,000 PTCCSs are well functioning, while another 1,500 societies operate at a low-intensity.

93.6% of the PTCCSs for which the sectoral breakdown was provided, are located in rural areas. This shows the prevalent rural character of SANASA. 4.9% of the PTCCSs are located in urban areas, while 1.4% of the PTCCSs are located in estate areas.

The Southern Province has by far the largest number of societies (1,079), indicating that it is in this region that SANASA has its stronghold. The Southern Province, together with the Eastern and Uva Provinces account for 56% of PTCCSs, while they represent only 26% of the Sri Lankan population. These three provinces also have average PTCCS densities lower than 3,000 people / society, while the nationwide average lies at 4,954 people / PTCCS. Highest densities are found in the Western (8,823 people / PTCCS), North Central (8,348 people / PTCCS) and Central (7,481 people / PTCCS) provinces.

A comparison between the regional distribution of PTCCSs and of the population living under the poverty line, as reported by the last census of 2002, is presented in the table below.

Table 1-2 Regional distribution of SANASA PTCCSs vs. poverty distribution

Province	Persons Below the Poverty Line (PBPL)		PTCCSs		PBPL/ PTCCS
	No.	%	No.	%	
Western *	323,710	12.1	376	12.1	861
Central	547,401	20.4	324	10.4	1,690
Southern	558,619	20.9	1,079	34.8	518
North Western *	305,364	11.4	260	8.4	1,174
North Central *	57,567	2.1	43	1.4	1,339
Uva	356,540	13.3	530	17.1	673
Sabaragamuwa	528,824	19.7	491	15.8	1,077
Total	2,678,025	100.0	3,103	100.0	863

Note: * Poverty data from Gampaha District in the Western, Puttalam District in North Western and Anuradhapura District in North Central Provinces was excluded from the table above, as these districts, although having active PTCCSs, could not be covered by the survey.

The poverty percentage was calculated as percentage of the total population living under the poverty line in a given province. The percentage of branches was recalculated excluding the North and Eastern Provinces as poverty data for these provinces was not available.

PTCCSs have an extensive coverage, characterised by important regional variations in the density of the persons below poverty line (PBPL) served per PTCCS. The densities range from only 518 PBPL / PTCCS in the Southern Province to 1,690 PBPL / PTCCS in the Central Province. The nationwide average (excluding the North and East) lies at 863 PBPL / PTCCS. From the comparison of PTCCS and poverty distribution across provinces, the Southern Province is over-served with 34.8% of the branches compared to 20.4% of the poor. Similarly, Uva has 17.1% of the PTCCSs, while only 13.3% of the PBPL. Significantly underserved is the Central Province with only 10.4% of the PTCCSs, while being the home of 20.9% of the country's poor. Densities higher than the average are the districts covered by the survey in the North Western and North Central Provinces and in the Sabaragamuwa Province, this being indicative of the fact that the PBPL in these areas are underserved by PTCCSs.

Clients

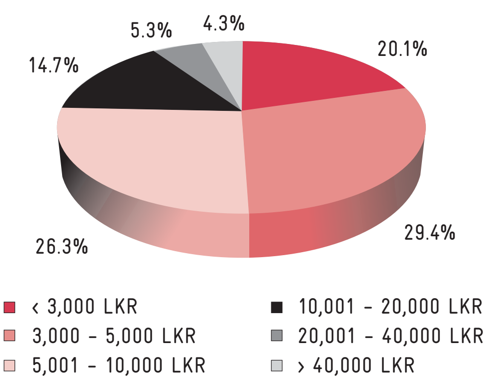
The entire microfinance customer base of the 28 secondary unions interviewed could not be determined. The national federation records indicate a total number of 860,611 registered members in 2006. However, due to the high percentage of inactive PTCCSs, this figure, together with the estimated coverage of 16.64% of the population (mentioned in the SANASA Statistical Report 2006-2007) is largely overestimated. According to data provided by the Federation, the number of loan accounts of around 4,500 PTCCSs was 214,803. Considering the fact that most clients would not receive multiple loans from the same institution and that a considerable number of clients may only have savings accounts with SANASA, this figure can be considered a very conservative estimation of the number of clients of the PTCCSs.

71% of the respondents focus their microfinance activities on particular target groups. These include: women (90% of those who focus on target groups), farmers (80%), low income groups (70%), entrepreneurs and youth (65% for each of the two categories).

The proportion of female clients, the most prominent target group, was declared to be between 50% and 75% for 64% of the respondents and over 75% for 11% of respondents. One respondent reported having less than 25% female clients. Considering the total membership of SANASA, both active and inactive, female members account for 54%, according to data available at Federation level.

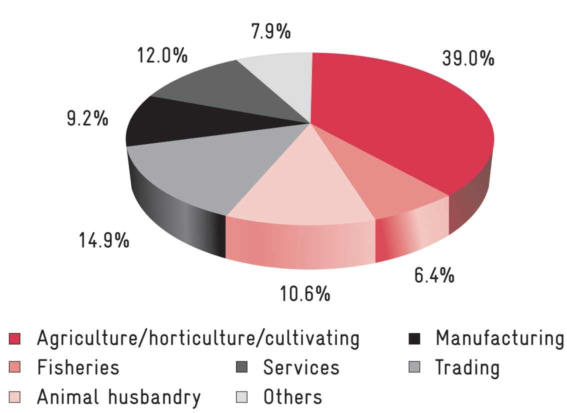
Around 20% of customers of the interviewed SUs/PTCCSs were reported to have a monthly household income below Rs. 3,000, the average threshold for a low income household defined by the respondents being Rs. 2,800. The majority of SANASA customers (55.7%) come from households with an income between Rs. 3,000 and 10,000. In total, more than 75% of the clients served by SANASA have a household income of less than LKR 10,000 a month.

Figure 1-1 Monthly income of SANASA clients



The microfinance customers of SUs/PTCCSs represent a wide range of economic activities; the main focus is on the primary sector owing to the strong presence in rural areas. Considering that SUs/PTCCSs are geographically confined, diversification of their lending portfolio could be difficult. The structure of the client portfolio, represented in the following chart, is dominated by agriculture, horticulture and cultivation (39%), followed by trading (15%), services (12%) and animal husbandry (11%).

Figure 1-2 Economic activity of SANASA clients



On the question of growth of their customer base on a product-wise basis, the majority of SUs/PTCCSs (between 54% for loans and 90% for pawning) indicated that their customer base has increased over the last year (2006); some institutions (between 10% for pawning and 31% for compulsory savings) claim even a substantial increase. Although aggregated data of the Federation shows a positive tendency in terms of SANASA membership for 2006, the increase is rather moderate (from 858,125 at the end of 2005 to 860,611 at the end of the following year). Moreover, the increase in terms of volumes of savings and loans in 2006 seems to be only temporary, as it was followed by a decline in 2007. A possible explanation for this situation could be that year 2006 was the 100th anniversary of the SANASA Movement and many new programmes were introduced to mark this occasion, which could have led to the increase observed for 2006.

Lending methodology

92% of all SUs are involved in wholesale lending, 61% offer individual lending, while only a quarter is involved in joint liability lending. 32% of SUs are not engaged in lending at the retail level individual and offer only wholesale lending to PTCCSs. All PTCCSs offer individual loans, 54% provide group loans, while only 14% claim be involved in wholesale lending to an intermediary. 43% of PTCCSs claim to be involved exclusively in individual lending.

For SUs involved in more than one type of lending, individual loans represent on average 59%, group loans 25%, while wholesale lending represents on average 35% of the loans. The strong involvement of some SUs in individual lending might indicate a reorientation of several of them towards direct provision of microfinance services to clients in view of the reduction of their scope of services to PTCCSs since the advent of the SANASA Development Bank. 84% of the loans of PTCCSs adopting a mix of lending methodologies are individual loans. Joint liability group loans, with a share of only 17%, do not play an important role for PTCCSs.

Identifying potential clients

The SUs/PTCCSs interviewed seem to adopt a pro-active approach in utilising the information gathered by their field staff and existing clients for the identification of potential customers. SUs/PTCCSs identify potential microfinance clients mainly through inspection and field visits (89%). Evaluation of client's past performance and recommendations from existing reliable customers or third parties are also widely used (68% and 54%, respectively) as a means of identifying and appraising new clients. Only a little over a third (36%) of the SUs/PTCCSs utilise opportunities arising out of the non-microfinance activities of the institution for this purpose. In view of the array of non-financial services offered by the SANASA group, this potential seems to be underestimated.

Loan processing time and approval procedure

The average processing time for a loan is around 23 days. Only 25% of SUs/PTCCSs interviewed indicate a processing time of not more than 15 days. Over a third of respondents have indicated a loan processing time of 30 days. Opening a deposit or savings account usually takes one day. The processing time for an insurance application is between one and seven days.

93% of SUs/PTCCSs interviewed entrust a credit committee with the approval of loans, while 45% of them require a credit evaluation by the loan officer and 32% provide the manager with a loan approval limit. This rather decentralised loan approval process, which involves branch managers and credit officers, fits well with the particularities of member-owned thrift and credit cooperatives.

Loan monitoring and provisioning

The majority of SUs and PTCCSs (61%) manage their microfinance operations manually while 39% employ a mix of manual and computerised systems. Hence, it is not surprising that 94% of those who claim to monitor loan portfolio quality rely mostly on log books and manual records. Visit records filed by field officers are used by 63% of the respondents. Only 33% of them use computerised financial statements for monitoring purposes.

57% of the respondents claim to measure the portfolio-at-risk (PaR) in relation to their loan portfolios, but from the definitions given, PaR seems to be equated with non-performing loans. Even for the respondents who perceived PaR to be the risk in recovering loans, it was not clear whether only overdue instalments were considered to be at risk or the entire loan amount.

The SUs/PTCCSs interviewed seem to follow an age analysis of overdue loans. At least some of them classify their loans into categories such as sub-standard, doubtful or loss depending on the extent of late payments. Nonetheless it remains unclear how many of them actually systematically undertake such a classification.

46% of respondents do not make provisions on their non-performing loans while 54% declared they do. Of those who provide for potential loan losses, only a minority (26.7%) seem to apply individual provisioning rates for the loan classification categories identified. Others apply provisioning rates to the total loan portfolio (including performing loans) or to the annual revenue (26.7%) or confuse loan recovery measures with loan loss provisioning (13.3%).

Defaulting clients

89% of the institutions interviewed claim to take legal action in case of failure to comply with requests for repayment of an overdue loan. SUs and PTCCSs thus seem to quickly engage in legal action against a defaulting borrower. Since seizing borrower's property does not play a significant role (only 14%), this might be either just announced as a deterrent to default, or court action might be used to enforce personal guarantees. Another possible explanation could be that for some respondents the term legal action has a wider meaning, including other procedures of recovery besides court action. In fact, court action is generally too costly for recovery of a small microfinance loan, therefore the information coming out of the survey should be interpreted with care. Further, 61% of respondents have stated they apply penalties on defaulting borrowers, while 54% and make use of group and social pressure and 43% of arbitration to recover the loan.

Operational challenges

The main operational challenges related to the microfinance business of SUs/PTCCSs are: delayed repayment of loans (79%), inadequate information system and poor technology (71%), strong competition (68%), shortage of funds (64%) and lack of equipment (57%).

1.4 Products and Markets

All SUs and PTCCSs covered by the survey provide loans and savings products, 36% of them offer pawning facilities and 18% claims to offer insurance. Pension products and leasing are each offered by one respondent. A brief overview of the key features of the main products is presented in Table 1-3.

Table 1-3 Microfinance product portfolio of SANASA SUs and PTCCSs

Product / Service	No. of SUs		No. of PTCCSs covered	Volume Outstanding ('000 Rs.)	No. of Accounts	Average outstanding account balance (Rs.) ***	Annual Interest Rate (%)
	Offer the product/service	Provided information					
Savings and Deposits	28	21	280*/311**	981,674	134,344	8,093	3-24
Loans	28	22*/18**	255*/1,100**	824,151	112,460	25,825	4-18
Pawning	10	7	58*/74**	45,249	4,551	2,807	15-21

Notes * Number of SUs / PTCCSs for which the volume outstanding was disclosed.

** Number of SUs /PTCCSs for which the number of accounts was disclosed.

*** The average outstanding account balance was calculated solely based on outlets for which both volume outstanding and number of accounts were disclosed. Due to significant differences in the number of outlets covered for the two indicators, the result of this column is significantly different from the mere division of the column "Volume outstanding" by the column "Number of accounts".

It has to be noted that information regarding the products and markets of SANASA remains, despite all efforts, scarce. Most of the interviewed SUs did not have aggregate data for all the PTCCSs under their umbrella. Conducting interviews at PTCCS level was, in view of the high level of resources required, not feasible. This has resulted in a very low coverage of outlets. With the exception of the number of loan accounts, where information was available for 29% of the PTCCSs and SUs, the overall coverage for this section is rather symbolic (information is available for only 7% to 8% of the total number of societies) for savings & deposits and loans, products which are offered in all outlets.

Loan products

Loans are offered by all respondents. For the 255 societies for which information regarding volume outstanding of loans is available, an average loan portfolio of Rs. 3.2 million per society could be observed. In terms of number of accounts, the average lies at 102 loans per society for the 1,100 societies for which information was obtained. Almost all SUs and PTCCSs (96%) require compulsory savings as a condition for obtaining a loan. In 61% of the institutions interviewed, the minimum loan amount is not more than Rs. 5,000.

It is also interesting to note that this group of MFIs is characterised by flexibility in terms of loan period. Loan products have a rather long maturity going up to 96 months in the case of housing loans. 43% of the respondents have loan products going up to 60 months and more. But short-term loans are also an important part of the loan portfolio of SANASA societies – 36% of the respondents have mentioned the existence of loan products with repayment period of under 12 months.

All SUs and PTCCSs calculate interest on a declining balance basis. 54% of the institutions charge service fees for processing a loan. Except for penalty interest on late payments (imposed by 43% of institutions interviewed) and interest rate reductions on early payments (21%), there are no other special terms and conditions attached to loan products. Concessionary interest rates for specific groups of customers are offered by only 14% of the respondents.

SUs/PTCCSs declared they set their lending rates mainly at a given margin above their deposit rate (43%) or by benchmarking to commercial bank rates (36%). In 14% of the cases, interest rates are set based on a computation of product cost.

As for the level at which decisions regarding interest rates are taken, 50% of SUs/PTCCSs indicate the district or regional level, while 39% assign this function to the individual societies. This is an interesting outcome, considering the fact that PTCCSs are member-owned institutions, having the final decision power in all strategic and operational issues, including the setting of interest rates. The regional and national levels of the SANASA movement can only issue recommendations and could in certain situations link access to funds to the adoption of their recommendations, but they cannot overrule the decisions of the Board of Directors of the PTCCSs or the SUs. Thus, the respondents do not seem to be fully aware of the rights of the SUs and PTCCSs.

Formal lending requirements

SUs/PTCCSs estimate that on average 4.7% of loan applications received are rejected. However, 13 out of 28 institutions interviewed claimed to have a 'rejection rate' of 0%. The reason for this could be that SUs/PTCCSs are member-based organisations that cannot reject applications as long as the member complies with the minimum lending requirements. But it could also be that the actual rejection rate is in fact higher; SUs might not have complete information on rejected applications at the primary society level, or the initial screening process is quite effective. On the other hand, one respondent in the Eastern Province has mentioned a rejection rate of loan applications of 50% due to the non-availability of funds.

Loans are available exclusively to members. The most important lending requirements are as follows: maintaining a minimum deposit balance (93%), having guarantors (89%), providing proof of established residency (79%) and proof of income sources (71%). Further requirements include collateral (61%) and receiving the approval of the district union (54%). Considering the above listed requirements, loans seem to be over-collateralised. Another surprising fact coming from the survey was the fact that 54% of respondents have mentioned that the approval of the SU is required before a loan can be granted. Since PTCCSs are all member-owned societies, they have full independence as to the disbursement of funds collected by them. In the case of funds received from the SUs, PTCCSs are formally required to inform the SUs regarding the utilisation of the funds. In practice, in the case of some SUs, the requirement to provide information seems to be transformed into an approval requirement, thus making the loan approval process more complex and lengthy.

Savings products

All SUs and PTCCS covered by the survey offer savings and deposit facilities. On average, the 280 societies for which information on savings volumes were available had a savings portfolio of Rs. 3.5 million per society. The 311 societies where information on the number of savings/deposit accounts was disclosed had on average 432 savings and deposit accounts each. We can notice that while the average savings portfolio is only slightly higher than the loan portfolio, the average number of savings accounts per society is more than four times that of loan accounts. This is also reflected in the considerably lower average outstanding account balance of Rs. 8,093. All respondents who provided the information reported the minimum amount required to open a savings account was Rs. 500 or less. In fact, for three quarters of these respondents, the amount required was no more than Rs. 100.

Other products

The availability of pawning facilities was reported by 10 SUs (36%) according to the survey. The average pawning portfolio of Rs. 0.78 per society for the 58 societies for which information was provided seems rather modest. In terms of the number of pawning accounts the situation is similar – the average per society is 62 pawning accounts. It is interesting to note that the average outstanding balance on a pawning account is, at Rs. 2,807, almost ten times lower than the average outstanding loan account (see Table 1.3 above). 40% of respondents have indicated that the minimum value of goods that can be pawned is Rs. 500 while another 40% indicate a higher value of Rs. 1,000. This indicates that pawning facilities cater mainly to the liquidity needs of the low-income group.

Five respondents (18%) have also mentioned insurance products in their product portfolio, but in all cases they retail insurance products of the SANASA Insurance Company, which is covered by Chapter 6 of this report.

Delivery of products and marketing strategies

Products and services are mainly delivered directly through SANASA societies (86%) and only a small proportion of respondents use field officers (29%) or links with other institutions (11%) as delivery channels for their products and services. Product marketing is done through a number of different channels: all respondents claim to rely on promotion by members, 71% distribute leaflets, while 64% use other SANASA activities to promote their microfinance business. Banners and posters and doorstep marketing are employed by 54% and 46%, respectively. SUs and PTCCSs seem to employ a cost-effective marketing approach; mass media advertising does not play a significant role, a fact which could be explained by the limited geographical outreach of SUs and PTCCSs.

Product development

Some SUs and PTCCSs appear to experiment with other products apart from the traditional savings and loans, but this is on a rather limited scale. 79% of the respondents have indicated the existence of plans to introduce new microfinance products in the near future. For the majority of these respondents new loan and savings products lead the way (95% and 73%), followed by fixed term deposits (55%), pawning (41%), insurance products (18%), pension products and leasing (each 14%) and money transfer services (9%).

Asked about the number of products introduced during the last two years, the average lies at 2.4 products, with significant discrepancies among the respondents. While 21% of the respondents haven't introduced any new products, one respondent reports ten new products introduced, while another one reports 15 new products introduced. 82% of the respondents have not withdrawn any products from the market over the last two years, while 11% have withdrawn one product and 7% of them have withdrawn 3 products.

In 61% of cases product development is handled at a central level drawing on inputs from all societies, while in 46% it is done at PTCCS level by an internal team or by the manager (25%). The SANASA Federation, SANASA Campus and Shakthi Officers are also consulted in the process of designing new products. It can be concluded that the process is strongly participative, but at the same time draws on the expertise of the different levels and companies of the SANASA group. This is supported by the outcome of the survey regarding the methodological approach to product development. New products are developed based on staff experience (61%), on discussions at Federation level (54%) and with customers (46%), on formal market surveys (36%) and based on products offered by competitors (32%). This approach allows the SUs and PTCCS to offer more demand-oriented products.

1.5 Human Resources

2,797 of the PTCCSs covered by the survey employ a total of 11,737 staff, an average of 4.2 staff per society. Respondents were asked to provide information on all types of staff – paid as well as un-paid volunteer staff, but despite all efforts, differences in reporting may still exist resulting in an underestimation of volunteer staff on the part of some respondents. 24 of the 28 SUs interviewed employ a total of 357 staff, an average of 14.9 staff per SU. In view of the fact that both SUs and PTCCSs are engaged in other activities besides providing financial services, it cannot be assumed that the staff mentioned above are exclusively involved in microfinance operations, even though they represent the core activity of SANASA. It remains unclear to what extent the SANASA staff is involved in non-microfinance operations.

Table 1-4 Microfinance staff complement of SANASA

		Total Staff* (SUs and PTCCSs)	Managerial	Credit/Field Officer	Clerical	Others/ Support Staff
Absolute Number (%)	PTCCSs	11,737	(69.2%)	(8.1%)	(19.1%)	(3.6%)
	SUs	357	(34.6%)	(25.8%)	(25.1%)	(14.4%)
Minimum Qualification Required			A/L passed (53%) / tertiary education (21%) / O/L passed (15%) / no requirement(11%)	A/L passed (47%) / O/L passed (29%)/ no requirement (7%) / tertiary education (4%)	A/L passed (64%) / O/L passed (18%) / no requirement (11%) / tertiary education (4%)	n/a
Experience required		yes (68%) / no (32%)	yes (57%) / no (29%)	yes (61%) / no (36%)	n/a	

n/a not available

Note * Total staff figures provided cover 24 secondary unions and 2,797 attached primary societies. Furthermore, the staff breakdown was provided only by 22 respondents regarding SUs and by 23 regarding attached primary societies, therefore the absolute numbers could not be determined.

In terms of types of positions considerable differences can be observed between PTCCSs and SUs. The proportion of managers out of total staff is almost 70%. This is surprisingly high for primary societies and could indicate either that some respondents did not consider entirely the volunteer workforce involved in their operational activities or that the volunteer workforce is given incentives in the form of "managerial"positions which are largely title only even though the tasks performed do not justify such positions. Given the large volunteer workforce reported (see below), the latter seems more probable. This can be also supported by the almost insignificant percentage of credit and field officers. The absence of field officers could be understood through the localised, village based operations, which may make field officers dispensable, but the lack of credit officers is hard to account for. Either their respective tasks are performed by managerial staff or by volunteer workers who are not included in the reporting. SUs have a more balanced distribution of positions – 35% managerial, 26% credit / field officers, 25% clerical and the remaining 14% support staff.

The minimum qualifications required by SUs and PTCCSs do not differ noticeably for the various types of positions: the majority of the respondents expect at least A/L qualifications and relevant experience. However, for non-managerial positions more SUs and PTCCSs are willing to accept lower qualifications (such as O/L).

As for the type of employment, 93.9% of the 10,702 staff for which the breakdown was reported is employed on a volunteer basis. The permanent staff of the PTCCSs and SUs accounts for only 5% of the reported staff figures.

Recruitment challenges

For all types of positions SUs and PTCCSs identify similar difficulties in recruiting suitable staff for microfinance operations. The attractive remuneration and benefits offered by competing institutions is cited to be the most important recruitment challenge for managerial (57%) and clerical staff (46%), as well as for credit and field officers (46%). Another important issue mentioned is the lack of candidates with microfinance experience and training (mentioned by 36% of SUs and 50% of PTCCSs). The lack of a pension scheme also ranks high in the challenges mentioned by the respondents (between 36% and 50%). Other issues mentioned include unattractive locations (18% to 36%), employment (14% to 25%) and working conditions (18% to 21%), the fact that microfinance is not considered to be an attractive career option (14% to 25%), as well as political influence and nepotism (14% to 18%).

Staff retention

64% of the respondents have identified inadequate remuneration and incentives as the two most important factors in retaining good staff. The following issues in the order of importance are technology related: 61% have identified lack of technology and 50% manual processes to be a challenge in retaining talented staff. The incompatibility of new technology with current operating models was cited by 39% of the respondents to be a staff retention issue. Further challenges identified include the difficult nature of operations (32%), the work overload (21%) and lack of operational flexibility (14%). The staff retention issues are in line with the operational challenges (i.e. poor technology, lack of equipment) and difficulties related in recruiting suitable staff (e.g. remuneration).

Incentives

SUs and PTCCSs have identified training opportunities as the main incentive they are able to offer their staff (93% of the respondents). 57% have named remunerative incentives, 50% performance appraisals and rewards, while 43% mention the distribution of revenue as an incentive. However, in view of the staff recruitment and retention issues cited above, these incentives seem to be inadequate. Other incentives mentioned include subsidies such as funeral assistance or work uniforms (43%), overtime pay (39%), moral incentives (36%), workman compensation in case of sickness or accident (36%) and free or subsidised transportation (18%).

Training is reported to be the most important incentive element for the staff of SUs and PTCCSs. Indeed, SANASA has a specialised training institution, the SANASA Education Campus, which provides training for SANASA staff. According to the survey all staff categories, but especially managerial staff, receive extensive training in a broad range of fields. However, the impression is that the training programmes are not sufficiently focused: information provided in the survey indicates that managers participate in less relevant trainings on group mobilisation, record keeping and accounting, credit officers and clerical staff are included in trainings on HR development and business planning. At the same time important courses are only offered on a limited scale such as leadership skills for managerial staff and language skills for managerial staff and credit/field officers.

1.6 Financial Performance

Only 14 SUs submitted their own financial statements. Some of them were microfinance specific while the others were overall statements covering both the microfinance and non-microfinance activities of the organization. Since these are unconsolidated financial statements, not covering any of the PTCCSs under their umbrella, and considering the differences in operations of the SUs from those of the PTCCSs, we cannot offer a picture of the financial performance of the SANASA microfinance operations. It is hoped that the computerisation and standardisation efforts of the Shakthi Programme will also bring about an improvement in the availability of more comprehensive financial data.

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Cooperative Rural Banks

2. Cooperative Rural Banks and Multi-Purpose Cooperative Societies

2.1 Institutional Background

Next to the Thrift and Credit Cooperative Societies (TCCSs), Cooperative Rural Banks (CRBs) owned by the Multi-Purpose Cooperative Societies (MPCSs) are the second major player in the cooperative sector dealing with rural finance. Many Co-operative Credit Societies were formed by the government in the early decades of the 20th century against the framework of the Co-operative Credit Societies Ordinance No. 7 of 1911. Subsequently, during the Second World War, consumer co-operative societies were formed to facilitate food distribution. In the post-war period of the 1950s these co-operatives were renamed Multi-Purpose Co-operatives Societies and their scope of activities was widened. MPCSs offer microfinance services through the Cooperative Rural Banks (CRB) which are owned by them. At present there are 305 MPCSs in Sri Lanka through which 1,628 CRBs are operated.

This chapter also covers the Women's Development Cooperative Societies (WDCs). The umbrella institution for the WDCs was incorporated in 1991 as a district society and in 1998 upgraded to national level. The mission of the institution is to support and uplift its members based on the principles of self-help and mutual aid.

For the purpose of this survey 198 MPCSs and the umbrella institution of WDCs have been interviewed. Throughout this report the term MPCSs includes WDCs, unless otherwise specified. MPCSs were asked to provide information only regarding their microfinance operations which are carried out through CRBs. Due to the fact that CRBs are not separate entities[5] and a clear division of activities does not exist in most cases, limitations exist in the present analysis. Furthermore, access to data was difficult, as a large number of MPCSs were unwilling to cooperate. Several MPCSs refused to participate in the survey despite having obtained recommendation letters from the Department of Cooperative Development both at national and provincial levels.

Only 8% of the MPCS respondents focus on providing financial services only, while the rest (92%) offer both financial and non-financial services. When asked about the percentage of microfinance activities within their CRBs, the data provided by the respondents suggests that on average 85% of the activities of the CRBs are related to microfinance. 45% of the respondents have stated that 90% or more of the activities of their CRBs are related to microfinance, while for 20% of the respondents, their CRB's activities were entirely related to microfinance.

The most prevalent definition of microfinance among this group of respondents is: providing (small scale) loans to low income groups and to small businesses as capital investments. In fact, 92% of the respondents have mentioned provision of loans in their definition, 31% of them deposits and savings, while only 17% of the respondents have offered a broad definition of microfinance to include other financial services besides loans and savings. This could be explained by the fact that other financial services (with the exception of pawning, which is often assimilated to loans) are not commonly offered by this group of institutions.

The MPCS' definition of microcredit goes slightly beyond the definition for microfinance: it includes the purpose of lending (development), the target group (low income and entrepreneurs) and some of the definitions refer to the loan size as well (between Rs. 15,000 and 100,000).

The definition of the level of monthly income of a low income household is on average Rs. 3,362. However, the responses provided range from Rs. 750 to Rs. 8,000. 9% of the respondents could not provide a definition.

5 An attempt to de-link CRBs from MPCSs was made by the Asian Development Bank through its Rural Finance Sector Development Programme. Due to resistance from various quarters this initiative was largely unsuccessful.

Only 5% of the respondents have defined the threshold monthly income of a low income household as more than Rs. 5,000, while 21% have defined a low income household as having an income of less than Rs. 3,000 a month.

2.2 Organisational Structure and Governance

Organisational Structure

Multi-Purpose Cooperative Societies are member-owned organisations. Operations are coordinated by a Board of Directors at the Divisional Secretariat level. In addition to this general representative body, each MPCS has its own board. This board is responsible for the operations of the MPCS and the CRBs which are owned by it. In addition to this, there is a bank union at provincial level which handles investment activities for MPCSs.

Regulation and Supervision

Multi-Purpose Cooperative Societies and the Women's Development Cooperative Societies are registered under the Cooperative Societies Act No. 5 (1972) and subsequent amendments thereto.

When asked whether they are regulated or supervised, 77% of the respondents have mentioned they are regulated, while 96% acknowledged they are supervised. In fact, all MPCSs are regulated and supervised by the Department of Cooperative Development.

As for the regulating authority, 44% of respondents consider their Board of Directors performs this function, a clear indication that the respondents do not have adequate knowledge regarding the regulatory processes involved. Only 41% correctly identified the Department of Cooperative Development as the regulatory authority.

In the case of supervision, the respondents seem to be better informed (it is also a process which concerns them more directly) – 84% of the respondents who have reported they are supervised have identified the Department of Cooperative Development as the supervisory body, 10% have named their Board of Directors and 7% of them have named the state-owned People's Bank.[6]

Supervisory measures include regular inspection/audit of accounts (mentioned by 87%) and, to a lesser extent, submission of operational information on a regular basis (53%), as well as representation on the management committee or the Board of Directors (46%).

Audit

62% of the respondents have reported that the activities of the MPCSs, and implicitly those of their CRBs, are audited both internally and externally. 29% have reported only an internal audit is performed, while 9% rely exclusively on external audit. According to the legislation in force concerning the MPCSs, all of them should be audited externally by the Department of Cooperative Development, but due to resource constraints, this does not always take place.

Decision making / Strategic planning

97% of respondents claim to set microfinance development goals and design plans and strategies to achieve them. 95% of them claim to follow these goals, plans and strategies. In the majority of cases (between 89% and 95%), annual business plans and strategies regarding interest rates, product design, human resources and target group are set through group decisions (management and Board members, affiliated institutions, staff) through discussions. This hints to a decentralised decision procedure in the case of MPCSs, which is to be expected in member-owned societies.

The overall operating policies are defined by the Board of Directors (95% of respondents) of each MPCS, hence at a central level. However, considering the fact that the organisational structure is quite flat, this implied loss of flexibility is not considerable, having the advantage of a more strategic orientation. For the remaining respondents (4%), a Management Committee has the decision making power.

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6 The People's Bank was established in 1961 with one of its main aims being to provide financial support to the co-operative movement. The bank has since changed its orientation, but it might be that in view of the historical close relations between the People's Bank and the Co-operative Rural Banks a few respondents perceive it to have supervisory authority. At present, the Department of Cooperative Development is exclusively responsible for the supervision of CRBs.

2.3 Operations

Outlet distribution

The 198 MPCSs interviewed maintain a total of 1,452 CRBs. On average, each MPCS has 7 CRBs through which financial services are extended. The number of CRBs attached to an MPCS ranges from one to 55 (MPCS Jaffna).

Table 2-1 Regional and sectoral coverage of CRBs

Province	CRBs		Sector			Population Density per CRB (Population / No. of CRBs)**
	No.	%	Urban	Rural	Estate	
Western	235	16.2	81 (34.5%)	153 (65.1%)	1 (0.4%)	22,898
Central	170	11.7	30 (17.6%)	138 (81.2%)	2 (1.2%)	14,259
Southern	256	17.6	34 (13.3%)	222 (86.7%)	0	8,889
North Western	247	17.0	6 (2.4%)	241 (97.6%)	0	8,785
North Central	112	7.7	1 (0.9%)	111 (99.1%)	0	9,863
Uva	128	8.8	10 (7.8%)	113 (88.3%)	5 (3.9%)	9,198
Sabaragamuwa	170	11.7	17 (10.0%)	153 (90.0%)	0	10,596
Northern *	8.7	6.0	19 (21.8%)	68 (78.2%)	0	7,382 *
Eastern	47	3.2	9 (19.1%)	38 (80.9%)	0	30,204
Total	1,452	100.0	207 (14.3%)	1,237 (85.2%)	8 (0.6%)	12,946

Note * Vavuniya, Mullaittivu and Killinochchi Districts were not covered in the survey. The average CRB density was adjusted to exclude the three districts which were not covered and therefore refers only to the situation in the Jaffna and Mannar Districts.

** The source for population per province is the Census of Population and Housing, Department of Census and Statistics – Sri Lanka, 2001. For the Northern and Eastern Provinces, 2001 estimates from the Department of Census and Statistics were used.

CRBs are present in all provinces of Sri Lanka, but 15 MPCSs in the conflict affected districts of Vavuniya, Mullaittivu and Killinochchi in the Northern Province, were not covered by the survey due to the prevailing security situation, therefore the number of CRBs in these districts could not be ascertained. CRBs have the weakest presence in the Eastern Province with just 47 outlets, while the strongest presence (256 outlets) is found in the Southern Province. However, compared to the population of each of the provinces, the highest outlet density is found in the North Western Province (one outlet for 8,785 inhabitants), followed by the Southern Province (one outlet for 8,899 inhabitants). The lowest outlet density is in the Eastern Province (one outlet for 30,204 inhabitants), followed by the Western Province (one outlet for 22,898 inhabitants).

Regarding the Northern Province, the two districts for which survey data was available (Jaffna and Mannar), seem to be particularly well served with one CRB for 7,382 inhabitants. The three provinces with the largest percentage of CRBs (Southern, North Western and Western), which together account for 50.8% of the total number of CRBs, represent, in terms of population, 52.3% of the total population.

Most CRBs (85.2%) operate in rural areas, compared to 14.3% in urban areas and 0.6% in the estate sector.

Table 2-2 Regional distribution of CRBs vs. poverty distribution

Province	Persons Below the Poverty Line (PBPL)		CRBs		PBPL/ CRB
	No.	%	No.	%	
Western	323,710	12.1	235	17.8	2,307
Central	547,401	20.4	170	12.9	3,220
Southern	558,619	20.9	256	19.4	2,182
North Western	305,364	11.4	247	18.7	1,912
North Central	57,567	2.1	112	8.5	1,785
Uva	356,540	13.3	128	9.7	2,785
Sabaragamuwa	528,824	19.7	170	12.9	3,111
Total	2,678,025	100.0	1,318	100.0	2,432

Note: The poverty percentage was calculated as percentage of the total population living under the poverty line in a given province. The percentage of branches was recalculated excluding the Northern and Eastern Provinces as poverty data for these provinces was not available.

On average, each CRB covers 2,432 people below the poverty line (PBPL) but considerable disparities across regions can be observed. The provinces best served relative to the prevailing poverty levels are the North Central and North Western provinces with 1,785 and 1,912 PBPL served per CRB. These two provinces together have 13.5% of the PBPL in Sri Lanka (according to the Census of Population and Housing, 2001) compared to 27.2% of the total number of CRBs. At the other end of the scale, the Central and Sabaragamuwa provinces seem to be particularly underserved by the CRBs compared to the share of PBPL living in these provinces (one CRB for 3,220 and 3,111 PBPL in Central and Sabaragamuwa province respectively). When looking at the percentage distribution of PBPL compared to that of the CRB outlets, we observe that while these two provinces together account for 40.1% of the PBPL covered by the poverty census, only 25.8% of the CRBs are located in these two provinces.

Clients

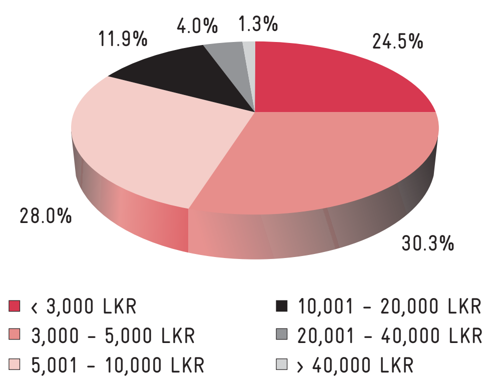
It is almost impossible to estimate the number of microfinance clients of CRBs, since centralised data is available only for the overall banking business of the CRBs and covers mostly account information. The CRBs covered by the survey, maintain over 10 million savings and deposit accounts, close to 3 million loan accounts and around 700, 000 pawning accounts. Even though the respondents were specifically asked for microfinance account information, it is likely that a large number of them provided data concerning their overall banking business. However, considering the fact that 85% of their financial activities are microfinance activities, this could reasonably be taken to be representative of their microfinance portfolio. The issue lies in the fact that it is very likely that clients have multiple savings and deposit accounts within the same institution, therefore estimating the number of clients based on account numbers carries with it the likelihood of some amount of overestimation. However, even allowing for this, CRBs seem to have a good outreach.

Only 63% of the respondents have stated they focus on target groups, suggesting there is no strong client orientation in this institutional group. Of those who focus on target groups, 77% focus on the lower income groups, 75% on women, 71% on farmers, 62% on entrepreneurs and 54% on youth.

Regarding the gender profile of their customers, a slight majority of CRBs seem to serve predominantly women: 51% of respondents have stated they have more female than male customers. 9% of the respondents have stated their female customer share is lower than 25%, while for 38% of the respondents the share of female customers in the total customer base is between 25% and 50%.

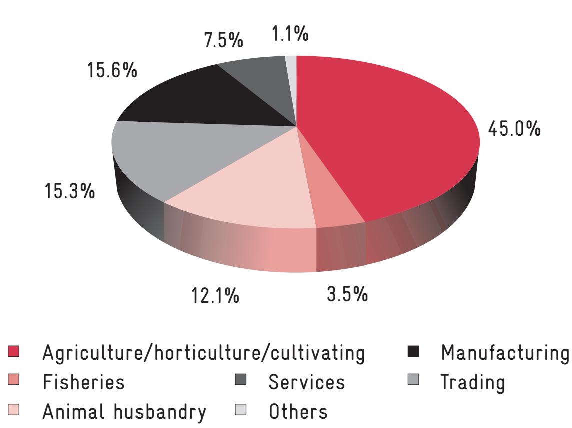
The respondents were also asked to provide an estimation of the income profile of their customers. According to their reporting, 24.5% of their customers have a household income lower than Rs. 3,000 per month, 30.3% of the customers have an income between Rs. 3,000 and Rs. 5,000, 28% have an income between Rs. 5,000 and 10,000, while the remaining 17.2% of the clients have an average household income higher than Rs. 10,000. With almost 55% of their clients earning a maximum of Rs. 5,000, CRBs seem to have a considerable outreach among the lower income group.

Figure 2-1 Monthly income of CRB clients



The highest proportion of CRB customers are involved in agriculture, horticulture and cultivating (45%), followed by manufacturing (15.6%) and trading (15.3%). This is consistent with the fact that CRBs mainly operate in rural areas.

Figure 2-2 Economic activity of CRB clients



According to the survey, the evolution of the customer base in the previous year (2005) has been a positive one: only between 3% and 12% of the respondents have identified a negative development regarding their client base for different products (loans, different types of savings products and pawning), while between 75% and 93% have reported an increase in the client base for the same products. The most successful product from this perspective seems to be pawning. Only 3% of the respondents have reported a decrease, while 93% have reported an increase in the customer base. The most significant loss of customers (12%) is reported for loans.

The respondents who experienced a decline in their customer base have attributed this to lack of funding (52%), increased competition from other microfinance institutions (38%) and the prevailing conflict situation (24%). The first reason mentioned is somehow paradoxical, since the volume outstanding of savings and deposits in the case of CRBs largely exceeds that of loans. The fact that more than half of the respondents have mentioned lack of funding suggests that deposits are used to support other activities of MPCSs. This can also explain the resistance of MPCSs to separate CRBs from their other operations.

Lending methodology

The focus of CRBs is almost entirely on individual lending (99% of the respondents), joint-liability lending is offered by 28% of the respondents, while only one respondent engages in wholesale lending to intermediaries. 72% of the respondents offer individual loans exclusively, while only one respondent provides solely group lending. Even in the case of a mixed lending methodology (individual and group lending), individual loans predominate (on average 85.3% of the loans in the respondents' portfolio).

Identifying potential clients

Potential microfinance clients are identified by CRBs through inspection and field visits (81% of the respondents), evaluation of client's past performance (57%), recommendations of reliable current clients (57%) and to a lesser extent, opportunities arising out of non-microfinance activities of the organisation (21%). It appears that CRBs do not make full use of the opportunities arising from their relationship with the MPCSs.

Loan processing time and approval procedure

The processing time for a loan varies from institution to institution and is between one day and 45 days with a comparatively low average of 18 days. 49% of MPCSs have reported that their CRBs have a loan processing time of under 15 days, while 29% of them have a processing time of at least 30 days. All of the respondents have stated that they require one day for opening a savings account. Pawning facilities can also be obtained within one day.

A minority of MPCS (41%) employ a decentralised loan approval process: they equip their CRB managers with loan approval limits. Most loan applications, however, are submitted to the credit committee or the regional level control body for approval (85%) either directly or if the loan approval limit of the branch manager is exceeded. It is noteworthy that only 35% of MPCS include the evaluation of the loan officer in the loan approval process.

Loan monitoring and provisioning

74% of MPCS have reported their CRBs manage their microfinance operations on a manual basis, 25% of them use a mixed system of both manual and computerised operations. Only one of the 196 respondents has a fully computerised system in place for its CRBs. The access to modern communication technology is also rather limited. Only 7% of the respondents report having access to email facilities and 6% to the Internet.

This lack of access to modern technology has implications for the portfolio monitoring process. Therefore, 91% of respondents rely on log books and other manual records for portfolio monitoring purposes, 56% utilise field visit records, while only 17% rely on computerised financial statements.

When asked whether they carry out a portfolio quality analysis and measure indicators such as Portfolio-at-Risk, 65% of the respondents have stated that they do. However, when asked to define Portfolio-at-Risk, 41% provided an age analysis and made reference to non-performing loans (NPL). Only 24% mentioned the relation between the risk of loss and the loan portfolio in their definitions, 17% consider PaR to be a fixed percentage of the total loan portfolio, while the remaining provided different definitions which are either not related to the concept of PaR or are too general to be able to comment on the degree of understanding of this concept by the respondents.

When asked to define non-performing loans, 73% have referred to an age analysis, while 22% didn't have or couldn't provide such a classification. But even in the case of respondents which have provided classification, a large heterogeneity could be observed, with definitions of non-performing loans going up to five years.

58% of the respondents claim to make provisions for microfinance NPLs. 40% of those who claim to provide for loan losses calculate the provision based on the aging categories. 31% of the responses showed confusion between provisioning and loan recovery mechanisms, while the remaining 26% of the responses were setting fixed provision rates on total loan portfolio, income or profit.

Defaulting clients

In case of a defaulting client the following measures are employed: legal action (83% of respondents), penalties and fines (57%), group or social pressure (44%), and freezing savings/deposit account (44%). It is interesting to notice that arbitration does not play a significant role in the recovery process of CRBs (only 28% of respondents follow this route). The high percentage of legal action is surprising since confiscating and seizing property does not play a major role in recovering loans (16%).

Operational challenges

The respondents identify the main operational challenges for their microfinance business to lie in the inadequacy of Management Information System (MIS) and in poor utilization of technology (65% of all respondents), delayed repayments of loans (58%), strong competition (55%), shortage of funds (46%) and lack of equipment (40%). It has to be noticed that most of the challenges are interrelated: inadequate MIS, poor technology and equipment make loan quality monitoring difficult, which results in poor loan repayment performance. The shortage of funds reflects more an issue of misallocation rather than of funds mobilisation.

2.4 Products and Markets

Loan products are offered by 99% of the respondents (194 out of the 196 respondents). Savings and deposit products are offered by all respondents, two of which have stopped providing loans and offer only savings and deposits. Pawning seems to be a popular product among CRBs as 82% of the respondents have stated they offer it through their CRBs. Leasing and insurance does not play an important role for this group of institutions. These two products are each offered by only two of the 196 respondents. An overview of the product portfolio of CRBs is offered in Table 2-3.

Table 2-3 Microfinance product portfolio of CRBs

Product / Service	No. of MPCSs		Volume Outstanding ('000 Rs.)	No. of Accounts	Average outstanding account balance (Rs.) ***	Annual Interest Rate (%)
	Offer the product/service	Provided information				
Savings and Deposits	196	192*/194**	19,500,033	10,356,388	1,881	3-20
Loans	194	192*/188**	10,829,698	2,783,000	3,631	2-24
Pawning	160	158*/156**	4,272,482	715,823	5,819	14-24

Note * Number of MPCSs which have disclosed the volume outstanding corresponding to their CRBs.

** Number of MPCSs which have disclosed the number of accounts corresponding to their CRBs.

*** The average outstanding account balance was calculated solely based on outlets for which both volume outstanding and number of accounts were disclosed. Due to differences in the number of outlets covered for the two indicators, the result of this column may be different from the mere division of the column "Volume outstanding" by the column "Number of accounts".

Loan products

Loan products are offered by the CRBs of 99% of the respondents. Two MPCSs in the sample have stated their CRBs offer only savings products and no loans. A respondent has an average loan volume outstanding of Rs. 56 million and 14,803 loan accounts. The volume outstanding ranges between Rs. 95,000 and Rs. 1 billion. The CRBs under the umbrella of the five largest MPCSs (3% of the respondents) account for 30% of the total volume outstanding. As for the number of loan accounts, these range from just four to 2.4 million accounts. Here, the discrepancy is even more evident, as the largest MPCS in terms of number of accounts holds 86% of the total number of accounts. In fact, if this respondent is excluded from the sample, the average number of accounts per MPCS drops to only 2,054. The average outstanding loan balance of Rs. 3,631 is intriguingly low and may reflect the risk aversion of CRBs in granting larger loans to clients with a low degree of creditworthiness as well as the generally low absorption capacity of their clients.

A number of CRBs offer strongly subsidised loans. 43% of the respondents have reported at least one product with an interest rate no more than 15%, which is significantly under the rate of inflation and is therefore a negative interest rate.

Minimum loan values available to customers (excluding wholesale lending) range between Rs. 250 and Rs. 30,000. The minimum value in case of 71% of the respondents does not exceed Rs. 5,000. 37% of the respondents have maximum values not exceeding Rs. 50,000, which is also quite low.

The repayment period of the loans ranges from one to 144 months. 78% of MPCSs have reported loan products with a repayment period of 36 months or more. This indicates that CRBs cater to the long-term needs of the customers, such as housing.

97% of the respondents require compulsory savings in order to approve a loan.

Interest rates are set by 57% of the respondents at regional level, while 36% of the respondents have mentioned the CRBs under their umbrella have the authority to decide on the interest rates charged. Interest rates are mainly set based on commercial rates (67%), while 30% of respondents set them at a rate which maintains a set margin above the deposit rate.

61% of the respondents have reported they apply penalties on late payments and interest rate reductions for early payments. 33% of the respondents have reported no special conditions, while 16% have special terms for specific target groups.

98% of the respondents have stated their CRBs calculate interest rate based on the declining balance basis. 62% of the respondents have mentioned that they charge a service fee in order to process a loan application.

Formal lending requirements

On average 3% of loan applications received are rejected, with rejection rates ranging between 0% and 25%. It is interesting to notice that 34% of the respondents do not reject any application, while only 13% of the respondents reject 10% or more of the loan applications received. The low rate of rejection may be explained by the existence of a pre-screening process of clients, since formal requirements are extremely rigorous, at least according to the information provided by the respondents.

In order to qualify for a loan, potential clients have to be members of the MPCS (mentioned by 96% of the respondents), present guarantors (94%), show proof of having income sources (86%), hold a minimum deposit with the CRB (80%), show proof of established residency (80%), provide collateral (63%) and receive the approval of the regional level control body (40%). Around a third of the respondents have also mentioned the need for a recommendation from a third party such as a CRB leader or member.

The conclusion of the analysis of the formal lending requirements in the case of CRBs indicates that loans offered by this group of institutions tend to be over-collateralised. Besides the fact that almost two thirds of the respondents have mentioned physical collateral as a requirement, a large majority require other forms of security such as guarantors, proof of income sources, minimum deposits etc. It is difficult to believe that the typical microfinance client will be able to comply with these all these requirements.

It is also noteworthy that despite such stringent formal lending requirements, CRBs mention delayed loan repayment to be one of the main operational challenges they face. This suggests that either in practice these lending requirements are not always enforced or that CRBs are highly inefficient in enforcing loan repayment, despite all the loan securitization measures in place.

Savings products

All CRBs offer savings products to their customers. On average the savings volume outstanding is Rs. 102 million per CRB, but there are large heterogeneities in the sample. The savings volumes outstanding of individual respondents range from Rs. 49,700 to Rs. 1.2 billion. The ten largest respondents, representing 5% of the total number of respondents, together hold 28% of the savings portfolio. As for the number of accounts, on average each respondent has 53,383 accounts. The range for the number of accounts lies between 25 and 5.6 million accounts. The concentration in terms of number of accounts is even more evident. The largest MPCS holds more than half (54.5%) of the total number of accounts, while the ten largest respondents hold together 62.2% of the total number of accounts.

The average savings account balance of Rs. 1,881 is extremely low. This speaks for a low savings capacity of the microfinance client base of CRBs, which is in line with their estimate that 55% of their clients have a monthly income level of Rs. 5,000 or less. At the same time, there was no information available on the average number of savings accounts one each client holds, whereby the average savings balance at client level might be higher.

With respect to interest rates, 95% of the respondents have mentioned their CRBs have at least one product with an annual interest rate below 11%, the inflation rate for 2006. [7] In the case of 45% of the respondents all their savings products carried interest rates of below 11%, clients thus receiving negative real interest rates. The average interest rate offered by all respondents across all savings/deposit products is 8.65% per annum. The minimum amount required to open a savings account ranges from Rs. 5 to Rs. 500. 75% of the respondents do not require more than Rs. 100.

Other products

The CRBs of 160 of the 196 (82%) MPCSs offer pawning facilities. The volume outstanding on pawning accounts for the CRBs covered by the survey ranges from Rs. 101,750 to Rs. 190 million, an average of Rs. 27 million per respondent. The ten largest respondents (6% of the respondents) account for 27% of the volume outstanding. The number of pawning accounts ranges from 11 to 32,828, which gives an average per respondent of 4,588. The ten largest respondents hold 21% of the total pawning accounts.

Interest rates on pawning facilities range from 14% to 24% per annum, with 80% of respondents charging less than 20%. The minimum value that can be obtained through pawning goes up to as much as Rs. 10,000, but 89% of the respondents have mentioned minimum values of no more than Rs. 5,000. 55% of the respondents have a maximum available value of Rs. 50,000 or less.

It is interesting to notice that the average outstanding balance of a loan is smaller than that of a pawning account. We can infer that CRBs prefer to offer pawning than loans to the lower income groups as they carry fewer risks since they have recourse to an asset to recover outstanding dues in the event of default. However, this makes access to finance for the poor conditional upon having something of value which could be pawned. Therefore the goal of microfinance to facilitate access to financial services for the lower income group cannot be considered to be attained in the case of CRBs.

7 The World Bank, World Development Indicators.

Insurance, leasing and a pension product are each offered by two of the 196 MPCSs. This group of institutions thus seems to have little diversification of their product portfolio, concentrating only on traditional loan and savings products.

Delivery of products and marketing strategies

Products and services are directly delivered through branches (95%) and to a lesser extent through field officers (22%). 9% of the respondents have stated they deliver their products through links with other institutions.

CRBs marketing strategies focus on leaflets (76%), promotion through the general activities of the MPCSs (73%), banners, posters and hoardings (68%) and through members of the MPCS (67%). The respondents seem to have an appropriate approach to marketing – they employ cost effective measures and use their organisational potential.

Product development

Microfinance product development is mainly handled at MPCS level with inputs from individual CRBs (72%). The Board of Directors of the MPCS decide on the products to be introduced. However, the approval of the Assistant or Provincial Commissioner of Co-operatives is required in order to introduce new products on the market. From the responses obtained, in 15% of the cases, product development is handled at CRB level by an internal team and in 11% of the cases by the manager. Considering the fact that this group of institutions has a rather flat structure, it seems reasonable to place product development at the MPCS level.

When asked about new products to be introduced to the market, 77% of respondents claimed they had plans to introduce new products, while 23% do not. Of the respondents which had plans to introduce new products, the majority focused on a further diversification of existing savings (85%), loans (83%) and pawning (43%) products. Only 10% of the respondents with plans to introduce new products considered pension products. Other products such as insurance, leasing and money transfer were mentioned by 3% to 6% of the respondents with plans to introduce new products.

During the previous two years, 40% of the respondents have not introduced any new microfinance products, while 46% have introduced between one and three new products. The remaining 14% have introduced between four and 15 new microfinance products. During the same period, only 5% have withdrawn between one and three microfinance products from the market. This indicates that products once introduced are usually kept in the product portfolio irrespective of their success.

2.5 Human Resources

The total staff of the MPCSs interviewed ranges from four to 376, while Women's Development Cooperative Societies employ a total of 3,000 staff. On average, the institutions covered by this chapter employ 14 staff per outlet. The following table provides an overview of MPCS/WDC staff. The total number of staff involved in microfinance is not known. At the same time, considering the fact that CRBs are not separate entities, in 88% of the cases staff is also involved in other non-financial activities of the MPCSs.

Table 2-4 Microfinance staff complement of Multi-Purpose Cooperative Societies

	Total Staff* (MPCSs and WDCs)	Managerial	Credit/Field Officer	Clerical	Others/ Support Staff
Absolute Number (%)	20,077	(30.3%)	(7.4%)	(38.5%)	(23.6%)
Minimum Qualification Required		A/L passed (51%) / O/L passed (22%)/ below O/L (11%)/tertiary education(13%)	A/L passed (45%) / O/L passed (39%) / below O/L(14%)	A/L passed (45%) / O/L passed (40%) / below O/L(12%)	n/a
Experience required		yes (78%)	yes (67%)	yes (67%)	n/a

n/a not available

The share of clerical staff is comparatively high at 38.5%, while credit/field officers account for only 7.4% of total staff. The minimum qualifications required for clerical staff and credit/field officer positions do not differ significantly. It is however surprising that a considerable number of respondents (between 11% and 14% for the different staff categories) accept staff without even O/L qualifications.

Of the 19,757 staff for which the break down by contract type was provided by the respondents, 71% of them had permanent status, 15% were volunteer staff, while the rest of them were time-bound workers, short term staff or casual workers. The relatively high percentage of volunteer staff comes from the fact that all staff of Women's Development Cooperative Societies are volunteers.

Recruitment challenges

The respondents have identified the following challenges to recruiting suitable staff for their microfinance operations: the absence of a pension system (between 60% and 63% depending on the type of positions), attractive remuneration and benefit packages in competitor organizations (between 51% and 55%), as well as the lack of skilled staff (between 49% and 52%). In addition to these main challenges the respondents have identified a series of other issues including unattractive locations (between 42% and 44%) and the lack of staff with experience in microfinance (between 29% and 57%).

Staff retention

The most important staff retention issues mentioned by MPCSs were: lack of technology and the wide utilisation of manual processes (78%), inadequate remuneration (71%), inadequate incentives (63%), and overload of work (36%).

Incentives

The incentives provided by MPCSs for their microfinance staff include, according to the survey: training opportunities (92%), remunerative incentives (68%), staff loans at concessionary rates (67%) and overtime pay (66%). In view of the staff recruitment and retention issues mentioned above, these incentives seem to be insufficient.

MPCSs provide differentiated training according to each category of staff. Managers receive training mainly in human resource development (mentioned by 67% of respondents), project management (62%), customer care (60%), marketing (54%) and business planning (52%). It has to be noticed that the courses offered by the majority of the respondents cover general management skills and do not address specific microfinance management issues, even though the lack of staff with microfinance training was mentioned as one of the main recruitment constraints. Clerical staff receives training in record keeping (60%), accounting skills (52%) and customer care (51%), while credit and field officers receive training in client and customer care (58%) and credit evaluation (50%). It has to be mentioned that language and IT training seems to receive little attention from this group of institutions, being mentioned only by a minority of the respondents.

In terms of number of courses offered per year per respondent for each staff category, managerial staff received on average 3.4 training sessions per year, followed by credit and field officers with 2.9 training courses per year, clerical staff with 2.7 training courses and support staff with 1.7 training sessions per year.

2.6 Financial Performance

In 195 of the 196 institutions interviewed the set of financial statements was available; 25 of them had microfinance specific statements, the others had overall statements in which the microfinance segment was included. Of this number, 171 (88%) were willing to provide information regarding their financial performance.

Performance ratios could not be calculated based on the data provided since balance sheets consolidated all activities of the MPCSs, while income statements provided were related only to the activities of CRBs. Considering all these issues, an analysis of the financial performance of the CRBs could not be carried out.

Around the half of the CRBs (52%) covered by the survey have declared that they transfer their surplus earnings to their respective MPCS or to the Department of Cooperative Development at district or provincial level, while the rest has stated they retain their profits within the CRB. At MPCS level, 58% of respondents have said they pass their surpluses on to the Department of Cooperative Development at district or provincial levels. This mixed picture hints at misunderstandings at MPCS level regarding their rights and duties and creates the premises of public interference in their business affairs. This may represent an important source of inefficiencies. According to information available from the representatives of the Department of Cooperative Development at district level, MPCSs are allowed to use internally generated surpluses to build provisions. For any other use of the surplus earned, according to the respondents, MPCSs need the approval of the Department of Cooperative Development (head office in Colombo). According to the Co-operative Societies Law, registered co-operative societies are required to transfer at least 25% of their net profits to a reserve fund. The remainder of the profit may be used for the payment of dividends to members, payment of bonuses to employees, contributions to funds etc. As member-owned organisations, MPCSs should be allowed more independence to decide regarding the utilisation of their profits. This would be a strong incentive for them to operate more efficiently. A consequence of the current regulation could be an underreporting of profits, thus distorting the true picture of the financial performance of MPCSs and their CRBs.

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Samurdhi Bank Societies

3. Samurdhi Bank Societies

3.1 Institutional Background

Samurdhi Bank Societies (SBSs) were established in 1996 as part of the National Samurdhi Programme, a wide-ranging governmental poverty alleviation programme targeting youth, women and the disadvantaged. The Samurdhi Programme is implemented by the Samurdhi Authority of Sri Lanka. The Programme has three major components: provision of a consumption grant (food stamps); provision of savings and credit facilities; and rehabilitation and development of rural infrastructure. The second component is carried out through the SBSs.[8]

The establishment of the SBSs was aimed at promoting savings among low-income groups and providing financing for entrepreneurial and business development. The SBSs have been involved solely in microfinance activities since their inception, targeting low-income households (defined as households having an income of less than Rs. 1,500 a month). Microcredit is defined by SBSs as a loan below Rs. 100,000.

3.2 Organisational Structure and Governance

Organisational Structure

As can be seen in figure 3-1 the organisational structure of the Samurdhi Programme is complex and highly hierarchical, going from the Grama Niladhari Division level up to the zonal, divisional, district and national levels. Financial services are provided through the Banking Finance Division of the Samurdhi Authority and follow a similar hierarchical structure. The Banking Finance Division is considered the Head Office of the Banking Societies.

Although for the purpose of this study, only the Banking Finance Division of the Samurdhi Authority was interviewed, the responses provided concern the general operations of the SBSs. In view of the high level of centralisation of the operations, this was considered to be representative.

Regulation and Supervision

The activities of SBSs are governed solely by the Samurdhi Authority Act No. 30 of 1995. Although the Auditor General's Department was cited as the responsible supervisory authority, its role is not a supervisory one, as it is in reality limited to an annual audit, which in turn is limited by several factors as mentioned below. According to the information provided by the respondent, both offsite and onsite inspections of accounts are performed and the SBSs have to report monthly to the Samurdhi Authority – note that the responses refer to internal supervisory measures and to an external audit, but that there is no independent supervisory body.

SBSs are not supervised by the Central Bank of Sri Lanka (CBSL). Deposits are not insured by the Government of Sri Lanka.[9] In fact, the CBSL is cited to have stressed the risks of SBSs mobilising large volumes of savings without proper regulation and supervision in its 1997 Annual Report[10]

Audit

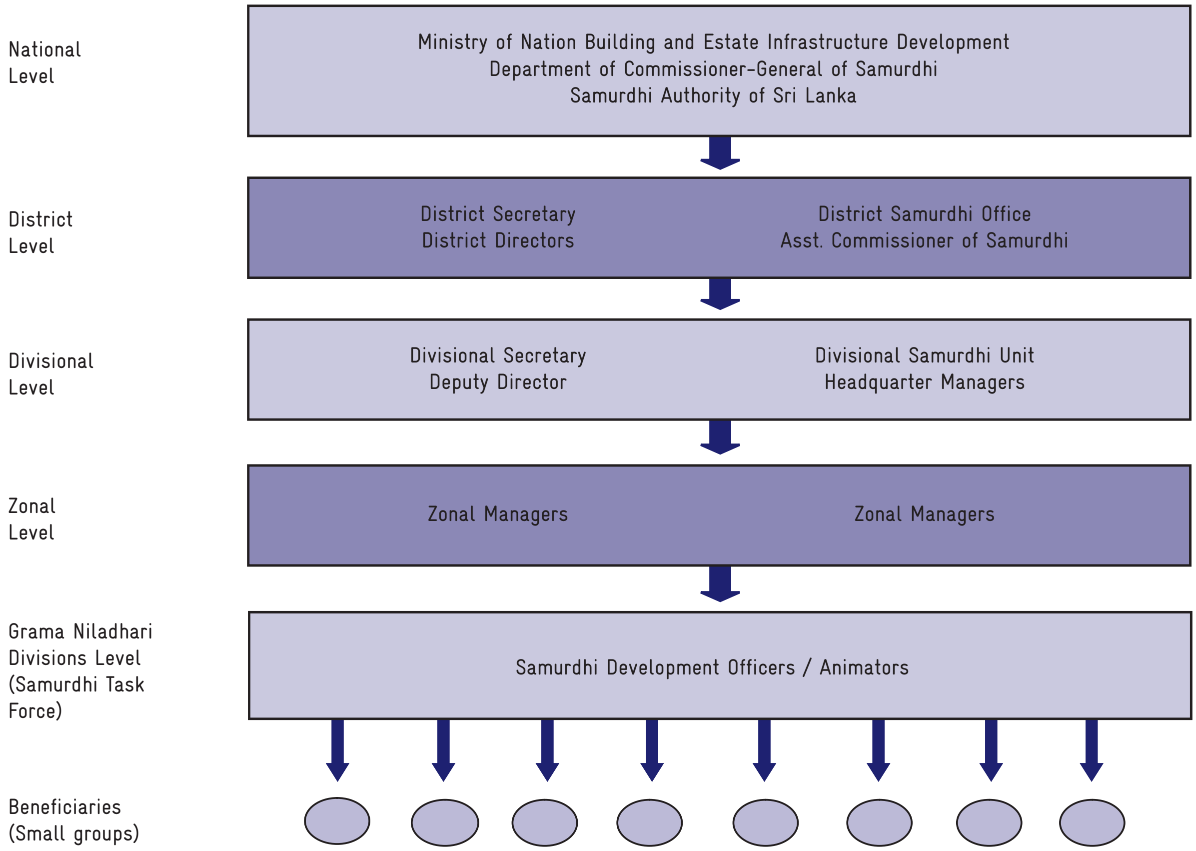
Although SBSs are part of the comprehensive Samurdhi Programme, they are managed as separate entities with their own books of accounts. The Samurdhi Authority has an Internal Audit Department, which is responsible for the internal audit of the SBSs. Due to capacity limitations, the internal audit is performed from the Maha Sangam level upward (a Maha Sangam covers approximately 10 SBSs). The accounts of the individual SBSs are checked by the accounting departments at Divisional level.

8 See World Bank (2003), "An Empirical Evaluation of Samurdhi Programme" and ILO (2000), "The Samurdhi Poverty Alleviation Scheme".

9 World Bank (2003), "An Empirical Evaluation of Samurdhi Programme"

10 Conroy, John D. (2000), "Sri Lanka", in: "The Role of Central Banks in Microfinance in Asia and the Pacific", Vol. 2: Country Cases.

Figure 3-1 Administrative Levels of the National Samurdhi Programme



Source: Annual Report of the Samurdhi Authority (2003) and http://www.priu.gov.lk/

External audit is performed by the Auditor General's Department for the Samurdhi Authority only. Individual SBSs are not audited by the Auditor General. Instead, the accountants of the Divisional Secretariat offices have been authorised to audit SBSs. Considering the complexity of the National Samurdhi Programme, as well as the obvious staff and resource constraints of Divisional Secretariat offices, there is no meaningful external audit of the SBSs taking place.

Decision making / Strategic planning

The Samurdhi Authority declares that the SBSs prepare, and adhere to, microfinance business development goals in accordance with the business plans and strategies designed by the government or the relevant authorities. Available information suggests that the responsible Ministry plays a role in determining key strategic elements such as interest rates (which, according to the respondent, are based on the computation of product costs), human resource management, product design, target group definition, as well as the general policies of the SBSs. The Treasury determines the funds available to the SBSs through the Banking Finance Division.

The operating policies of the SBSs are defined by the Board of Directors of the Samurdhi Authority. The question arises whether there is sufficient microfinance specialist knowledge at such a high hierarchical level.

3.3 Operations

Outlet distribution

The regional and sectoral distribution of the SBSs is presented in the table below:

Table 3-1 Regional and sectoral coverage of SBSs

Province	SBSs		Sector			Population Density per PTCCS (Population / No. of SBSs)*
	No.	%	Urban	Rural	Estate	
Western	184	17.7	21 (11.4%)	163 (88.6%)	0	29,137
Central	165	15.9	5 (3.0%)	159 (96.4%)	1 (0.6%)	14,725
Southern	160	15.4	8 (5.0%)	151 (94.4%)	1 (0.6%)	14,322
North Western	167	16.1	3 (1.8%)	164 (98.2%)	0	12,920
North Central	75	7.2	1 (1.3%)	74 (98.7%)	0	14,941
Uva	70	6.7	3 (4.3%)	67 (95.7%)	0	16,725
Sabaragamuwa	90	8.7	2 (2.2%)	88 (97.8%)	0	19,866
Northern	37	3.6	5 (13.5%)	32 (86.5%)	0	28,134
Eastern	90	8.7	6 (6.7%)	84 (93.3%)	0	19,666
Total	1,038	100.0	54 (5.2%)	982 (94.6%)	2 (0.2%)	18,419

Note * The source for population per province is the Census of Population and Housing, Department of Census and Statistics – Sri Lanka, 2001. For the Northern and Eastern Provinces, 2001 estimates from the Department of Census and Statistics were used.

SBSs have good nationwide coverage and serve mainly rural areas (95%). The only districts which are not covered are Mannar, Mullaittivu and Killinochchi, due to the conflict situation. The distribution between the urban and rural sectors ranges between 1.3% and 13.5% in the urban sector and between 86.5% and 98.7% in the rural sector. The Northern and Western Provinces have a higher proportion of urban branches compared to other provinces. The population density per SBS varies between 12,920 in the North Western Province and 29,137 in the Western Province, with a national average of 18,419 people per SBS.

12.2% of all SBSs are located in the Northern and Eastern Provinces. Poverty figures are not available for these provinces but it is noted that the coverage closely corresponds with the percentage of the country's population living in these provinces (approximately 13%).

The estate sector is clearly underserved, with only 0.2% of SBSs located in estate areas. This is particularly significant, especially considering the fact that 8.57% of persons below the poverty line (PBPL) in Sri Lanka live in the estate sector.[11]

Table 3-2 compares the regional distribution of SBSs with that of the population living under the poverty line.

11 ILO (2000), "The Samurdhi Poverty Alleviation Scheme.

Table 3-2 Regional distribution of SBSs vs. poverty distribution

Province	Persons Below the Poverty Line (PBPL)		SBSs		PBPL/ SBS
	No.	%	No.	%	
Western	542,157	16.9	184	20.2	2,947
Central	547,401	17.1	165	18.1	3,318
Southern	558,619	17.4	160	17.6	3,491
North Western	472,384	14.4	167	18.3	2,829
North Central	199,875	6.2	75	8.2	2,665
Uva	356,540	11.1	70	7.7	5,093
Sabaragamuwa	528,824	16.5	90	9.9	5,876
Total	3,205,800	100.0	911	100.0	3,519

Note The poverty percentage represents the percentage of the total population (excluding the Northern and Eastern Provinces) living under the poverty line in a given province. The percentage of SBS branches was re-calculated as poverty data for the Northern and Eastern Provinces was not available.

The density of PBPL per SBS ranges between 2,665 in the North Central Province to 5,876 in the Sabaragamuwa Province, which suggests rather large regional disparities in serving the poor. Comparing the percentage of population that lives under the poverty line with the percentage of SBSs in each province, it is observed that Uva and Sabaragamuwa are significantly underserved with 11.12% and 16.49%, respectively, of the persons below poverty line in the country, but only 8.23% and 7.68%, respectively, of the SBSs. The Western, Central, North Western and North Central Provinces display a higher percentage of SBSs compared to their poverty percentage.

Clients

SBSs serve a total of 2.3 million members and another 227,000 non-member clients who hold only savings accounts with the SBSs and are not entitled to loans. Both female and male clients are served; however, females represent the majority of clients (around 65%).

Approximately 85% of all clients have a monthly household income of less than Rs. 1,500 (and therefore fall within the target group definition of the SBSs), while the remaining 15% are from higher income groups. These figures must be analysed with caution as they may be only rough estimates made at the top hierarchical level. The proportion of clients with incomes greater than Rs. 1,500 could be higher due to the fact that non-members can open savings accounts as well. It could also be due to the SBSs lending to individuals outside the target group, thus contravening the Samurdhi Programme's poverty focus. It has to be noted that even though the Samurdhi Programme has an income-based exit criterion for its members, a report of the International Labour Organisation (2000) finds its enforcement virtually nonexistent, due to the lack of effective controls and also due to political pressure.[12]

Lending methodology

Although the respondent categorised the lending as being solely individual, the procedures in place suggest that group lending is the methodology used by the SBSs. Only members (shareholders) can borrow, and to do so, the borrower has to be in a group of five people, with the other four members guaranteeing the loan repayment.

12 ILO (2000), "The Samurdhi Poverty Alleviation Scheme"

Identifying potential clients

According to the respondent, SBSs identify microfinance clients by carrying out field visits, evaluating past performance and following up recommendations of reliable current clients. In view of the answers given, it would seem that the SBSs do not make good use of the opportunities that arise out of the other components of the Samurdhi Programme, but due to the restrictions in the sample selection, the reality in the field might be different.

Loan processing time and approval procedure

The average processing time for a loan is 14 days. This is the average time from handing in an application up to the disbursement of the loan. For opening a deposit or savings account, the processing time is one day. Loan approval is through a credit committee at the regional level control body (Palaka Mandalaya), which denotes a centralised approach.

Loan monitoring and provisioning

Microfinance operations are managed on a manual basis. The consequent monitoring of loan repayment relies on checking of log books, account entries and manual records.

SBSs use the following classifications with regards to overdue loans:

- Portfolio-at-risk (PaR) is used as a measure of loan portfolio quality and is defined as the outstanding debt in case any one instalment of the loan is overdue for more than 70 days. [13]

- Non-performing loans (NPL) are used as a measure of bad debts and refers to loans with any instalment overdue for more than nine months.

Loan loss provisions are calculated only for NPLs. The loan loss reserve stood at 7.4% of the gross loan portfolio as at 2005. So far, according to the information provided, write-offs against provisions have not been executed.

Defaulting clients

In case of default by a client, SBSs exert social pressure by contacting guarantors, impose penalties and freezing savings account(s). If these measures fail, SBSs engage in arbitration through a mediation board. SBSs do not seem to take legal action against defaulting clients, probably due to the social mission of the Samurdhi Programme and due to the fact that the cost of engaging in legal action is high relative to the average loan size.

Operational challenges

SBSs identify their main operational challenges to be staff-related. On one hand, they face overstaffing which leads to high operational costs; on the other hand, the staff lack appropriate skills. The respondent also cited the high level of staff fraud as a challenge. Other operational challenges, as identified by the respondent, include the lack of a clear definition of the target group and a lack of awareness among potential beneficiaries as to how to use the funds appropriately, which results in an insufficient demand for loans. Another challenge mentioned was the lack of cohesion among group members, which could be due to the fact that groups are often built arbitrarily by the Samurdhi Development Officers and not based on existing social relationships and affinities.[14]

3.4 Products and Markets

SBSs offer different types of savings and loan products. An overview of the product portfolio is presented in table 3-3.

The SBSs are able to mobilize savings quite well even though the average outstanding balance for voluntary savings is extremely low (slightly under LKR 2,000). The average outstanding loan balance of less than LKR 12,000 is also relatively low, indicating a low absorption capacity of SBS borrowers.

13 The internationally accepted norm for microfinance loan portfolio quality is PaR30 for weekly or bi-weekly loan repayments (i.e. loan portfolio greater than 30 days past due) and PaR90 for monthly loan repayments.

14 See ILO (2000), The Samurdhi Poverty Alleviation Scheme".

Table 3-3 Microfinance product portfolio of SBSs

Product / Service	Volume Outstanding ('000 Rs.)	No. of Accounts	Average outstanding account balance (Rs.)	Annual Interest Rate (%)
Voluntary Savings / Short-Term Deposits (for Members and Non-Members)	8,815,360	4,520,894	1,950	5.64%
Compulsory Savings	8,799,000	1,352,330	6,507	8.5%
Shares	3,196,000	2,422,396	1,319	-
Loans	7,785,071	656,330	11,862	14-18%

Figures as at 30 June 2007

Loan products

Interest rates on loans are calculated on a declining balance basis and there is no service charge for processing loans. There is no minimum loan amount and maximum loan amounts range from LKR 5,000 for distress loans to LKR 100,000 for self-employment loans. The repayment periods vary from 3 months for distress loans to 60 months in the case of loans for self-employment, production, agriculture and fisheries. More details are provided in the table below:

Table 3-4 Overview of terms and conditions of SBS loan products

Loan Purpose	Maximum Loan Amount (Rs.)	Maximum Repayment Period (Months)	Annual Interest Rate (%)
Self Employment	100,000	60	14-18%
Production, Agricultural/Fisheries	15,000	60	18%
Self Empowerment	Not Mentioned	Depends on Repayment Capacity	2% Above Deposit Rate
Housing	30,000	36	18%
Distress	5,000	3	18%
Consumption	10,000	6	18%

Lending conditions

In order to obtain a loan, eligible individuals have to be at least 18 years of age, become a member of an SBS and own at least one SBS share of Rs.500, present a certificate from the Samurdhi Development Officer (SDO), maintain a minimum deposit or bank balance, be part of a group of five members with the other four members having the role of guarantors and receive the approval of the regional level control body. The requirement for a group of guarantors and maintenance of a minimum deposit balance are essentially collateral substitutes.

Savings products

Whereas loans are available only to members who own at least one share of an SBS, valued at LKR 500, which can be built up through savings over time, savings are accepted from both members and non-members. There are both compulsory and voluntary savings schemes, the compulsory loan scheme being a requirement for borrowing. SBSs offer specific savings schemes for particular target groups such as women, students, and children.

Delivery of products and marketing strategies

Products and services are directly delivered through SBS branches as well as through SDOs.

Product development

New product development is handled at the central level with support from individual SBSs based on the experiences of field officers. The products offered by competitors are also monitored. The respondent mentioned preparations in progress to introduce fixed term deposits, pawning, micro leasing and money transfer services.

3.5 Human Resources

The following table provides an overview of the SBSs' staff complement.

Table 3-5 Microfinance staff complement of SBSs

	Total Staff*	Managerial	Loan Officers / Clerical Staff	Samurdhi Development Officers (SDOs)
Absolute Number	14,500	1,040 (16%)	5,460 (84%)	8,000
Type of Employment	Permanent	Permanent	Permanent	Permanent
Staff per Branch (Average)	14	-	-	-
Staff Productivity**	437	-	-	-
Minimum Qualification Required		Graduate	O/L passed	Not mentioned
Experience Required		No	No	No

Note * A third of the SDOs are included, as apportioned by the Samurdhi Authority in their financial reporting.

** Staff productivity is calculated as the total number of savings and loan accounts divided by the total number of staff.

Recruitment challenges

The respondent did not mention any challenges with regard to the recruitment of SDOs, probably due to the fact there are no strict minimum qualification requirements and employment with the state is considered attractive. A report of the International Labour Organisation (2000) suggests that recruitment of the SDOs is done "to satisfy the employment creation motive of the government and to gain political mileage".[15]

The respondent mentioned several challenges with regards to recruiting managerial staff, which include the difficulty of finding skilled people with microfinance experience, more attractive packages and/or remuneration offered by competing organisations, the absence of a pension system, and poor working conditions.

Staff retention

The main retention issue mentioned is the lack of technology. This must be seen against the background that SBSs' operations are run on a manual basis, which probably leads to some frustration among staff. However, one would have expected monetary issues to play a role in retaining staff since attractive remuneration packages offered by competitors are seen as a challenge in recruiting managers.

15 ILO (2000), *"The Samurdhi Poverty Alleviation Scheme"*.

Incentives

The incentives cited by the respondent were of a monetary nature (remunerative incentives and distribution of revenue in the form of bonuses) and in the form of training opportunities and medical insurance. It has to be noted though that the respondent cited insufficient remuneration as a constraint in recruiting managers. Performance-based incentives seem to be insignificant or altogether non-existent.

Staff training

According to the responses received, the key focus areas of training for both managerial staff and field officers are: human resources development and staff productivity, group mobilisation, and accounting skills. In addition, the respondent mentioned that managerial staff receives training in project management, marketing, business planning, record keeping, IT, development of language skills, risk management, and training in basic financial analysis.

3.6 Financial Performance

The following tables summarise SBS balance sheets for 2005 (Table 3-6) and income statements for 2004 and 2005 (Table 3-7).

Table 3-6 SBSs – Consolidated Balance Sheet (Rs. '000)

Items	2005
Total Current Assets	24,905,300
Total Non - Current Assets	14,297
Net Loan Portfolio	7,651, 179
Total Assets	32,570,776
Total Deposits	20,995,511
Total Borrowings*	2,085,433
Total Other Liabilities	2,657,552
Total Liabilities	25,738,496
Total Equity	6,832,280
Total Liabilities and Equity	32,570,776

Note *Concessional borrowings

SBS sources of funding are mainly short-term deposits from members and non-members (81.6% of total liabilities). The cost of funds[16] is 5.8% while the lending rate[17] is 11.4%. Hence, the financial spread is 5.6%. The financial spread covers administrative expenses and risk costs.

The lending activity ratio (i.e. gross loan portfolio over total assets) is 25.4%, i.e. only every fourth Rupee is invested in lending activities, hence in financial intermediation. SBSs major financial activity seems to consist of investing customers' savings with other financial institutions.

16 Interest and fees on funding liabilities / average total funding liabilities of that period.

17 Interest income from lending / average gross loan portfolio of that year.

Table 3-7 SBSs – Consolidated Income Statement (Rs. '000)

Items	2005	2004
Total Operating Revenue	2,749,616	2,364,365
Total Financial Expenses	1,335,999	1,046,055
Total Operating Expenses	298,517	323,642
Loan Loss Provision Expenses	7,569	172,625
Net Income from Operations	1,107,529	822,042
Net Income	1,107,529	822,042

The reported operating expenses are substantially underestimated, as personnel expenses are largely borne by the Government and are not reflected in the SBSs financial statements. The proportion of personnel costs of the SDOs attributable to the SBSs is estimated at one-third considering the fact that SDOs are not assigned solely to banking activities. It has to be noted that this estimate is rather arbitrary.

The actual operating expenses booked to the SBSs are computed on the basis of 45% of the interest earned on compulsory savings. Furthermore, SBSs do not pay taxes, and as a wholly state-owned programme, might benefit from other indirect subsidies. The decrease in operating expenses between 2004 and 2005 is surprising and further analysis is needed in order to be able to explain its causes. The decrease in loan loss provision expenses in the same period is also substantial and noteworthy.

NGOs

4. NGOs

4.1 Institutional Background

A large number of non-governmental organizations (NGOs) – national as well as international – and community-based organisations (CBOs) operate in Sri Lanka. NGOs are not-for-profit organisations that provide humanitarian or development aid to disadvantaged groups, and are operational across the island, including conflict areas. In recent years, a significant number of NGOs have become involved in microfinance activities. This chapter focuses on NGOs as microfinance providers – as such, the use of the otherwise broader term NGO should be understood as referring to NGO Microfinance Institutions (MFIs).

For the purpose of this survey, all identified NGOs with significant microfinance outreach (i.e. with at least 500 microfinance clients – in the Northern and Eastern Provinces, this threshold was lowered to a minimum of 100 microfinance clients) were interviewed. As a result, the sample includes 83 institutions with significant microfinance operations. Among these, 69 are national NGOs, 3 are international NGOs, and 11 are institutions with a similar profile to NGOs, although registered as companies limited by guarantee (5 of them), limited liability companies (5 of them) and 1 mutual society. We will, henceforth, refer to all of the above as NGOs.

All NGOs interviewed were established between 1962 and 2005, and started their microfinance activities in Sri Lanka between 1984 and 2006. However, only 6 NGOs started microfinance activities before 1990, while 60 NGOs (72%) interviewed started their microfinance operations in or after 1995. While four NGOs provide financial services only, the remaining 79 NGOs offer both financial and non-financial services:

- Financial services: loans (99% of the sample), savings (89%) and insurance (28%). Other products such as leasing, pawning or grants are each offered by only one NGO respectively. Of the 23 NGOs offering insurance products, 15 have insurance products of their own and 8 retail the products of insurance companies.
- Non-financial services: training and skills development (95% of the 79 NGOs offering non-financial services), financial advisory services (86%), group mobilisation (86%), business development services (62%) and marketing assistance (51%). In addition, NGOs provide a large range of other services such as welfare, medical, and educational services.

On average, in terms of resources utilized, 73% of activities of the NGOs in the sample are related to microfinance. 73 NGOs in the sample declared the proportion of their microfinance activities to be at least 50%. For 30 of them, this figure is 90% and higher.

The most prevalent definition of microfinance is: providing loans to low-income groups, to the self-employed and (small) businesses as capital investments in order to empower them and/or enhance their lives. It appears that most NGOs equate microfinance with microcredit despite the fact that a large number offer savings facilities, too.

4.2 Ownership and Governance

Ownership

65% of the NGOs in the sample are reported to be owned by members, 14% of them by the Director Board and 11% by individuals. Only 5% of the NGOs are owned by another organisation. With regard to ownership by the Board of Directors, it is unclear whether this response reflects the true situation, as it is possible for some respondents to wrongly attribute ownership to the body having deciding power.

Regulation and Supervision

Voluntary social service organisations are required to register under the provisions of the Voluntary Social

Service Organisations Act No. 31 of 1980, amended by Act No. 8 of 1998. The Circular Letter of the Secretary to the President, dated 26/2/1999, established that international voluntary social service organisations and national ones operating with foreign funding, or in more than one administrative district, have to register with the National Secretariat for NGOs under the Ministry of Social Services. Local NGOs operating in one district only are to register with the District Secretary, while such organisations operating in one division only are required to register with the Divisional Secretary.

On the other hand, not-for-profit organisations can also be registered under Section 21 of the Companies Act No. 17 of 1982. With the enactment of the new Companies Act No. 7 of 2007, companies registered under the old Act have to re-register with the Registrar of Companies.

The microfinance activities of NGOs do not, otherwise, come under specific regulation.

47% of interviewed NGOs state they are registered with the Ministry of Social Services, 24% claim to be registered with the Department of Social Welfare (NGO Secretariat Office) which is a department of the same Ministry of Social Services, another 24% with the Registrar of Companies, and 5% with the District Secretariat Office. Thus, only a minority appears to be registered under the Companies Act, while most seem to be registered under the Voluntary Social Service Organisations Act. In fact, the institutions covered in this section can be registered under both Acts; therefore, the figures cited above should be taken with care. The extent to which such double registration occurs could not be estimated based on the data available from the survey.

Audit

77% of NGOs interviewed report that their accounts are audited both internally and externally, while 20% of the NGOs' accounts are audited externally only. Of the 2 remaining NGOs, 1 declared only an internal audit is performed, while 1 is not audited at all.

87% of NGOs interviewed claimed to carry out their microfinance activities through a functionally separate unit. This surprisingly high rate of segregation of activities should be interpreted with care, since it is not fully supported by some of the findings of the survey related to the features of functional separation. Accounting separation is, for example, a prerequisite of functional separation. However, only 47% of the NGOs in the sample reported that microfinance-specific statements are prepared, and even for these respondents, it is rather unlikely that there is a well-defined mechanism in place to attribute common costs in order to reflect accurate financial information. The situation is even less encouraging in terms of separation of employees. Only 28% of the NGOs in the sample have staff exclusively involved in microfinance operations, Therefore, it can be assumed that only a minority of the respondents have indeed functionally separate microfinance units, but a large majority has some form of separation of activities, even though incipient.

Decision Making/Strategic Planning

All but 1 of the NGOs interviewed declared they establish business development goals, a business plan and strategies for achieving the targets set for their microfinance activities. These goals, plans and strategies were said to address interest rates, product design, human resource management, target group and general policy. 3 NGOs admitted that although goals are set and plans and strategies developed, they are not followed in day-to-day operations.

Most NGOs (72%-84%) seem, at a first glance, to have a rather centralised decision-making approach in place in matters such as interest rate setting, product development, and human resource and target group orientation: business planning is performed at the head office or parent organisation level and board members are usually involved. For the remaining NGOs, the design of business plans and strategies is at branch level, mostly involving group decisions (management and staff). Considering the fact that almost half of the NGOs in the sample (48%) have no branches at all and operate only at head office level, the puzzling finding, which hints to centralisation, can be thus explained. The reference to the head office as a decision-making body should not be equated with a highly hierarchical organisation, as a large number of NGOs in the sample are rather small institutions operating only at a regional level.

The operating policies of NGOs are, in 67% of the institutions, defined by the Board of Directors and in 29%, by a management committee. Only 2 of the 43 NGOs with branches allow the management of individual branches to take such strategic decisions. This hints to a centralised decision making process with a high involvement at the level of the Board of Directors.

4.3 Operations

Branch Distribution

An analysis of the regional and sectoral distribution of the NGO outlets is found in Table 4-1. We note that the information provided in this table may slightly underestimate the total number of microfinance outlets, since some of the 43 NGOs in the sample with branches may offer financial services not only through their branches, but also at the head office level. NGOs in the sample have an average of 27 outlets, but the group is highly heterogeneous. In fact, if the outlet network of SEEDS is excluded, the average drops to just 8 outlets per institution. 40 of the 83 NGOs in the sample do not have any branches and operate only through their head office.

The interviewed NGOs maintain 2,993 outlets and cover all nine provinces of Sri Lanka (in the Northern Province, the districts of Kilinochchi and Mullaittivu are not covered by any of the NGOs in the sample). Of the outlets for which the sectoral distribution was available, 26.3% are located in the urban sector, 72.4% in the rural sector and 1.3% in the estate sector.

The province with the largest NGO presence is the Southern Province, which accounts for 19.3% of all outlets of this group, followed by the Western and Central Provinces with 13.9% and 13.1% respectively. 37% of all branches are located in the Northern, Eastern and Southern Provinces – i.e. in those regions mostly affected by the tsunami of 2004. 17.6% of the branches are in the Northern and Eastern Provinces.

Table 4-1 Regional and sectoral coverage of NGOs

Province	Branches		Sector* (No. of Branches)			Population Density per Branch (Population/No. of Branches)**
	No.	%	Urban	Rural	Estate	
Western	416	13.9	21 (42.9%)	23 (46.9%)	5 (10.2%)	12,935
Central	392	13.1	11 (35.5%)	18 (58.1%)	2 (6.5%)	6,184
Southern	577	19.3	39 (22.0%)	138 (78.0%)		3,948
North Western	270	9.0	11 (44.0%)	14 (56.0%)		8,037
North Central	382	12.8	4 (16.0%)	21 (84.0%)		2,892
Uva	203	6.8	6 (26.1%)	16 (7.0%)	1 (4.3%)	5,800
Sabaragamuwa	225	7.5	7 (33.3%)	14 (66.7%)		8,006
Northern	159	5.3	6 (7.9%)	70 (92.1%)		6,547
Eastern	369	12.3	64 (29.8%)	151 (70.2%)		3,847
Total	2,993	100.0	169 (26.3 %)	465 (72.4%)	8 (1.3%)	6,280

Note *The sectoral breakdown was not available for 2,315 active societies and 26 service centres attached to SEEDS, therefore the sum of the sector total figures does not match the total number of branches. The percentages in brackets regarding the sectoral distribution of outlets were calculated based on the outlets for which this breakdown was available.

**The source for population per province is the Census of Population and Housing, Department of Census and Statistics – Sri Lanka, 2001. For the Northern and Eastern Provinces, 2001 estimates from the Department of Census and Statistics were used.

These 2 provinces seem to be well served by this group of MFIs, since their population share is estimated to be 13% of the total population. It is true that the threshold for the NGOs in the sample was lowered for these 2 provinces (minimum of 100 microfinance clients compared to 500 for the other provinces), but this has not significantly impacted the sample. Only 2 NGOs in the sample have less than 500 clients. Through this focus on the Northern and Eastern Provinces, NGOs may compensate for the fact that these areas are underserved by other types of institutions.

The Estate sector appears to be underserved, even by NGOs, with only 1.3% of the branches, whereas the population under the poverty line living in the estate sector is approximately three times higher (8.57%).

A comparison between the regional distribution of NGO branches and the population living under the poverty line, as per the Census conducted in 2002, is presented in Table 4-2 below.

Table 4-2 Regional distribution of NGO branches vs. poverty distribution

Province	Persons Below the Poverty Line (PBPL)		NGO Branches		PBPL/ Branch
	No.	%	No.	%	
Western	542,157	16.9	416	16.9%	1,303
Central	547,401	17.1	392	15.9%	1,396
Southern	558,619	17.4	577	23.4%	968
North Western	472,384	14.4	270	11.0%	1,750
North Central	199,875	6.2	382	15.5%	523
Uva	356,540	11.1	203	8.2%	1,756
Sabaragamuwa	528,824	16.5	225	9.1%	2,350
Total	3,205,800	100.0	2,465	100.0	1,301

Note The poverty percentage was calculated as percentage of the total population living under the poverty line in a given province. The percentage of branches was recalculated, excluding the North and Eastern Provinces as poverty data for these provinces was not available.

We observe that there is an important regional variation in the density of the persons below the poverty line (PBPL) served per NGO branch, with as many as 2,350 PBPL/Branch in the Sabaragamuwa Province compared to 523 PBPL/Branch in the North Central Province. From a comparison of the branch and poverty distribution across provinces, a similar picture emerges – the North Central Province and the Southern Province are over-served, with 16% of the outlets compared to 6% of the PBPL for the former and 23%% of the branches, compared to approximately 17% of PBPL for the latter. A good coverage relative to the percentage of PBPL is observed in the Western Province (17% of the NGO outlets serve exactly as many of the country's PBPL). All other provinces display a lower percentage of branches compared to the poverty density, which gives an indication that they are underserved.

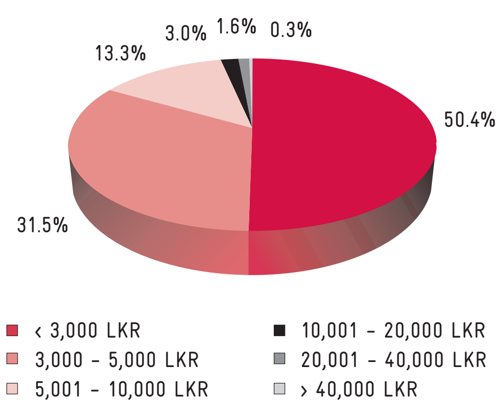
Clients

93% of all NGOs target particular client groups with their microfinance activities: women (78% of those NGOs that address target groups), low-income groups (71%), farmers (47%), entrepreneurs (40%) and disabled citizens (29%).

The entire microfinance customer base of all NGOs in the sample is approximately 956,000. On average, an NGO has 11,520 customers, but there are large disparities within this group. The 2 largest NGOs (Ceylinco Grameen Credit Company and SEEDS) account for almost 62% of the total customer base. Only 11 NGOs in the sample have a customer base exceeding 10,000. In 73% of the NGOs, female customers account for over 75% of the clients. Only 1 NGO in the sample has less than 25% female customers, while 3 NGOs have between 26% and 50% female customers.

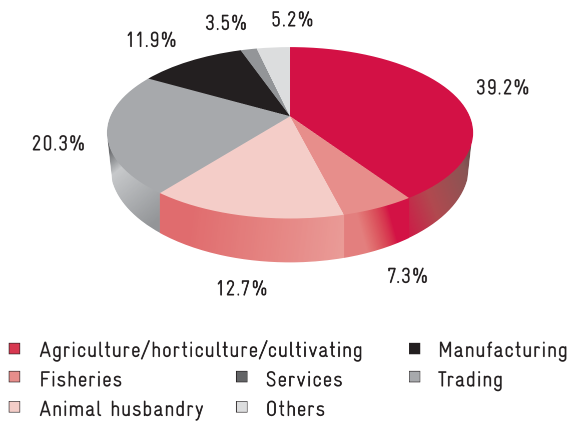
Of the 64 NGOs that provided an income profile of their customers, 82% of their clients have a monthly household income of less than Rs. 5,000 and another 13% earn between Rs. 5,000 and Rs. 10,000 a month. Only 5% of the clients are reported to have a monthly income of over Rs. 10,000. All these facts speak for a high depth of outreach, but the data has to be taken with caution as these are estimates provided by the NGOs, most of which do not maintain client profile records. It also has to be noted that the largest institution in the sample (Ceylinco Grameen Credit Company) has not provided details on either the income breakdown or the economic activity of its customers.

Figure 4-1 Monthly income of NGOs clients



On average, 39% of NGO clients are involved in agriculture, horticulture and cultivation. An additional 20% are involved in fisheries and animal husbandry. This is consistent with the prevalence of NGO branches in rural areas. A significant number of clients are also involved in trading (20.3%) and manufacturing (11.9%). The structure of the economic activity of NGO clients reflects the social mission of NGOs to provide financial services to sectors that are underserved by traditional financial intermediaries.

Figure 4-2 Economic activity of NGOs clients



Lending Methodology

On average, 60% of the NGOs interviewed said that they are engaged in individual lending, 59% offer group loans and 20% are involved in wholesale lending. Of the 82 NGOs in the sample that provide loans, 20 reported that they offer only individual loans and 19 reported that they are exclusively involved in group lending, while 8 work only with intermediaries (CBOs, village societies). The remaining 35 NGOs offer a mixture of at least 2 of the 3 types of loans.

Identifying Potential Clients

NGOs asserted that they identify potential microfinance clients through inspection and field visits (93% of all NGOs), recommendations of reliable current clients (60%) and opportunities arising out of their non-financial activities (51%). 16% of the NGOs rely on recommendation of a third party such as government officials and institutions, other organisations and respected people in the locality.

Loan Processing Time and Procedure

The average processing time for a loan varies from institution to institution and is between 1 and 90 days. On average, it takes 19 days to process a loan. In the case of 1/3rd of the NGOs, loan processing time does not exceed 7 days. 6% of the NGOs that provide loans have a processing period of more than 30 days. This should not necessarily be interpreted as a lack of efficiency on the part of the NGOs, as the shortage of funds (see the section on Operational Challenges) can also determine long waiting times until a loan can be approved. On the other hand, a very short processing time (e.g. 1 day) does not necessarily imply a lack of proper evaluation, since this mostly applies to wholesale lending to CBOs or village societies whose performance is known and monitored by the NGOs. As much as 64.6% of the NGOs that offer loan products do not need more than 15 days to process an application.

The majority of the NGOs in the sample employ a decentralised and participative loan approval process. 55% of NGOs refer loan applications to a committee at the branch level; district, regional or national structures are involved only in 19% of cases. 54% of the NGOs provide branch managers with loan approval limits and in 5% of the NGOs in the sample the Board of Directors can be involved in the approval process.

Loan Portfolio Monitoring and Provisioning

The majority of the NGOs in the sample (58%) manage their microfinance operations supported by a mixture of manual and computerised processes. More than a 3rd manages their operations exclusively on a manual basis. Only a minority (5%) has fully computerised operations in place – possible reasons for this could be the limited scale of operations, i.e. number of clients and/or the lack of funds for procurement. Only 73% of NGOs have access to e-mail and 63% to Internet facilities. This fact, coupled with a language barrier for some of the NGOs operating locally, has an isolation effect on many NGOs, leading to a lack of access to funding and information concerning international best practices and standards.

Only 51% of the respondents declared they monitor the quality of their loan portfolio using indicators such as Portfolio-at-Risk (PaR). Monitoring was reported to be done by following log books, manual records and entries (86% of the NGOs who monitor their loans), based on field visit records filed by field officers (74%) and computer-generated reports and statements (71%).

In some NGOs, the lack of computerisation and standardisation makes monitoring a rather difficult task. This is evident from the fact that only 38% of the NGOs with manual operations monitor portfolio quality compared to 58.3% of NGOs with a mix of computerised and manual processes. However, this is not the only limitation. Most NGOs do not seem to recognise the need to properly monitor their lending activities, and are likely to lack the necessary skills to do it. The fact that only 2 of the 4 NGOs with fully-computerised operations have a monitoring system in place proves that technology alone is not sufficient and needs to be combined with awareness and professional knowledge in order to lead to an improvement of procedures.

Only 22% of NGOs who declared they monitor PaR could correctly define it to be the percentage of overdue loans, even though the range of time differed considerably (the definitions ranged from loans overdue by 1 day to over 6 months). Another 17% restricted the definition either to a specific type of loan (e.g. agricultural loan) or to a specific event that prevented a loan from being repaid (death, illness, and disability). Another 17% provided an age analysis of overdue loans, while 11% defined PaR as a fixed percentage from the total outstanding volume of loans. The remaining 33% of the NGOs claiming to monitor PaR provided different erroneous definitions for this indicator.

With regard to non-performing loans, there are no common classifications and procedures in place among NGOs. Over a quarter of the NGOs in the sample (28%) do not have a classification for NPLs. Another 4% considered a loan to be non-performing only in the case of client disappearance or death. The remaining NGOs classify their loan portfolios based on an age analysis, calculating the months or the number of instalments overdue, but this is mostly rather vague and incomplete. The time considered in the age analysis ranges from 1 day to 3 years. A small group of NGOs (presumably the larger, more formal ones) adhere to the minimal classification required by the Central Bank of Sri Lanka for commercial and licensed specialised banks. However, we note that this is not appropriate for microfinance – a stricter classification should be followed by NGOs involved in microfinance activities.

41% of NGOs claim to provide for loan losses, while 58% admit that they do not. Of those claiming to provide for loan losses, only a small number of NGOs effectively provide for loan losses by calculating provisioning rates for classified loans. The remaining

NGOs apply general provisioning rates to the outstanding loan portfolio or to revenue.

Defaulting Clients

In the case of a defaulting client, the interviewed NGOs exert group or social pressure (84%), resort to arbitration (53%), freeze savings/deposit accounts (51%), file legal action (40%), recover the loan from guarantors (33%) and apply penalties (29%). The relative unimportance of seizing property (4%) could be indicative that NGOs' lending methodology is, in its tendency, not collateral-based. Contrary to this consideration, and rather surprisingly, taking legal action against defaulting borrowers is mentioned by 40% of the respondents. This could be explained by the fact that NGOs need a court decision in order to enforce loan recovery through guarantors. However, in practice, this is expected to be a rather exceptional measure taken by NGOs, since it is a rather cost-intensive recovery measure probably reserved for larger loans.

Operational Challenges

NGOs define their main operational challenges to be a shortage of funds (77%), delayed repayment of loans (47%), strong competition (33%), poor local infrastructure (25%), shortage of staff (25%), low profits (23%) and a lack of equipment (22%). The main explanation for the shortage of funds is the fact that NGOs do not have the legal authorisation to mobilise savings. We note that delayed repayments aggravate this shortage of funds. Another explanation for the shortage of funds could be the fact that donor support, in particular support received through post-tsunami rehabilitation projects, is phasing-out in Sri Lanka.

4.4 Products and Markets

The most important financial products provided by NGOs are loans (99% of respondents) and savings and deposit facilities (89%). Other products include insurance (28%), pawning, and leasing (1% each). The figures presented in this section should be taken with care as the largest player in the group (Ceylinco Grameen Credit Company, which accounts for 42% of the aggregate client base of the NGOs that were surveyed) refused to share information on products and markets.

Table 4-3 Microfinance product portfolio of NGOs

Product / Service	Number of NGOs		Volume Outstanding ('000 Rs.)	No. of Accounts	Average outstanding account balance (Rs.) *	Annual Interest Rate (%)
	Offer the product/service	Provided information				
Savings and Deposits	74	69	4,106,677	1,276,683	4,321	0-19.5
Loans	82	77	9,876,316	375,156	32,175	0-36
Insurance	23	17	39,630	53,207	1,373	-

Note *The average outstanding account balance is computed using data from NGOs that have provided information on both volume outstanding and number of accounts and, therefore, will differ slightly from the ratio between the total volume outstanding and the number of accounts reported in this table.

Loan Products

With the exception of Yasiru Mutual Fund Society, which offers only insurance products, all NGOs in the sample offer loan products. The average number of microfinance loan accounts per institution is 4,748, with a corresponding volume of Rs. 128 million. These averages hide large discrepancies between institutions. For example, if SEEDs data is excluded, the average number of microfinance loan accounts per institution drops to only 2,510. Another interesting observation is that, although microfinance is often equalled to microcredit, in terms of the number of accounts, loans represent only 22%, while savings make up 3/4ths of the total number of accounts. Utilization of loan facilities by NGO clients remains rather limited.

Interest rates are set by 45% of NGOs based on rates offered by commercial banks. In the case of 33% of NGOs, they are based on a computation of product cost. 7% do not charge interest at all. In the remaining NGOs, interest rates are set either by the parent organisation, by the Board of Directors, or by the funding institutions which have provided funding for specific loan schemes. 65% of NGOs calculate interest based on the declining loan balance, while 25% apply the interest rate to the original loan amount (flat rate).

Of the 6 NGOs offering interest-free loans, 2 are based in Jaffna (Northern Province), 2 in Ampara, 1 in Batticaloa (Eastern Province) and 1 in Puttalam (North Western Province). These NGOs serve between 400 and 2,250 clients. 4 of them are involved in Islamic finance.

When asked about special terms with regard to interest rates, 56% of the NGOs stated that they do not offer any special conditions, while 23% apply penalties for delayed repayment of loans, and 22% offer interest reduction for early payment. 10% of the NGOs have special conditions for specific borrower groups or loan types (low-income, staff, animal husbandry, emergency, etc).

In the case of 90% of the NGOs, there is a compulsory savings requirement in order to obtain a loan. 80% of the NGOs offer minimum loan amounts of Rs. 5,000 or less, an indicator that they cater to the needs of the poor. The median maximum loan amount is Rs. 50,000, which could be explained by the above-mentioned shortage of funds NGOs are confronted with and also by the lower absorption and repayment capacity of the microfinance clients of NGOs, the majority of whom are in the Rs. 5,000 or below, monthly income bracket (see Figure 4-1). The loan repayment period ranges from 1 to 48 months.

The wide range of interest rates can be explained, at least partly, by the social mission of NGOs. 7% of the NGOs provide interest-free loans. Another 21% charge less than 15% per annum for all their loans, while 16% offer a range of interest rates that includes both subsidised and commercial rates. 52% of the NGOs charge interest rates of 15% or more. Regional disparities could also be observed based on the data provided – on average, the lowest interest rates are charged in the Sabaragamuwa (10%), Northern (10.5%) and Eastern Provinces (11.6%). Only in three provinces are the average interest rates higher than 15%: Southern (15.63%), Western (15.69%) and Uva (21.58%).

Formal Lending Requirements

NGOs estimate that, on average, 4% of loan applications received are rejected, but there are significant disparities within the group. While 40% of the NGOs state that no applications are rejected, 6% of the NGOs have a higher rejection rate of between 25% and 45% of applications received. The high percentage of rejection might be motivated by the lack of available funds. Differences in the screening process of applications, too, may explain the large disparities within the group.

The most important lending requirements are: having a group of guarantors (92%), being a shareholder/member (82%), maintaining a minimum deposit or bank balance (75%), showing proof of having income sources (55%) and of established residency (40%). Other requirements include, in order of importance: meeting age and gender criteria, purchasing an insurance cover and having a group leader or third party recommendation. Only 8% of the NGOs mentioned collateral as a requirement to obtain a loan.

Savings Products

Savings and deposit products are offered by 74 of the 83 NGOs in the sample. This is rather surprising as NGOs are not allowed, under the current legal framework, to mobilise savings. Despite this fact, the total number of savings accounts for the 69 NGOs that provided this information was 6 times larger than that of loan accounts. At the same time, the volume outstanding was less than half for savings compared to loans. A possible explanation for this is that 65% of the NGOs in the sample are member-owned organisations and savings and deposits are collected under the legal form of shares. On the other hand, low savings volumes may hint to a combination of the legal obstacles preventing NGOs from taking deposits with clients keeping only the minimum required balance with the NGO but preferring more formal institutions to place the bulk of their savings, and a lack of capacity of NGO clients to save due to their very low household income (see Section 4-3 above).

An NGO has an average of 17,000 savings/deposit accounts and a respective outstanding volume of Rs. 52.8 million, but these averages are highly distorted by the large players within the group. SEEDS, alone, accounts for 75% of the total number of savings accounts and 82% of the volume outstanding. If SEEDS is excluded, the institutional average drops to 4,252 accounts and a corresponding outstanding volume of Rs. 9.9 million per NGO.

Interest rates offered for savings and deposits range from 0% to 19.5% per annum. 6 NGOs do not pay any interest on savings mobilised, while 2/3rds of the NGOs offering this service do not offer more than 10% per annum on savings and deposits. In the current high-inflation environment, depositors are, therefore, receiving a negative return on their deposits. Asked on the methodology used to set interest rates, 66% of the NGOs offering the service base their decision on commercial bank rates. The province with the lowest average interest rate for savings and deposits is the Northern Province (4.83%), followed by the North Western (5.58%) and Eastern Provinces (5.7%). The 6 NGOs in the sample which are not paying interest on savings and deposits are from these 3 provinces (4 from the Eastern Province and 1 each from the remaining 2). Clients of NGOs in the Uva and Sabaragamuwa Provinces have, on average, received the highest interest rates for their savings and deposits (8.92% and 8.25%, respectively).

NGOs require a low minimum amount to open a savings account, starting with Rs. 5. Of the NGOs offering savings products, 82% accept Rs. 100 or less to open a savings account, while only 8% require more than Rs. 500. All NGOs in the sample offering savings facilities require only 1 day to open an account.

Other Products

23 of the NGOs in the sample claim to provide insurance services. 15 of them offer their own products while 8 retail products of insurance companies. It should be mentioned that the former is not permitted by law although some institutions are following this practice. On average, each of the 17 NGOs that provided product information holds 3,130 accounts, with a corresponding volume outstanding of approximately Rs. 2.3 million. Pawning, leasing and other financial products and services do not seem to play an important role in this sector, with each of these products offered by only 1 institution.

Delivery of Products and Marketing Strategies

Products and services are directly delivered through branches or the head office (61%), field officers (43%) and through CBOs and village societies (40%).

88% of the NGOs in the sample declare that for marketing purposes, they rely on promotion by members, while 42% of them use the non-financial activities of the organisation to market their microfinance business. 36% of the NGOs promote their activities through joint programs with other institutions, 31% of them market their products through the distribution of brochures and leaflets and 30% of them involve their field staff in doorstep marketing.

NGOs seem to apply a cost-effective marketing approach, utilising the capacities available and refraining from cost-intensive measures such as media advertising. This approach could be explained not only by resource constraints but also by the local and regional nature of operations of most NGOs in the sample, which makes widespread media advertising unnecessary.

Product Development

With regard to the development of new microfinance products, NGOs exercise some degree of decentralisation. Even though in most cases it is handled at the central level, inputs are collected from branches (64%). A significant number of NGOs report that product development is performed at branch level either by the manager (19%) or by an internal team (13%). This is in line with the rather flat governance structures of NGO MFIs. 33% of the NGOs in the sample declared that they base product development decisions on a formal market survey and 10% said they hire an external consultant. However, the majority report that their microfinance products and services are developed based on discussions with customers (78%) and field officer and employee experience (77%). Interestingly, it appears that in their approach to product development, NGOs are not noticeably inspired by competitor offerings (only 27% of the NGOs).

83% of NGOs expect to introduce or develop new microfinance products and services in the near future. The list of envisaged new products is headed by loans (83%), savings (49%) and insurance (17%). Very few NGOs seem to consider expanding their current scope of services. Between 1% and 7% of the NGOs mentioned other products such as fixed-term deposits, leasing, pension products, pawning and money transfer services. This hints to a lack of dynamism within this group of institutions, possibly due to the operational constraints mentioned earlier (e.g. shortage of funds, competent staff, and equipment). It could also be due to legal constraints (e.g. money transfer services). It is interesting to note that during the last 2 years, 40% of NGOs have not introduced any new products. 1/3rd of the NGOs in the sample have introduced either 1 or 2 products. The high number of products introduced by the rest of the respondents (up to 16 new products) reflects a tendency of proliferation of loan and savings products.

4.5 Human Resources

Table 4-4 provides an overview of NGOs' microfinance staff. Total staff employed by NGOs in the sample ranges from 5 to 2,300 staff, with a total of 8,856 employees for all 83 respondents. This results in an average of 107 staff per NGO. However, it should be noted that this average is distorted by the few large players in the group. 82% of all NGO staff is reported to be involved in the microfinance business, which gives an average of approximately 11 microfinance staff per branch. Only 28% of NGOs interviewed declared that the reported microfinance staff is exclusively involved in microfinance activities so the degree of specialization of staff is quite low.

An overview of staff structure and minimum qualifications required for each staff category is provided in the following table.

Table 4-4 Microfinance staff complement of NGOs

	Total Microfinance Staff	Managerial	Credit/Field Officer	Clerical	Others/ Support Staff
Absolute Number (%)	7,273	1,527 (21%)	3,418 (47%)	1,164 (16%)	1,164 (16%)
Minimum Qualification Required		A/L passed (48%)/Tertiary education (41%)	A/L (48%) or O/L (30%) passed	A/L (54%) or O/L (18%) passed	n/a

It is interesting to note that the minimum job qualification for clerical staff is slightly higher than for credit/field officer positions.

With regard to the type of employment, 63% of the microfinance staff employed by NGOs are permanent workers and 21% are long-term contract workers (more than 1 year), followed by volunteer workers (11%).

Recruitment Challenges

NGOs mentioned similar difficulties in recruiting suitable staff in all categories – key issues are the lack of skilled personnel (39%-53%), attractive remuneration packages offered by competitors (27%-41%) and the lack of personnel with microfinance experience (28%-36%).

Staff Retention

The most important retention issues related to microfinance staff of NGOs are, in order of significance: inadequate remuneration (64%), the difficult nature of field operations (41%), inadequate incentives (40%), lack of technology (30%) and the overload of work (23%). The issues mentioned above are in line with the operational and recruitment challenges mentioned previously.

Incentives

NGOs interviewed said they offer the following incentive elements: staff training (81%), moral incentives (59%), remuneration incentives, and performance appraisals, rewards, awards and promotions (53%) and other subsidies (transportation, funeral assistance, work uniforms).

Training seems to be the most important incentive offered. Training is related to the specific tasks of the position such as HR development (81%), project management (80%) and business planning (67%) for managerial staff; record keeping (58%) and accounting (52%) for clerical staff; and customer care (67%), group mobilisation (59%), HR development (54%) or credit evaluation (47%) for credit and field officers.

On the number of training opportunities received, managers of NGOs participate, on average, in 6 training sessions a year, clerical staff in 4, and support staff in 3. Credit and field officers seem to have benefited from the most training opportunities (the institutional average is 7 sessions a year).

4.6 Financial Performance

In the process of this survey, 43 out of 83 NGOs submitted financial data, but only 29 could provide microfinance-specific statements. Due to high inaccuracy and/or incomplete data provided, the financial statements of 5 of the 29 NGOs were excluded from our analysis. In the process of gathering and analysing data on the financial performance of the NGOs, several difficulties were encountered. With the hope that all key stakeholders of the sector are made aware of the issues, and address them, we briefly discuss the main issues below:

- Lack of transparency – while this is an overall issue for Sri Lanka's microfinance sector, the level of response regarding financial performance is particularly low for NGOs. However, it has to be mentioned that the willingness to provide information increased in the second round of interviews conducted in November 2007 compared to the previous round held a year before.

- Lack of current data – the time period for which data was submitted was 2003-2007. Only 23 of the 43 NGOs that submitted financial information provided both the balance sheet and income statement for the most recent 2 years (2006-2007 and 2005-2006, depending on the end of their fiscal year). Another 6 NGOs provided information for 2005 and 2004. The remaining NGOs either provided information for only 1 year or provided incomplete information (only the balance sheet or the income statement). The fact that NGOs are not regulated and supervised and therefore, not required to submit financial information within a set timeframe, means that NGOs do not have the incentives to prepare these statements on time.

- Differences in the reporting period (financial year) – 8 NGOs had a financial year ending in March, while the remaining 16 NGOs had their reporting period end in December, with the calendar year.

- Poor quality of data – for some institutions, the quality of the statements was very poor, with wrong classifications and serious mistakes.

- No audit or poor quality audit – several NGOs in the sample were not audited and some of the remaining were audited by audit firms whose credentials are unknown, resulting in a poor quality of audit reports.

The above shortcomings make it impossible to present a representative picture of the financial performance of NGOs. Therefore, only a few tendencies can be sketched here.

The view of NGO profitability is rather mixed. 13 of the 24 NGOs reported losses from operations in the last financial year available. When non-operating income was included, this figure decreased to 9. For surplus-making NGOs, ROA ranges from 0.42% to 8.24%, while ROE takes values between 0.96% and 5.80%. As many NGOs benefit from donor funding or other subsidies, it is difficult to assess the true financial sustainability of this group of institutions. Based on the available information, no subsidy-adjusted indicators could be computed. Moreover, if the 2-digit inflation rates in 2006 and 2007 (13.7% in 2006 and 17.5% in 2007, CCPI annual average change[18]) are considered, the picture becomes even gloomier.

NGOs have a diverse financial activity profile – their lending activity ratio varies from 18% to 91%. However, only 17% of the NGOs in the sample have lending activity ratios lower than 50%, which hints to lending being the main activity for most of the NGOs in the sample. Almost 1/3rd of the NGOs in the sample have a lending activity ratio of over 75%.

Only a few NGOs finance their lending businesses predominantly from savings and deposits. This is a natural consequence of the fact that NGOs are not legally allowed to mobilise deposits. Debt from subsidised or programme-funding schemes plays an important role for most NGOs, while commercial debt, both short- and long-term, remains limited. For 50% of the NGOs in the sample, equity was at least partly donated. Considering this, for a majority of the NGOs, the cost of funds is quite low (approximately 50% of the NGOs in the sample have a cost of funds not exceeding 3%). The lending rate of the 24 NGOs that provided financial data is between 6% and 27% per annum, but 14 of the 24 are lending at 18% per annum or more.

Of the 24 NGOs in the sample, only 8 NGOs maintain a loan loss reserve.

The NGOs were also questioned regarding the appropriation of earned surpluses between branches and head office/ parent organisation. Of the 83 NGOs in the overall sample, 7 stated that they do not have surpluses, nor do they have an agreed methodology for appropriation in the event they were to have surpluses. For the majority of NGOs (72%), surpluses remain at the level where they were generated (46% of NGOs operate only from the head office, while 26% deliberately chose to leave the surplus with the branches where it is created). This is an important incentive for branches to generate surpluses, as they directly benefit from these. In 18% of the cases, the surplus is wholly-transferred to the head office, while only 1 NGO reported that the surplus is shared between head office/ parent organisation and branches.

With regard to the use of the surplus, on average, 78% of earned surpluses are claimed to be invested back into the microfinance business of the NGOs. This can be interpreted as indicative of a long-term interest by most NGOs in their microfinance business. 15% is used to support other social welfare activities of the institution while a small portion (7%) is distributed to the members or shareholders.

Concluding this section, we note that there is a vital need for standardisation and improvement in the accounting standards and practices of NGO MFIs if their long-term viability is to be assured. The regulation and supervision of this sector would stimulate NGOs to strive for greater professionalism.

18 Central Bank of Sri Lanka, Monthly Bulletin, January 2008, p. 14.

Regional Development Banks

5. Regional Development Banks

5.1 Institutional Background

Commencing in 1985, the Government of Sri Lanka established 17 Regional Rural Development Banks (RRDBs) through an Act of Parliament. Financed entirely by the Government, these institutions were given the task of reaching remote rural areas and smallholders without access to financial services from commercial banks. The RRDBs covered all districts of Sri Lanka with the exception of the North and East. However, their success was limited by internal structural weaknesses and excessive geographical fragmentation, which prevented them from reaching a critical mass. In addition, the banks lacked sound lending and monitoring policies, and operations were difficult to improve and standardise. A significant restructuring and recapitalisation took place in 1998-1999 and the RRDBs were consolidated into six Regional Development Banks (RDBs). This involved granting RDBs more autonomous management, allowing a broader ownership base, and having Board Members appointed by shareholders, all with the purpose of increasing the professionalization of operations and, thus, their viability and sustainability in the long-term.[19]

The Government of Sri Lanka has recently announced plans to merge all six RDBs into one Development Bank which would operate nationwide. This would have the advantage of better capabilities to mitigate regionally specific risks, but the disadvantage of a less flexible structure.[20] At the time of writing this report, a final decision was still in the offing.

All six RDBs were interviewed for the purpose of this survey. All six stated that they started microfinance activities in the respective year of establishment. While one RDB (Ruhuna Development Bank) stated that it provides financial services only, the remaining five offer both financial and non-financial services:

- Financial services: All six RDBs offer loans, savings and pawning facilities. Four RDBs provide short-term credit and three provide leasing. Two RDBs offer pension schemes (Ruhuna and Wayamba Development Banks).

- Non-financial services: Financial advisory services, training and skills development are offered by all five RDBs that offer non-financial services, while three RDBs also assist in group formation and provide marketing assistance to their clients.

The respondents estimate RDBs' microfinance activities to represent, on average, 86% of their portfolio of activities (based on the revenue earned), with variations from 50% (Uva Development Bank) to 95% (Sabaragamuwa Development Bank). This significant difference in responses can be better explained by a difference in understanding of microfinance than by a significant difference in operations. However, due to the increased popularity of microfinance, a tendency to overestimate the percentage of microfinance activities can be expected, especially in the case of formal institutions such as the RDBs which have a commission to reach the lower-income groups.

It is interesting to mention that RDBs do not distinguish significantly between micro and small enterprises. When asked to define microfinance and microcredit, the answers ranged from "providing loans to people who are unable to access loans from commercial banks" and "loans under Rs 75,000" to broader definitions such as "providing loans and accepting deposits" and "providing loans for small businesses". The findings of this chapter, therefore, should be interpreted in light of this heterogeneous understanding.

19 National Microfinance Study of Sri Lanka, 2002 by Gant, de Silva, Atapattu and Durant and Fitch Ratings, Sri Lanka Special Report, Regional Development Banks, November 2006.

20 Fitch Ratings, Sri Lanka, Fitch Maintains Rating Watch on Six Sri Lankan Regional Development Banks, September 2007.

5.2 Organisational Structure and Governance

Organisational Structure

RDBs are confined to specific regions across the country. With an average of approximately 36 branches per RDB, the organisational structure is more decentralised compared to microfinance programs and institutions which operate nationwide. The organisational structure of all six RDBs is similar, as this is prescribed through the Regional Development Banks Act.

Ownership

RDBs are owned by the Government of Sri Lanka either directly through the Treasury or indirectly through other Government-owned or managed institutions such as the Bank of Ceylon, People's Bank, National Savings Bank and the Employees Provident Fund. They are regulated and supervised by the Central Bank of Sri Lanka (CBSL). In addition to the supervision carried out by the supervisory department of the CBSL, a special monitoring department was created within the CBSL for the RDBs.[21]

Regulation and Supervision

RDBs are licensed specialised banks governed by the Regional Development Banks Act No. 6 of 1997. When interviewed, the respondents seemed to be better equipped to identify the supervisory authority than the regulatory one. All RDBs asserted that they are supervised by the CBSL. When asked about regulation, two RDBs even stated that they are not regulated at all. Of the four that declared they were regulated, two named the CBSL as the regulatory authority while the remaining two, respectively, identified the Ministry of Finance and the Government of Sri Lanka. When asked about the supervisory actions taken by the CBSL, the respondents mentioned measures such as inspection/audit of accounts (three RDBs), submitting operational information on a regular basis (three RDBs) and representation on the Management Committee or the Board of Directors (two RDBs).

Audit

According to the results of the survey, the accounts of all RDBs are audited both externally and internally. RDBs are required by the law to conduct an external audit. A list of approved auditors is provided by the CBSL, and the shareholders, at the AGM, select the external auditor. On the recommendation of the CBSL, all RDBs are now also internally audited.

Decision making/Strategic planning

Most RDBs follow an integrated business approach, which means that microfinance activities are not functionally separated from the other activities of the bank. This is understandable against the backdrop of the RDBs perception that, on average, over 85% of their activities are microfinance-related in terms of revenues earned, thus microfinance is their core business and the question of a separate unit does not arise. Only Kandurata Development Bank declared that it has a specific microfinance unit with its own staff and books of accounts.

The Board of Directors decides the overall operating policies of RDBs in five of the six RDBs while a Management Committee decides the overall operating policies of the remaining RDB. All RDBs claim to establish and follow business development goals, a business plan and strategies for achieving the targets set for their microfinance activities. These goals, plans and strategies address interest rates, product design, human resource management and target group orientation, and are mostly designed by, and decided at, the top management level (i.e. a centralised approach). Only one RDB seems to allow management and staff at the branch level to decide on product design and target group orientation.

5.3 Operations

Branch distribution

RDBs maintain a total of 215 outlets that offer banking services to clients. Their distribution, by province and sector, is presented in table 5-1.

21 Fitch Ratings, Sri Lanka, Fitch Maintains Rating Watch on Six Sri Lankan Regional Development Banks, September 2007.

Table 5-1 Regional and sectoral coverage of RDBs

Province	Outlets		Sector			Population Density per Outlet (Population/No. of Outlets)*
	No.	%	Urban	Rural	Estate	
Western	29	13.5	9 (31.0%)	20 (69.0%)	0	185,556
Central	32	14.9	11 (34.4%)	20 (62.5%)	1 (3.1%)	75,749
Southern	44	20.5	5 (11.4%)	39 (88.6%)	0	51,779
North Western	29	13.5	4 (13.8%)	25 (86.2%)	0	74,824
North Central	25	11.6	1 (4.0%)	24 (96.0%)	0	44,187
Uva	20	9.3	1 (5.0%)	15 (75.0%)	4 (20.0%)	58,868
Sabaragamuwa	29	13.5	6 (20.7%)	23 (79.3%)	0	62,115
Northern						
Eastern	7	3.3	3 (42.9%)	4 (57.1%)	0	252,849
Total	215	100.0	40 (18.6%)	170 (79.1%)	5 (2.3%)	89,058

Note *The source for population per province is the Census of Population and Housing, Department of Census and Statistics – Sri Lanka, 2001. For the Eastern Province, 2001 estimates from the Department of Census and Statistics were used.

RDBs cover seven out of the nine provinces entirely and the Ampara District in the Eastern Province. The number of outlets per province varies from seven (Eastern Province) to 44 (Southern Province). 79.1% of all RDB outlets are classified as rural and only five (i.e. 2.3%) outlets operate in the estate sector. The average population served per RDB outlet is approximately 89,000. The population per outlet is significantly lower

Table 5-2 Regional distribution of RDB outlets vs. poverty distribution

Province	Persons Below the Poverty Line (PBPL)		RDB Outlets		PBPL/ Outlet
	No.	%	No.	%	
Western	542,157	16.9	29	13.9	18,695
Central	547,401	17.1	32	15.4	17,106
Southern	558,619	17.4	44	21.2	12,696
North Western	472,384	14.4	29	13.9	16,289
North Central	199,875	6.2	25	12.0	7,995
Uva	356,540	11.1	20	9.6	17,827
Sabaragamuwa	528,824	16.5	29	13.9	18,235
Total	3,205,800	100.0	208	100.0	15,413

Note The PBPL percentage represents the percentage of the total population (excluding the Northern and Eastern Provinces) living under the poverty line in a given province. The percentage of RDB outlets was re-calculated due to the unavailability of poverty data for the Northern and Eastern Provinces.

than the average in the North Central, Southern and Uva Provinces. The highest population density per outlet is found in the Eastern Province with 252,849 people per outlet and the Western Province with 185,556 people per outlet. The high population densities per outlet can be explained by the lack of presence of RDBs in the Batticaloa and Trincomalee Districts in the Eastern Province, and, in the Western Province, due to the focus being on a few disadvantaged locations within the province.

Table 5.2 compares the regional distribution of RDBs with that of the population living under the poverty line in the respective provinces.

We notice that a higher concentration of outlets relative to the percentage of PBPL can be found in the Southern and North Central Provinces, which suggests that these regions are relatively better served than other regions. On the flipside, the provinces that are underserved by RDBs relative to the poverty rates are the Sabaragamuwa, Western, Central and Uva Provinces. On average, PBPL/Outlet is 15,413. However, the Sabaragamuwa, Western, Central, Uva and North Western Provinces have values above this average, supporting the finding that they are underserved compared to the other provinces.

Clients

According to the respondents, the microfinance client base of the RDBs is estimated at 1.85 million people. It has to be noted that the way each RDB defines microfinance has a significant impact on its definition of the customer base. Moreover, only one bank collects data on a client level while the remaining five estimate their client base based on the number of accounts, which very likely overstates the number of clients due to the possibility of multiple accounts.

Five of the RDBs focus on specific target groups. These are primarily low-income groups (all five RDBs), but also women, youth, entrepreneurs and farmers (four of the five RDBs which focus on target groups). Only one RDB explicitly indicated the 'rural population' as being a target group.

RDBs serve both female and male clients. Females, however, represent the majority of clients for four of the six RDBs, with Kandurata Development Bank having more than 75% female customers. Only two RDBs (Uva and Rajarata) have more male than female customers. The income distribution of RDB clients is given in Figure 5-1. Approximately 38% of all clients have a monthly household income of no more than Rs. 5,000 and, hence, fall within the RDBs' target group definition of low income (the threshold for low income households, as indicated by RDBs, is, on average, Rs. 4,417 a month). This implies that the remaining 62% of RDBs' customers do not fall within the microfinance definition as provided by the RDBs, and raises the question as to whether the initial purpose of the RDBs and the targets stated above are met.

Figure 5-1 Monthly income of RDBs' microfinance clients

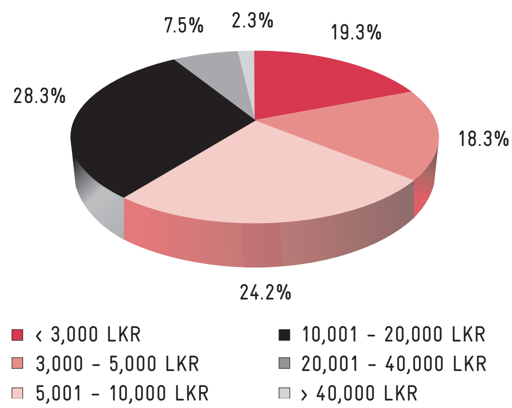
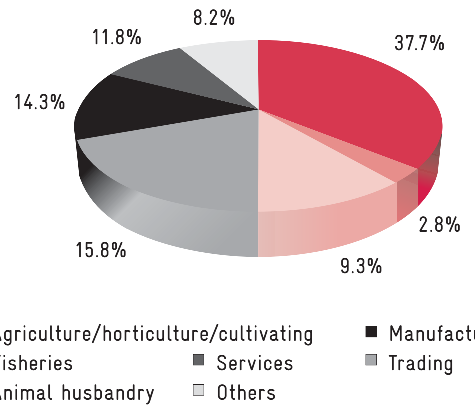


Figure 5-2 illustrates the economic activity that RDBs' microfinance clients are engaged in. The client portfolio seems to be reasonably well diversified, with the largest group of clients involved in agriculture (37.7%), followed by trading (15.8%) and manufacturing (14.3%). This large involvement of clients in the primary sector (agriculture, fisheries and animal husbandry, represent 49.8% of the economic activities of microfinance clients of RDBs) is well explained by the fact that almost 80% of the branches of RDBs are in the rural sector.

Figure 5-2 Economic activity of RDBs' microfinance clients



Lending methodology

RDBs declared that they are mainly engaged in individual lending (90.5% on average, percentages range from 80% to 97%), while group loans are also offered (3%-19%, on average 8.8%). In addition, Uva and Ruhuna Development Banks provide wholesale loans to other intermediaries on a rather limited scale (1%-3%, on average under 1%).

Identifying potential clients

RDBs identify potential microfinance clients through inspection and field visits (all six RDBs), using the opportunities arising from the non-microfinance activities carried out (three out of the six RDBs) and following up recommendations of reliable current clients (three out of the six RDBs). Sabaragamuwa and Wayamba Development Banks reported employing an agency for sourcing potential clients. These "collecting agencies" mobilise deposits and inform potential clients about available loan products. The agency is paid a commission depending on the number of clients they secure. However, even in the case of these banks, field officers remain the principal source for identification of potential clients.

Loan processing time and approval procedure

On average, loans are processed in 26 days. The average processing time for a loan varies from institution to institution and is between seven and 60 days; only two of the six RDBs indicated an average processing time of less than two weeks. Opening a deposit or savings account normally takes one day as does obtaining a pawning facility. The processing time for lease applications varies from three to seven days.

For all six RDBs, Credit Committees are involved in the approval process, either for all loans or when loan approval limits are exceeded. Four of the six RDBs interviewed have a rather decentralised loan approval process in place, whereby branch managers have loan approval powers subject to value limits. In certain cases, two of the RDBs declared that they involve the Board of Directors in the loan approval process but this is also likely to be applicable in the case of loans above a certain value.

Loan monitoring and provisioning

All six RDBs manage their microfinance operations using a mix of manual and computerised records. This has an impact on the monitoring measures performed. All RDBs use computerised statements and records filed by field officers to track the quality of their loan portfolio. Log books and manual records and entries are also used by five of the RDBs in addition to computerized statements.

While all RDBs declared that they measure Portfolio-at-Risk (PaR) in relation to their loan portfolio, when asked to define it, some of the RDBs provided an age analysis of non-performing loans, or declared the overdue instalments to be at risk. A proper understanding of the concept is apparent only in the response of two of the RDBs. PaR should be based on outstanding debt and not only the instalments overdue.

Loans are subject to an age analysis and classified as non-performing (NPL) based on the number of overdue instalments or months (over three months in arrears). NPLs are further broken down into four categories: overdue (between 3 and 6 months), sub-standard (between 6 and 12 months), doubtful (between 12 and 18 months) and loss (over 18 months).

Loan loss provisions are calculated according to regulations set by the CBSL, based on age analysis and the classification of the loan portfolio. Each loan category carries its individual provisioning rate – 20% for sub-standard, 50% for doubtful and 100% for loss. Additionally, a statutory general provision of 1% on total performing loans and the overdue loans category net of loans and advances secured by cash deposits, gold and government securities was introduced in December 2006 – RDBs have three years to progressively reach the required level of general provision.

The classification method and provisioning standards mentioned above are the minimum prescribed by CBSL but RDBs could choose to adopt more stringent standards. The CBSL regulations are common to both commercial and licensed specialised banks and are therefore not adapted to the microfinance context. According to the survey, the RDBs adhere only to the minimum requirements set by CBSL; therefore, the loan classification can be considered rather lenient and the provisioning rates fairly low for microfinance.

Defaulting clients

In case of a defaulting client, four RDBs claimed to use social pressure by contacting guarantors or group members, and freezing the client's savings/deposit accounts. If this fails to cover the loan, RDBs seize mortgaged property and engage in legal action. Three RDBs reported that they apply penalties and fines on defaulting clients. It is interesting to note that only one RDB makes use of arbitration.

Operational challenges

RDBs define their main operational challenges, in order of importance, as: strong competition (four RDBs), shortage of staff (three RDBs) and delayed repayment of loans (three RDBs).

5.4 Products and Markets

RDBs have a rather diversified product portfolio that includes savings/ deposits, loans, pawning, leasing and pension schemes. The first three types of products are offered by all RDBs, while the remaining two are offered by three and two RDBs, respectively. An overview of the product portfolio in terms of volumes outstanding, number of accounts and interest rates is given in Table 5-3.

Table 5-3 Microfinance product portfolio of RDBs

Product / Service	Volume Outstanding ('000 Rs.)	No. of Accounts	Average outstanding account balance (Rs.)	Annual Interest Rate (%)
Savings and Deposits	13,329,144	2,063,988	6,458	3-15
Loans	9,426,380	311,204	30,290	6-24
Pawning	4,041,562	485,084	8,332	14-20
Leasing	86,344	1,282	67,351	12-16
Pension Products	58,271	14,485	4,023	7.5-10

Loan products

Each RDB has, on average, 52,000 microfinance loan accounts with an average volume outstanding of Rs. 1.6 billion. Interest rates are set by four of the RDBs at a rate that maintains a desired margin above the deposit rate. In the remaining two RDBs, rates are set based on Central Bank rates and on the rules and regulations of funding agencies where specific loan schemes are involved. Interest rates for loans are calculated on a declining balance basis. Two RDBs apply penalty interest rates for late payments, and three grant interest rate reductions for early payments. All six RBDs have a compulsory savings scheme as a condition for obtaining a loan, and five charge service fees for processing the loan. The minimum repayment period ranges from 1 to 6 months and the maximum period ranges from 36 to 60 months.

Lending conditions

RDBs report that, on average, 4.5% of loan applications received are rejected. This could, however, be the result of strict pre-selection procedures – as such, few applications, once received, are rejected. This should not be interpreted as easy access to credit. All RDBs require loan applicants to present proof of established residency and to have guarantors. Five RDBs require proof of income sources, while four RDBs require collateral and maintenance of a minimum deposit or bank balance. The foregoing display RDBs' tendency to hedge risk related to lending; four out of the five formal requirements mentioned are directly related to securing the loan. Although not all RDBs require all the collateral measures presented here, there is a risk that loans are over-collateralised to the detriment of the borrower.

Savings and deposits

On average, one RDB has 344,000 savings/deposit accounts and a corresponding volume outstanding of Rs. 2.2 billion. There are significant differences between the RDBs, but it is not clear how much of these differences reflect differences in the size and operations of the banks and how much are due to a heterogeneous understanding of microfinance. RDBs have, however, classified the most important part of their total savings and deposits portfolio as microfinance. Considering the average outstanding balance per account of slightly below Rs. 6,500, this seems realistic. An account can be opened with as little as Rs. 10 in two RDBs and with amounts varying between Rs. 100 and 500 in the remaining RDBs.

Other products

Pawning facilities are offered by all RDBs at an interest rate ranging from 14% to 20% per annum. On average, each institution has 80,850 pawning accounts with a corresponding average volume outstanding of Rs. 674 million. Four of the RDBs have no minimum limits on the amount which may be obtained through pawning; another RDB has a minimum limit of Rs. 500, and the remaining has a Rs. 12,000 minimum value. Three RDBs have no explicit upper limit for pawning, while the remaining three have limits between Rs. 18,000 and 50,000. This explains the rather low average outstanding balance for pawning of Rs. 8,332.

It is interesting to notice that for the RDBs, the total number of pawning accounts is larger than the number of loan accounts. This implies that the RDBs provide more for the emergency cash needs of customers rather than for income generating activities.

Leasing is a rather small product line for RDBs. Leasing is mostly offered for small businesses for the purchase of vehicles and equipment. Three of the six RDBs are involved in leasing – the average number of accounts per institution is 427, which is rather low. With regards to volume outstanding, one institution has, on average, Rs. 28.8 million.

Two RDBs (Wayamba and Ruhuna) offer a pension product, but only Wayamba has a significant portfolio (14,358 accounts and Rs. 57 million volume outstanding). Since Ruhuna's scheme has only 127 accounts, we restrict our comments to the former. The minimum value of Rs. 100 required to participate in the scheme makes it well adapted to the microfinance segment. With an average outstanding account balance of approximately Rs. 4,000, this is clearly a microfinance product.

Delivery of products and marketing strategies

Products and services are mainly directly delivered through RDBs branches. In addition, two RDBs use links with other institutions as well as field officers to deliver their microfinance products.

RDBs utilise an array of direct and indirect marketing instruments including printed material such as leaflets, banners and posters (all RDBs) and doorstep marketing (five RDBs). Advertisements in newspapers, magazines or newsletters and joint programmes with other institutions are used by three RDBs. Two RDBs stated that they cross-sell their microfinance products and services with other bank products. Only one RDB reported utilising radio and television advertising as a marketing instrument.

Product development

New product development mainly takes place at the central level, but input from branches is sought. In the case of one RDB, new products are developed by the managerial committee alone, while in the case of another, it takes place at the individual branch level under the responsibility of an internal team.

Microfinance products and services are developed based on the experience of field officers and employees (all RDBs). In addition to this, four RDBs look into products offered by competitors and three RDBs have discussions with customers to identify their needs. Three RDBs also reported that they base their product development on a formal market survey.

During the last two years, on average, four new products were introduced per RDB (the range is from one to eight new products) while no product was withdrawn. Five out of the six RDBs intend to introduce new products, mainly loan and saving products. This indicates a tendency to proliferate products within the traditional range instead of introducing new, non-conventional products.

5.5 Human Resources

The collective staff strength of the RDBs is 1,926 but there are quite wide variations across the individual banks. The largest RDB in terms of staff, Ruhuna Development Bank, employs 435. Rajarata Development Bank, the smallest RDB in terms of staff, has only a little over a third of the staff of Ruhuna Development Bank. On average, the RDBs employ approximately nine staff per branch. It has to be noted also that two of the RDBs (Wayamba and Rajarata) have a large number of trainees (307 and 52, respectively) who have been excluded from the total staff figures considered in this report. These trainees are school leavers who join the RDBs to obtain work experience until they start university. Despite their large number, due to the short period that they are with the bank and their lack of qualifications, they were not considered to be playing an important role in the operations of the two banks.

Out of the total staff employed by the RDBs, 80% (1,554 staff members) is stated to be involved in the microfinance business, resulting in an average of approximately seven microfinance staff per RDB branch. The actual number of staff involved in microfinance ranges from 36 to 435. This wide range can also be explained by the heterogeneous understanding of microfinance among RDBs and by the differences in the organisation of microfinance operations. Only Kandurata Development Bank stated that microfinance staff were exclusively involved in microfinance activities – the remaining RDBs use their microfinance staff for other activities as well.

Regarding the composition of the microfinance staff employed, a breakdown is provided in table 5-4 together with the minimum qualifications required for employment. With regards to the experience required to fill the respective positions, 67% of the RDBs reported that experience is not a must for recruitment, while the remaining 33% considered it essential. 94% of the RDB staff are permanent, while 6% are time-bound contract staff.

Staff productivity

1,414 microfinance staff (support staff were excluded for the purpose of computing productivity) handle a total of 2,876,043 microfinance accounts, resulting in staff productivity of 2,034 accounts per staff member. Due to the lack of a clear separation between microfinance

Table 5-4 Microfinance staff complement of RDBs

	Total Microfinance Staff	Managerial	Credit/Field Officer	Clerical	Others/ Support Staff
Absolute Number %	1,554	329 (21%)	650 (42%)	435 (28%)	140 (9%)
Minimum Qualification Required		Graduate (67%)/A/L passed (17%)	A/L passed (67%)/O/L passed (17%)	A/L passed (67%)/O/L passed (17%)	-

activities and the other operations of the RDBs, it is difficult to assert how well this measure reflects the real staff productivity within this group of institutions.

Recruitment challenges

Two of the RDBs (Ruhuna and Kandurata) did not report any difficulties in recruiting staff. For all levels of staff, the remaining four RDBs mentioned similar difficulties in recruiting suitable staff for microfinance operations. Interference, nepotism and political issues, as well as the absence of a pension system, were mentioned by two RDBs. The lack of skilled people and people with microfinance experience were cited by one RDB. In addition, the unattractive locations and the fact that microfinance is not considered an attractive career option were reported.

Staff retention

The most important retention issue mentioned was the difficult nature of field operations. Other issues mentioned were inadequate incentives, the turnover of highly qualified staff and the fact that microfinance is not considered an attractive career option. Once again, Ruhuna and Kandurata Development Banks stated that they do not have staff retention issues.

Incentives

RDBs claim to offer their staff a wide range of incentives but these incentives appear to be inadequate in retaining good employees (see section above on staff retention). All RDBs stated that they offer performance related rewards, staff training opportunities and reimbursement of medical costs. Five of the six RDBs have remunerative incentives and payment of overtime. Four RDBs provide incentives in the form of distribution of revenue.

Staff training

On average, managerial staff received seven training courses during 2006, followed by clerical staff (five training sessions), credit and field officers (five training sessions) and support staff (three training sessions). All RDBs reported that they offer training for managers covering the following areas: project management, marketing/promotional, costing, business planning, credit evaluation, risk management and profitability monitoring. All RDBs offer clerical staff training on record keeping and five RDBs, on accounting skills development. For credit and field officers, five RDBs offer training on group mobilisation, project management, record keeping, language, accounting skills development, and credit evaluation. We conclude that managers undergo a more comprehensive training than other categories of staff, covering all relevant areas. Training for credit and field officers is focused on technical skills (accounting, appraisal) and language skills.

5.6 Financial Performance

Tables 5-5 and 5-6 present the consolidated balance sheet and income statement of the six RDBs for 2005 and 2006. Financial data presented here reflects the entire business of RDBs – microfinance specific financial statements were not available. Given the fact that the core business of RDBs was classified by the respondents as microfinance, their overall performance is briefly discussed below. The reader, should, however, bear in mind the possible tendency of the respondents to overstate the share of microfinance operations as discussed in Section 1, and should thus interpret the figures in this section with care.

Table 5-5 RDBs-Consolidated Balance Sheet (Rs. '000)

Items	2006	2005
Total Current Assets	5,654,921	4,072,089
Total Non - current Assets	924,188	719,382
Net Loan Portfolio	19,549,779	15,868,103
Total Assets	26,128,888	20,659,574
Total Short - term Deposits	18,750,757	14,220,704
Total Current Liabilities	2,256,972	1,956,690
Total Non - current Liabilities	2,887,652	2,480,193
Total Liabilities	23,895,381	18,657,587
Total Equity	2,233,507	2,001,987
Total Liabilities and Equity	26,128,888	20,659,574

RDBs'sources of funding are mainly short-term deposits (78.5% of total liabilities), a pattern that was stable in recent years (2005: 76.2%). The quantum of short-term deposits might be slightly overestimated as no clear age analysis is available for deposits, and are based on estimates instead. Nevertheless, the major source of funding for the RDBs is clearly their deposit base – reliance on debt is relatively low. Funds mobilised are mainly invested in credit as can be derived from the lending activity ratio (i.e. gross loan portfolio over total assets), which was 77.5% in 2006 (2005: 80.1%). This shows a high level of financial intermediation.

The cost of funds, calculated as the ratio of interest plus fees on funding liabilities to the average funding liabilities of that period, was 7.1% in 2006. The lending rate (interest income from lending to the average gross loan portfolio) was 19.0% during the same period, generating a financial spread of 11.9%.

Table 5-6 RDBs-Consolidated Income Statement (Rs.'000)

Items	2006	2005
Total Operating Revenue	3,731,156	2,809,784
Total Financial Expenses	1,359, 184	892,901
Total Operating Expenses	1,632,460	1,143,321
Net Income from Operations*	739,512	773,562
Net Income	298,019	380,523

Note * Net income from operations before provision and before tax

Financial performance: In 2006, the return on equity (ROE) was 14.1%%, while the return on assets (ROA) was 1.3%. At the end of 2006, RDBs' loan loss reserves were at 3.5% (2005: 4.1%) of the gross loan portfolio. It has to be noted also that in 2006 the net income of the RDBs represented only 8% of total operating revenue – the comparable figure for 2005 was 13.5%. The decline in net income in 2006, despite a 33% growth in operating revenue is due to a 52% growth in financial expenses and 43% growth in operating expenses.

Banks & Other Financial Institutions

6. Banks and Other Financial Institutions (OFI)

6.1 Institutional Background

Microfinance has been for a long time regarded as falling under the competence of social development driven institutions and as being dependent on public or donor funds. But with strong competition diminishing the returns from the traditional business of formal finance institutions and with the growing evidence that microfinance can be profitable, new players have become interested in this sector. While most microfinance programmes were launched with a social focus, experience has shown that if managed efficiently, they could be a profitable venture. Initially, microfinance programmes were launched in formal financial institutions either as measures to show corporate social responsibility, or as part of the obligations imposed by governments on the financial sector. Only recently, a global trend of formal institutions stepping into the microfinance sector could be observed.

In Sri Lanka, the government has traditionally used the two state-owned commercial banks (Bank of Ceylon and People's Bank) as implementing agencies of its various policies in the fields of agricultural development and poverty alleviation. These schemes were in the past characterised by subsidised loans, re-financing and periodic debt forgiveness. Of the private banks, Hatton National Bank has had a development focus from its very beginning, but focused more on large scale development projects at first and less on the individual development of the low-income population. With the emergence of microfinance commercial banks have oriented their programmes towards the lower income group and other formal institutions have followed.

At present, a considerable number of traditional financial institutions (which belong to what is commonly referred to as the 'formal financial sector') have reported significant operations in the field of microfinance (more than 500 microfinance clients). But this has to be taken with caution as it is based on the self-reporting of these institutions. Since microfinance has become a trendy concept and is positively perceived by the public, for some of the institutions in the sample, microfinance is nothing more than a corporate social responsibility measure. But it can be hoped that these institutions discover the potential of this market and become in the future more committed to the sector.

The formal financial institutions with microfinance operations were selected for interviews following a screening process, which included all licensed banks, finance and insurance companies, according to the information available from the Central Bank of Sri Lanka and the Insurance Board of Sri Lanka. A total of 86 institutions were screened (38 banks, 33 leasing and finance companies and 15 insurance companies). The purpose was to identify formal financial institutions engaged in microfinance with a client base of at least 500. The analysis of this chapter refers to the 19 institutions which met the screening criteria. Table 6-1 provides an overview of these institutions.

Table 6-1 Banks & OFIs interviewed

Financial institution	
Banks	
- Commercial Banks	
Government owned	Bank of Ceylon
	PeoplesBank
Private banks	Hatton National Bank
	Sampath Bank
- Licensed Specialized Banks	Sanasa Development Bank
	Ceylinco Savings Bank
	Housing Development Finance Company
Leasing & Finance Companies	Asian Finance Limited
	LB Finance
	Lanka Orix Leasing Company
	Trade Finance and Investments Ltd
	The Finance Company
Insurance Companies	Ceylinco Insurance Ltd
	Sanasa Insurance
	HNB Assurance PLC
	Janashakthi Insurance Co. Ltd
	Union Assurance PLC
	Hayleys AIG Insurance Co. Ltd
	Cooperative Insurance Company Ltd
Total	19

The banks, finance and insurance companies interviewed for the purpose of this survey were established between 1888 (Hatton National Bank) and 2001 (Ceylinco Savings Bank), and they have reported they started their microfinance activities between 1970 (Bank of Ceylon) and 2006 (Sampath Bank). Banks seem to have been the first group of formal institutions entering the microfinance sector – most of the banks in the sample have started microfinance operations in the 80s and 90s, only two institutions of this group (Ceylinco Savings Bank and Sampath Bank) have started microfinance operations after 2000. According to the information provided, the first finance company starting microfinance operations was Trade Finance and Investment in 1978, followed by Asian Finance in 1996. The reader should however be aware that these two institutions have a very broad definition of microfinance (providing smaller scale financial services), which differs considerably from the common understanding of microfinance, which implies an income group targeting and a poverty alleviation component. Since the principle of this survey was to let the respondents provide their own microfinance definitions, the results of this chapter should be interpreted with care. The remaining respondents are reported to have entered the microfinance field in 2000 and after. The last group to enter the microfinance sector is the group of insurance companies, with Union Assurance reporting they have ventured into microinsurance in 1988. But in the case of this respondent the same comment applies as in the case of Trade Finance and Investment and Asian Finance above. The majority of the respondents from this group (57%) have entered the sector after 2001.

12 out of the 19 financial institutions interviewed provide financial services only; the remaining seven provide both financial and non-financial services. Most banks (86%) provide both financial and non-financial services, most leasing and finance companies (80%) offer financial services only, while all insurance companies focus solely on financial services.

- Financial services: all seven banks offer short term credit, loans (for specific purposes) and savings products; pawning is offered by five of them, leasing is offered by two, while products such as insurance, share investment schemes, pension schemes and fee based facilities and guarantees are each offered by one institution All five finance companies offer leasing, four of them offer loans for specific purposes; savings products and hire purchase facilities are each offered by three of the respondents, pawning by two, while short term credit and insurance are each offered by one of the respondents. All insurance companies offer solely insurance services to micro and small enterprises or low income groups.

- Non-financial services: of the banks providing nonfinancial services all offer financial advisory services to their customers, 67% of them provide training and skills development, 50% group formation and 33% marketing facilities. Of the finance companies, only LOLC provides non-financial services to microfinance customers, which include financial advisory services and training and skills development. As a conclusion, most of the non-financial services offered can be regarded as "credit plus" services.

As to the extent to which the institutions covered in this chapter are involved in microfinance operations, the survey has revealed that for the five banks that provided information, the average percentage of microfinance activities was estimated to be 39%, expressed in terms of the contribution of the microfinance business to total revenue. This covers a broad range of quoted values: from 1% (Sampath Bank) and 4% (Bank of Ceylon) at one end to 60% (SANASA Development Bank) and 85% (Ceylinco Savings Bank) at the other. On average, 28% of the activities of finance companies are related to microfinance. This ranges from 5% in the case of The Finance Company to 95% in the case of Trade Finance and Investments. Except for the latter respondent, none of the other respondents has mentioned values above 15%. For the six insurance companies which have provided information, an average of 17% is represented by their micro insurance activities. This ranges from 0.6% in the case of Hayleys AIG to 80% in the case of SANASA Insurance and 100% for Cooperative Insurance Company. For half of the respondents who have provided the information, microinsurance activities represent less than 5% of their portfolio. It has to be reminded though that the answers to this question rely on the self evaluation of each respondent and of their own interpretation of microfinance, therefore the heterogeneity of the sample is amplified by the different interpretations of microfinance. Therefore a closer look at the definitions provided by the respondents is necessary.

An analysis of the definitions offered for microfinance could be pursued along following common elements: products, target group, purpose of the services and special conditions. In the case of banks, all seven respondents mention products and target group, while the remaining two categories are mentioned each by two of the respondents. Regarding the products, one of the respondents mentions loans alone, while the remaining six mention a broader range of financial services. The target group is defined by four respondents in terms of income (e.g. lower income group), by three respondents in terms of the sector of residence (i.e. the rural sector) and by two respondents in terms of activities (e.g. entrepreneurs, farmers). The purposes stated by the two respondents who have mentioned them were: empowerment of the target group (both), investment (one respondent) and fulfilment of basic needs (one respondent). As a conclusion, the definitions of microfinance given by banks are quite complex, most of them include a broader range of products and focus on a clearly defined target group. Compared with them, the definitions provided by finance companies are less specific. While all five mention the products offered, only four of them include a target group (three respondents mention income, while one refers to the type of activity, i.e. entrepreneurs), while the purpose (i.e. investment) and special conditions (a maximum of Rs. 100,000 for loans) are mentioned each by only one respondent . Of the six insurance companies who could define the concept of microinsurance, all of them mentioned a target group (based on income for five of them and on the type of activity – i.e. SMEs for one of them). Half of them have mentioned small premiums as a characteristic of microinsurance.

When asked to define what they mean by “low income” (i.e. the monthly income threshold of a low income household), only three out of the seven respondents belonging to the group of banks could or were willing to do so. From the values stated by these three respondents an average income below Rs. 6,333 qualifies a household to the “low income” status. The actual values stated ranged between 3,000 (Bank of Ceylon) and 10,000 (SANASA Development Bank). All finance companies have provided a threshold, which on average was as high as Rs. 11,000. The individual values ranged between 5,000 (The Finance Company) and 20,000 (Asian Finance). From the insurance group, only one respondent (Ceylinco Insurance) had a definition for a low income household – Rs. 3,500, although almost all of the respondents have mentioned “low income” as their target group.

The characteristics of microcredit given by the respondents of the group of banks could be grouped according to the target group – i.e. loans to the lower income group (two respondents) or entrepreneurs (five banks) – and in terms of conditions – i.e. simple terms and conditions (two banks), small loans (one bank) and small instalments (one respondent). The definitions of finance companies included the following characteristics: small loans – e.g. up to Rs. 100,000 or Rs. 250,000 – mentioned by three of the respondents, entrepreneurs (two respondents) or lower income households (one finance company) as target groups.

6.2 Organisational Structure and Governance

Organisational Structure

This is a rather heterogeneous group; therefore it is difficult to comment on the type of organisational structure of the group. There seems to be a trade-off between a centralised hierarchical structure and outreach to the lower income groups. There is a large degree of standardisation and monitoring, as these are formal institutions, well organised.

Ownership

With the exception of the two government-owned banks (Bank of Ceylon and People’s Bank), established by dedicated legislation (BOC Ordinance No. 53 of 1938 and People’s Bank Act No. 29 of 1961) all other institutions are limited liability companies registered under the Companies Act No. 7 of 2007. The shareholders of this group of institutions are a mix of national and international private enterprises (including venture capital funds) and individuals, the Government of Sri Lanka as well as state-owned banks and enterprises, SANASA primary societies and secondary unions, as well as Multi-Purpose Cooperative Societies (in the case of Sanasa Development Bank). Some of them are publicly listed companies.

Regulation and Supervision

Commercial and specialized banks are regulated by the Banking Act No. 30 of 1988 with its consecutive amendments, while leasing and finance companies are regulated respectively by the Finance Leasing Act No. 56 of 2000 and Finance Companies Act No. 79 of 1988 and subsequent amendments. For both types of institution, the regulatory and supervisory authority is the Central Bank of Sri Lanka, a situation correctly identified by most respondents. Insurance companies are governed by the Regulation of Insurance Industry Act No. 43 of 2000. The regulatory and supervisory authority is the Insurance Board of Sri Lanka.

The respective supervising authority was reported to employ the following measures: obtaining operational information on a regular basis (mentioned by 71% of the banks, all finance companies and 50% of the insurance companies), inspection and audit of accounts (all banks, 40% of the finance companies and 83% of insurance companies).

Audit

All banks and insurance companies, and three finance companies in the sample are audited both internally and externally. Two finance companies (Asian Finance and Trade Finance and Investments) rely solely on external audit and do not have an own internal audit function.

Decision making / Strategic planning

Five banks, three finance companies and three insurance companies have reported they set microfinance business development goals and develop annual business plans and strategies to achieve them. All of them have indicated that these strategies and plans, once set, are also put into practice.

Strategic decisions concerning interest rates, product design, Human Resource Management and target group orientation are taken centrally at management level for all types of institutions covered by the survey. The overall operating policies are decided by the Board of Directors for six of the banks, four of the finance companies and two of the insurance companies. Overall operating policies for insurance companies are mainly decided by the management committee (four respondents) or international corporate guidelines are followed (one respondent).

6.3 Operations

Branch distribution

The microfinance providers presented in this chapter have a total of 1,415 branches divided as follows: commercial banks with 921 branches, insurance companies with 404 and leasing and finance companies with 90 branches. The regional and sectoral breakdown is presented in Table 6-2. Each institution has on average 74 outlets, but significant discrepancies could be observed. For the group of banks the number of branches ranges from one (Ceylinco Savings Bank) to 324 (People's Bank), for finance companies between zero (Trade Finance and Investments) to 37 (LB Finance), and for insurance companies from 3 (Hayleys AIG) to 213 (Ceylinco Insurance). In addition to 324 fully fledged branches, the People's Bank operates an additional 314 service centres. Microfinance products are also available through these centres, but the regional and sectoral distribution could not be provided, therefore they were not included in table 6-1.

79% of the respondents in this group have indicated that their microfinance products are available in all of their branches. According to the information provided by the respondents, from the total number of 1,415 branches, microfinance products are not available in 102 branches of banks and 75 branches of insurance companies.

Table 6-1 Regional and sectoral coverage of Banks and OFIs

Province	Branches		Sector			Population Density per Branch (Population / No. of Branches)*
	No.	%	Urban	Rural	Estate	
Western	513	36.3%	358 (69.8%)	151 (29.4%)	4 (0.8%)	10,490
Central	155	11.0%	57 (36.8%)	65 (41.9%)	33 (21.3%)	15,638
Southern	159	11.2%	69 (43.4%)	79 (49.7%)	11 (6.9%)	14,329
North Western	137	9.7%	45 (32.8%)	92 (67.2%)	-	15,839
North Central	97	6.9%	20 (20.6%)	77 (79.4%)	-	11,388
Uva	91	6.4%	13 (14.3%)	63 (69.2%)	15 (16.5%)	12,938
Sabaragamuwa	120	8.5%	35 (29.2%)	65 (54.2%)	20 (16.7%)	15,011
Northern	64	4.5%	20 (31.3%)	44 (68.8%)	-	16,265
Eastern	79	5.6%	20 (25.3%)	59 (74.7%)	-	17,970
Total	1,415	100%	637 (45.0%)	695 (49.1%)	83 (5.9%)	13,284

Note *The source for population per province is the Census of Population and Housing, Department of Census and Statistics – Sri Lanka, 2001. For the Northern and Eastern Provinces, estimates of the Department of Census and Statistics for the same year (2001) were used.

Banks and other financial institutions are present in all nine provinces of Sri Lanka. Banks are present in all districts, including those affected by the conflict. Finance companies do not have a presence in Mannar, Mullaittivu and , while insurance companies are not present in Mullaittivu and . As for the number of respondents with operations in the Northern Province, five of the seven banks have a presence there (People's Bank, Bank of Ceylon, HNB, Sampath and SANASA Development Bank), compared to only one of the five finance companies (The Finance Company) with presence in the Northern Provinces. As for insurance companies, with the exception of Hayleys AIG and SANASA Insurance, all other respondents have operations in the Northern Province. The number of outlets per province varies from 64 in the Northern Province to 513 in the Western Province. The presence of outlets of banks and other financial institutions is clearly concentrated in the Western Province, where 36.3% of the outlets are located, compared to 29% of the population living there.

The average population served per branch ranges from 10,490 people / branch in the Western Province to 17,970 in the Eastern Province. The average lies at 13,284 people / branch.

As for the sectoral breakdown, branches are almost equally divided between the rural and the urban sectors, the first accounting for 49.1% of the branches, while the second has 45%. The remaining 5.9% are found in the estate sector. But this distribution varies considerably between the provinces. The proportion of branches in the urban sector ranges from 69.8% in the Western Province to 14.3% in the Uva Province. The estate sector accounts between 16.5% and 21.3% of branches in Uva, Sabaragamuwa and Central provinces, while in the Western Province it represents 0.8% of the outlets.

An analysis of the sectoral breakdown differentiated by the subgroups of the sample (banks, finance and insurance companies) has revealed the following: the majority of the bank outlets are in the rural sector (477 outlets), followed closely by the number of outlets in urban areas (367 outlets), the remaining 77 outlets being situated in the estate sector. Finance companies are mainly located in urban areas (64 outlets) and have only a modest presence in the rural sector (26 outlets). None of them has a presence in the estate sector. The outlets of insurance companies are almost equally located in the urban and rural areas, with a minor preference for the first: 206 outlets are in the urban and 192 are in the rural sector, while six branches are located in the estate sector.

Table 6-2 Regional distribution of Banks and OFI Branches vs. poverty distribution

Province	Persons Below the Poverty Line (PBPL)		Banks & OFI Branches		PBPL/ Branch
	No.	%	No.	%	
Western	542,157	16.9	513	40.3	1,057
Central	547,401	17.1	155	12.2	3,532
Southern	558,619	17.4	159	12.5	3,513
North Western	472,384	14.4	137	10.8	3,448
North Central	199,875	6.2	97	7.6	2,061
Uva	356,540	11.1	91	7.2	3,918
Sabaragamuwa	528,824	16.5	120	9.4	4,407
Total	3,205,800	100.0	1,272	100.0	2,520

Note The poverty percentage was calculated as percentage of the total population living under the poverty line in a given province. The percentage of branches was recalculated, excluding the North and Eastern Provinces as poverty data for these provinces was not available.

Comparing the regional distribution of branches of banks, finance and insurance companies with the poverty distribution across provinces, considerable disparities can be observed. The Western Province is by far the best served by this group of institutions – 40% of the outlets are located in this province, compared to only 17% of the poor. At the other end of the spectrum, Sabaragamuwa has only 9% of the outlets, while being the home of 17% of persons below the poverty line (PBPL). All provinces other than the Western and North Central Provinces are underserved compared to their respective shares of PBPL. An average of 2,520 PBPL are served per branch by this group of institutions, with values ranging from 1,057 PBPL / branch in the Western Province to 4,407 PBPL in Sabaragamuwa.

Clients

Not all institutions maintain records concerning the client base. Microfinance clients are not always separated from the entire customer base of the institution and in certain instances the overall client base is not known and can be only roughly estimated.

Banks have reported a total of 706,600 microfinance clients. However, this does not include the customers of People's Bank, which accounts for a large market share, especially in terms of savings and pawning (see section on products and markets). For the six banks who have reported their customer base, this ranges from 600 (Sampath Bank, a recent player in the field of microfinance) to 500,000 clients (SANASA Development Bank). Finance companies have reported a total of 85,583 microfinance clients, again with large variations from 550 (The Finance Company) to 65,033 (LB Finance). For insurance companies, a total of 142,550 clients were reported with ranges from 500 (HNB Assurance) to 73,470 (Ceylinco Insurance). These figures seem to be in line with the data provided regarding the number of accounts. In the case of banks, if all savings and pawning clients of the People's Bank were included, the overall client base of the group of banks would be significantly higher (see section 5.4.

The People's Bank has 6.3 million savings accounts, most of which are considered to belong to the lower income group, and a large number of pawning accounts, which could not be exactly estimated). As a conclusion, the banks have the largest outreach among the three subgroups presented in this chapter. Considering the fact that they also have the longest tradition in the sector, this is not surprising.

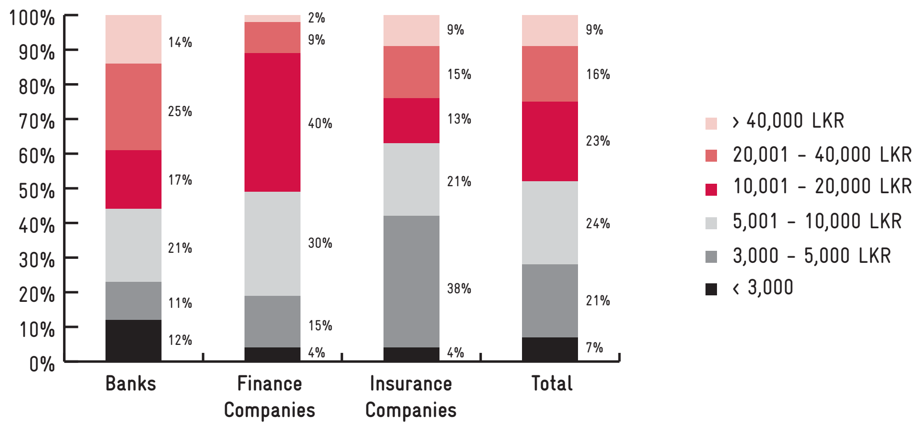
A word of caution needs to be added – all figures reflect the own definitions of microfinance of the institutions in the sample. In many cases, the definition is broader than the traditional acceptance of the term, which leads to an overestimation of the microfinance client base in the case of these institutions.

In the case of banks, five of the seven respondents focus on target groups such as: entrepreneurs (all five institutions), farmers (four banks), low income groups (three respondents), while two banks concentrate on women, youth and the disabled. One of the respondents, People's Bank, focuses on estate workers, which is also evident by the large number of branches in this sector. Of the five finance companies, four of them focus on target groups: two of the respondents target women, entrepreneurs and low income groups, while youth, farmers or three-wheel drivers are each chosen as target groups by one respondent. Only two of the seven insurance companies focus on target groups (Ceylinco Insurance and SANASA Insurance) such as: women and entrepreneurs for the first respondent and low income groups and farmers for the latter.

The traditional customers of the formal financial sector are men, a situation which is also true of the microfinance customers of most institutions in the sample. Five of the seven banks in the sample have more male than female microfinance customers. In the case of HNB the percentage of female customers is even lower than 25%. Only People's Bank has reported more than 75% female clients among their microfinance customer base. All four finance companies which offered information regarding the gender composition of their customer base (Asian Finance could not provide such information) have more male microfinance customers than female. For The Finance Company the percentage of female microfinance customers is lower than 25%. Of the insurance companies Janashakthi and Union Assurance could not provide information on the gender structure of their microfinance clients. One respondent, Hayleys AIG, has reported a percentage of between 50% and 75% of the served clients are women. This is, in fact, the direct consequence of operating their microinsurance scheme through an NGO-MFI (Sewa Finance). The remaining four insurance companies estimate their female customer base to be between 25% and 50%.

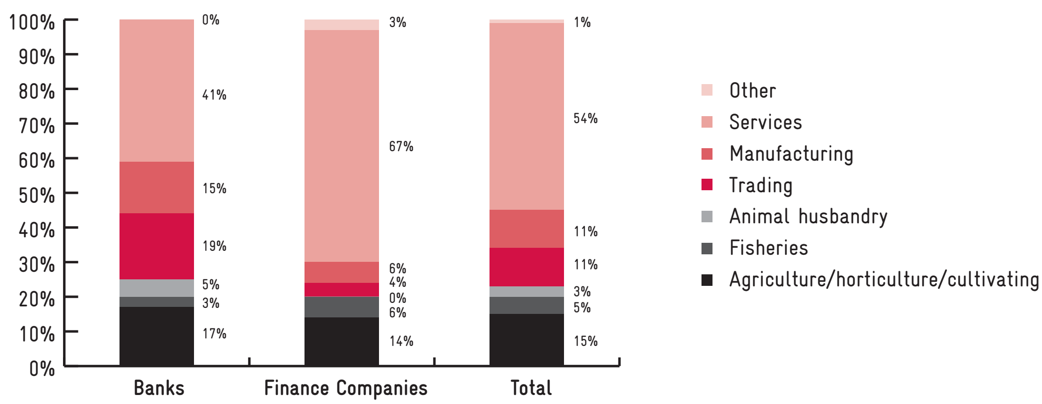
Five of the seven banks (with the exception of BOC and Sampath Bank), all five finance companies in the sample and four of the seven insurance companies (with the exception of Union Assurance, Cooperative Insurance and Janashatkhi) have provided information regarding the income structure of their microfinance clients. Only 28% of the microfinance customers of all three groups have a household income of Rs. 5,000 or less. This share is lower for finance companies (19%) and banks (23%) and higher for insurance companies (42%). 38% of the microfinance clients of banks, 70% of the finance companies and 34% of insurance companies have a monthly income between Rs. 5,000 and Rs. 20,000. As much as 39% of the microfinance clients of the banks have a monthly income of more than Rs. 20,000. The share of this income group is lower for insurance companies (25%) and finance companies (11%). We can therefore notice that a significant proportion of their clients are well above the low-income threshold as defined by the same respondents.

Figure 6-1 Monthly income of microfinance clients of Banks & OFIs



Five of the seven banks (with the exception of Bank of Ceylon and Sampath Bank), all five finance companies and only two of the insurance companies (SANASA Insurance and Hayleys AIG) have offered information regarding the economic activity profile of their microfinance clients. Due to the low response rate in the case of insurance companies, only the data for the banks and finance companies has been aggregated and presented in Figure 6-2 below.

Figure 6-2 Economic activity of Banks & OFIs



As can be noticed from the chart above, the clients of both banks and finance companies operate mainly in the service sector: 54% of the clients are on average engaged in this sector – 68% of the clients of finance companies and 42% of the clients of banks. Clients involved in agriculture, horticulture and cultivating represent only between 14% and 17% of the clients of banks and finance companies. An important share of the clients of banks (19%) is also involved in trading. As for the data provided by the two insurance groups, a large majority of their clients are in the agriculture, horticulture and cultivating (65%), reflecting thus the activity profile of the clients of their partner institutions (SANASA societies for SANASA Insurance and Sewa Finance for Hayleys AIG).

Over the last year almost all banks, finance and insurance companies indicated that their customer base has increased for each financial service provided, despite perceived strong competition.

Lending methodology

All banks offer individual loans. In addition to this, four of them offer group loans as well, while three provide wholesale funding to CBOs and village societies. For the banks offering a lending methodology mix, the share of individual lending is on average 79.5%. These banks offer on average 11.75% based on joined liability (individuals who receive the loan need to be in a group which guarantees repayment of the loan). The average share of loans offered to CBOs and village societies represents 11.67% of the portfolio of banks offering this service. Of the four finance companies who offer loans, three of them provide individual loans exclusively. The remaining institution has a loan portfolio made up of 95% individual loans, 1% joint liability and 4% of wholesale lending. As a general observation, the prevalence of individual lending can be observed, which for this group of institutions does not come as a surprising fact.

For insurance companies, the question asked was whether the policies offered were individual or bulk policies. One respondent could not provide information (Union Assurance), one offers only bulk insurance policies (Hayleys AIG provides insurance to microfinance customers of Sewa Finance), one other respondent (Cooperative Insurance) offers only individual policies, while the four remaining offer a mix of both with an average of 58.75% individual insurance cover and 41.25% bulk policies. Asked how many individuals were covered under the bulk policies, only two respondents could provide information and reported a total of 303,000 clients. This shows that the coverage of this subgroup extends well behind the direct customer base reported.

Identifying potential clients

Banks rely mainly on inspections and field visits (86%) in the process of identifying potential clients. 71% of the respondents evaluate the past transaction performance of potential clients. An equal number of respondents rely on recommendations from existing reliable customers, while 57% use opportunities arising out of non-microfinance activities of the organisations. This suggests that this group of institutions exploits well available opportunities.

All finance companies have reported they rely on recommendations from existing reliable customers, 80% of them on inspections and field visits and 40% on the evaluation of past transaction records.

As for insurance companies, 43% of them have reported no focused attempt to identify microinsurance clients. This could be explained by the fact that quite a few of the institutions in the sample have linkages with other financial organisations belonging to the same group (HNB Assurance, SANASA Insurance, Ceylinco Insurance) or work through partners (Hayleys AIG with Sewa Finance). These linkages are expected to play a significant role in identifying potential clients. 29% of the respondents have reported using inspections and field visits for the purpose of identifying new clients.

Agencies for sourcing don't play an important role for any of the three groups of institutions mentioned above (only one respondent from each group has mentioned them), a surprising finding especially for insurance companies which generally rely on a network of brokers to acquire new clients. The fact that banks and insurance companies don't use sourcing agencies might be explained by the KYC (know-your-customer) requirements in place and perhaps the cost of using an agency relative to the size of the MF portfolio.

Loan processing and approval procedure

All institutions have short processing intervals for all types of products, none of them being of over 15 days. The processing time for loans ranges from two to 14 days in the case of banks and from one to three days in the case of finance companies offering loans. Savings accounts are opened within one day for the institutions offering the service, insurance products require one day for banks and finance companies and one to 15 days for specialised insurance companies. The longer time required by specialised insurance companies could be explained by the more complex products, sometimes tailored to the needs of the customers. Leases and hire purchase contracts take between one and 14 days to be approved, pawns one day.

Concerning the approval of loans, 71% of the banks and 60% of finance companies give the branch manager a maximum approval limit, while 29% of the banks and 20% of the finance companies place the responsibility for the approval of the loan in the hands of a credit committee. In one bank, for loans exceeding a set value, approval falls under the responsibility of the Board of Directors, while in another the branch manager can approve all microfinance loans. In the case of the microfinance loans it is, however, unlikely that the set value would be exceeded, thus requiring the intervention of the Board of Directors.

Loan monitoring and provisioning

47% of banks, finance and insurance companies manage their microfinance operations on a computerised basis while 53% of them operate a mixture of manual and computerised systems. All institutions have both email and internet access.

Of the banks, all have declared they measure portfolio-at-risk (PaR) as an indicator of portfolio quality. Of the four finance companies offering loans, one does not monitor its portfolio quality; therefore of the 11 institutions offering loans, ten institutions (seven banks and three finance companies) monitor the quality of their microfinance portfolio.

The level of computerisation is also reflected in the monitoring activities employed by banks and finance companies. All three finance companies and six of the banks, which monitor portfolio quality, rely on computerised financial statements and client records. In addition to this, all three finance companies and five of the banks utilise field officer visit records. One finance company and two banks use manual entries and log books for this purpose.

When asked to define PaR, the majority of the respondents do not seem to clearly differentiate between the concept of PaR and that of non-performing loans (NPLs). It remains in particular unclear whether they consider only the respective overdue instalment as being at risk or the entire loan amount in case one instalment is not paid on time.

Most of the respondents have reported they use CBSL regulations to classify NPLs, generally performing an age analysis of defaulting loans. For commercial and specialised banks, CBSL requires a loan to be classified as non-performing after three months. Non-performing loans are classified as special mention (between three and six months), sub-standard (between six and 12 months), doubtful (between 12 and 18 months) and loss (over 18 months). CBSL requires finance companies to consider a loan non-performing after it has been overdue for three months, but provisioning commences after the loan has been overdue for more than six months. The classification of loans as overdue, doubtful or loss does not apply to finance companies, although it seems that some of them have adopted these classifications. For leasing companies, the provisions are even more lenient. A lease is considered to be non-performing after instalments have not been paid for more than six months.

All institutions have reported they make provisions for loans classified as NPLs, again following CBSL policies: 20% for overdue loans, 50% for loss and doubtful ones. One respondent has stated that their provisioning policy on overdue loans is 50% for loans with collateral and 100% for loans without collateral. The requirements of the CBSL differ slightly from those cited by the respondents. Banks are required to maintain a general provision of 1% on performing loans and advances. In addition to this, they are to build special provisions for non-performing loans: 20% on sub-standard loans, 50% on doubtful loans and 100% on loss loans. Finance companies are required to maintain a provisioning rate of 50% on loans overdue between six and 12 months and 100% for loans overdue more than 12 months. Provisioning requirements for leasing companies are similar to those for banks: 20% for leases overdue between six and 12 months, 50% for leases overdue between 12 and 18 months and 100% for leases overdue for more than 18 months.

Banks and finance companies apply Central Bank regulations as designed for their main lending business. These regulations are not microfinance tailor-made since loan classification is too lenient (i.e. periods are too long) and provisioning rates are too low leading to an over-stated asset base.

Defaulting clients

Both banks and finance companies employ similar measures in dealing with defaulting clients: all of them have reported engaging in legal action, although it is not clear whether for small loans such as for microfinance clients this is indeed an option considered in practice by banks or only a deterrent, remaining thus more at declarative level. Another explanation could be that the respondents have a broad understanding of the measures implied by the legal action and include the issuing of a legal Letter of Demand in this category. 71% of banks have declared they freeze savings and deposit accounts of defaulting clients. 57% of banks exert group or social pressure in order to recover loans, which could be explained by the low level of joint liability lending in this group of institutions. 80% of finance companies and 57% of banks apply penalties to defaulting clients. 57% of banks and 40% of finance companies confiscate property. Only 29% of banks and 20% of finance companies use arbitration to ensure repayment of defaulting loans. A possible explanation for this could be that the institutions in this group have experience in legal actions, an own legal department and with this the mechanisms are set in place for legal action. For this group of companies, social pressure and arbitration may prove in fact more costly.

Operational challenges

It is interesting to notice that the operational challenges mentioned by respondents were quite different from one to the other. In the group of banks two respondents did not mention any challenges while for finance and insurance companies two and three challenges respectively were mentioned each by two respondents. This is indicative for the heterogeneity of the group.

Among the issues identified by banks, the following challenges can be mentioned: strong competition, shortage of staff or lack of microfinance experience of existing staff, inadequate demand for products and services or difficulty to identify solvent clients, insufficient outreach to the low income segment, political influence (from the respondent of a state-owned bank) and lack of transparency and information about microfinance. Delayed and non-repayment of loans were each mentioned by two finance companies. Other challenges mentioned by this group include: strong competition, shortage of funds and of staff. Insurance companies have identified strong competition, shortage of staff and inadequate demand for products and services as the main operational challenges. Other issues include rigid insurance rules and regulations, lack of staff with microinsurance experience and insufficient outreach to the low-income segment.

6.4 Products and Markets

There are significant differences in the products offered by the three groups of companies presented in this chapter; therefore they will be treated separately. It should be mentioned here that the respondents were specifically asked to provide microfinance specific product information. As some of the respondents did not keep specific records, especially for savings and pawning, estimates were provided instead. The figures of this section should therefore be taken with care.

Banks

All banks in the sample offer savings and deposit products and loans, while five of them offer pawning as well. Table 6-3 offers on overview of the products offered by the seven banks in the sample.

Loan products

The six respondents who provided information during the survey have an average volume outstanding of Rs. 1.5 bn and a corresponding average of 37,525 accounts. But significant disparities exist. The volume outstanding ranges from as little as Rs. 1.4 million to Rs. 3.3 billion, while the number of accounts spans between 60 (a recently started microfinance business) and 111,858. Banks charge between 8% and 34% interest on loans offered to microfinance customers. Three of the seven respondents in this category have indicated minimum amounts available between Rs. 10,000 and Rs. 50,000 therefore catering mainly to the upper end of the lower income group. As to the maximum values available, the clients of two banks can access loans of up to Rs. 1 million, while other three banks have maximum limits of up to Rs. 250,000. The repayment period ranges from one to 120 months, but most (57%) of the respondents have repayment periods going up to 36 months.

Table 6-3 Microfinance product portfolio of Banks

Product / Service	No. of Banks		Volume Outstanding ('000 Rs.)	No. of Accounts	Average outstanding account balance (Rs.) *	Annual Interest Rate (%)
	Offer the product/service	Provided information				
Savings and Deposits	7	5**/4***	70,404,508	6,512,619	10,795	4-16
Loans	7	6	8,849,072	225,147	39,304	8-24
Pawning	5	2**/1***	66,636,942	238,875	2,415	18-23
Leasing	2	2	1,057,586	9,868	107,173	8-34
Pension Products	1	1	102,057	4,094	24,928	11
Insurance	1	1	6,000	400	1,500	-

Note * The average outstanding account balance was computed using data from banks which have provided information on both volume outstanding and number of accounts and therefore can differ from the ratio between the total volume outstanding and the number of accounts reported in this table.

** The number of respondents who have provided information regarding the volume outstanding.

*** The number of respondents who have provided information regarding the number of accounts.

Pawning

Five of the respondents interviewed offer pawning, but only two have provided information regarding the outstanding volume and only one regarding the number of accounts. But even this scarce information shows that pawning plays an important role for microfinance customers. In terms of volumes, the pawning portfolio of just two respondents is 7.5 times higher than the loan portfolio of six reporting respondents. In terms of number of accounts, the one reporting institution has more pawning accounts than all six banks which have reported the number of their microfinance loan accounts. This could indicate that banks are not yet ready to remove barriers to lower income groups and prefer offering to this market segment products which provide them with collateral.

Savings products

The five banks who have offered information regarding the volume outstanding have an average savings portfolio of Rs. 15 billion, but the average is highly distorted by the figures reported by one of the respondents (People's Bank). Excluding it, the average for the remaining four institutions is only Rs. 614 million. As for the number of accounts, the four reporting institutions have an average of 1.6 million accounts, but excluding again People's Bank, the average drops to just 70,873. The average outstanding account balance of Rs. 10,795 shows that banks have a broader definition of microfinance compared to other groups of institutions, attracting thus customers with a higher saving capacity than average microfinance clients. This is reflected also in the minimum value required to open an account: three respondents (43%) require Rs. 500, two (29%) ask for Rs. 100 and one (14%) has no minimum limit. For the savings and deposits mobilised, banks offer between 4% and 16% interest.

Other products

Two of the seven banks in the sample have reported they offer leasing. The two respondents together have a total portfolio of Rs. 1 billion to which correspond 9,868 accounts. The cost of a lease displays considerable variance, ranging from 8% to 34%. Two other products are offered each by one bank: a pension scheme (volume outstanding Rs. 102 million and a corresponding 4,094 accounts) and insurance (400 policies)

Finance companies

All five finance companies offer microfinance customers leasing services, four of them offer loans, while three of them offer savings and deposits and hire purchase. Table 6-4 offers an overview of the products offered by finance companies.

Leasing

The average volume outstanding of leasing contracts for microfinance customers reported by the five finance companies is Rs. 863 million, while the average number of accounts is 4,038. But there are significant discrepancies within the group. The volume outstanding of three of the five respondents is under Rs. 10 million and under 100 accounts, while the remaining two have portfolios of between Rs. 1 and 3 billion and over 5,000 accounts. The minimum amount of a lease ranges between Rs. 5,000 and Rs. 100,000. Four of the five respondents have a maximum lease amount between Rs. 100,000 and 500,000. This is also reflected in the high average outstanding account balance (Rs. 213,670). The cost of a lease is between 15% and 29%.

Table 6-4 Microfinance product portfolio of Finance Companies

Product / Service	No. of Finance Companies		Volume Outstanding ('000 Rs.)	No. of Accounts	Average outstanding account balance (Rs.)	Annual Interest Rate (%)
	Offer the product/service	Provided information				
Leasing	5	5	4,314,000	20,190	213,670	15-29
Loans	4	4	573,100	10,486	54,654	4.5-25
Savings & Deposits	3	2	81,500	1,820	44,780	9-17
Hire Purchase	3	3	3,846,400	10,511	365,940	15-29
Pawning	2	1	900,000	62,533	14,392	23.5

Loan products

Four finance companies offer loans to their microfinance clients. On average, each of the four institutions has a microfinance loan portfolio of Rs. 143 million and a corresponding number of 2,622 accounts, but large discrepancies do exist. If LOLC is excluded, the average drops to Rs. 24 million and 162 accounts. The average outstanding account balance of Rs. 54,654 is considerably higher than for banks. The customers of finance companies pay between 4.5% and 25% for their loans.

Savings products

Only three finance companies offer savings and deposits, of which two have provided information. They have an average outstanding account balance of Rs. 44,780, explained by the fact that all savings under a certain limit (e.g. Rs 100,000 for one of the respondents) are considered to be microfinance, irrespective of the income of the client. One of the respondents requests a minimum of Rs. 2,500 to open an account, a significant barrier for lower income groups to save with finance companies. Clients of finance companies receive between 9% and 17% for their savings and deposits.

Other products

Hire purchase plays an important role in the product portfolio of the finance companies. The three companies which offer this service have an average portfolio of Rs. 1.2 billion with a corresponding average of 3,504 accounts per respondent. LB Finance has also an important pawning portfolio with 62,533 accounts and a corresponding volume outstanding of Rs. 900 million. The minimum value of a pawn is Rs. 5,000. One respondent has claimed to offer insurance as well, but no information regarding this product was made available during the survey.

Insurance companies

Insurance companies have a diverse product portfolio for low-income clients. The respondents in the sample who were willing to provide information regarding their product portfolio seem to have specialised in different types of products. Therefore, only loan protection insurance and life insurance are offered each by two respondents while all other products are offered by only one company each. An overview of the insurance products offered by the insurance companies in the sample is provided in Table 6-5.

Six of the ten insurance schemes presented in the table target individual clients, one scheme targets both individual and groups, while the remaining three address only groups. Therefore, the picture of the sector is diverse, with values of the annual average gross written premium per policy ranging from Rs. 852 to Rs. 720,000 in the case of one group policy covering 3,000 individuals.

Table 6-5 Microfinance product portfolio of Insurance Companies

Product	No. of Insurance Companies	Gross Written Premium ('000 Rs.)	Insured Value ('000 Rs.)	No. of policies	Average Gross Written Premium/Policy (Rs.)	Average Insured Value/Policy (Rs.)
Loan Protection insurance	2	16,182	1,038,000*	7,687	2,105	143,767*
Life insurance	2	60,977	414,170**	71,610	852	37,112**
Health insurance	1	2,120	26,000	52	40,745	500,000
Vehicle insurance	1	17,062	948,558	5,909	2,888	160,528
Personal Accident insurance	1	720	300,000	1	720,000	300,000,000 ***
Natural Disaster insurance	1	4,564	40,000	2,000	2,282	20,000
Education insurance	1	6,975	–	5,580	1,250	–
Total	1	18,600	–	7,440	2,500	–
	10 schemes	127,200	2,766,728 ****	100,279	1,268	27,590***

Note Janashakthi Insurance, Union Assurance and Co-operative Insurance have refused to disclose information regarding their products.

*The data refers to only one of the two respondents (SANASA Insurance). HNB Assurance could not provide information regarding the insured value under the Loan Protection Insurance scheme.

**The data refers to only one of the two respondents (SANASA Insurance). Ceylinco Insurance could not provide information regarding the insured value of the Life Insurance scheme.

***Group policy covering 3,000 individuals.

****Insured value information is not available for four of the ten insurance schemes.

Formal lending conditions

All banks require proof of established residency, while 86% of the respondents have mentioned guarantors, a minimum bank balance and proof of income sources as conditions for obtaining a loan. Further, 57% of them have mentioned insurance cover and collateral, while 43% ask for recommendation of a third party. All finance companies require guarantors, 80% of them proof of established residency and income sources, 60% have mentioned insurance cover and collateral, while 40% of the respondents ask for a third party recommendation. The lending conditions of both banks and finance companies are quite restrictive for microfinance clients, therefore casting a doubt on whether in practice the goal of providing financial services to the disadvantaged can be attained by this group of institutions.

Other lending conditions

71% of the banks require clients to build compulsory savings in order to approve a loan request. Only two respondents (HNB and BOC) don't. None of the finance companies requires compulsory savings.

This group of institutions has a centralised approach to interest rate setting. This is not surprising for this group of structured, formal institutions offering a uniform set of products and services across their outlets. Only 14% of the banks and 20% of finance companies (one respondent from each group) allow individual branches to take decisions concerning interest rates. The remaining respondents have mentioned a centralised system. In both groups (banks and finance companies) there was one respondent operating only from the head office, therefore the question was not applicable to them.

Regarding the methodology used to set interest rates, 57% of banks and 80% of finance companies orientate themselves at the deposit rate and decide on a set margin above it. Surprisingly, no respondent from these two groups has mentioned product cost computations as a basis for interest rate setting for microfinance products.

Four of the seven banks have mentioned special terms with regard to interest rates. These refer to concessionary rates for targeted groups (three banks) and penalties for late payments (two banks). Four of the five finance companies have special terms: two of them have special conditions for specific customer groups, three request penalties on late payments, while another three offer interest rate reductions on early payments.

As for the methods of interest rate calculation, all banks, as well as two of the four finance companies offering loans use the declining balance methodology. The remaining two finance companies calculate interest due based on the original loan amount.

Five of the seven banks and two of the four finance companies offering loans charge a service fee for the loan processing.

On average, 6.6% of all loan applications are rejected in the case of banks and 17.6% in the case of finance companies. Large discrepancies exist within these two groups. While 2 of the banks have reported no loan applications to be rejected, the rejection rate goes up to 25% in the case of another respondent. In the case of finance companies the rejection rate ranges from 3% to 50%. But it has to be noted that these discrepancies could also reside in the different loan approval procedures of the institutions, some of which may include an initial screening of the clients, which results in a low rejection rate.

Delivery of products and marketing strategies

For all institutions, the main delivery channel for the products is their own branches and outlets (86% in the case of banks and insurance companies and 80% for finance companies). An important role is also played by field staff: 60% of finance companies, 57% of banks and 43% of insurance companies engage them in the process of product delivery. One bank, one finance company and two insurance companies use links with other institutions to deliver their products.

The most popular marketing instruments used by both banks (86%) and finance companies (60%) are leaflets, banners and posters, and door step marketing. 71% of insurance companies prefer advertisement in the media (radio, newspapers, magazines), instruments used by an equal number of banks as well. Other instruments employed by banks include joint programmes with other institutions and cross-selling with other bank products (each 57%). Only one bank relies on existing customers to promote their products. For finance companies media advertising also plays an important role, but to a lesser extent than for the other two groups of institutions and with a preference for TV and radio advertising (40%). Print media, along with joint programmes with other institutions, cross selling with other products and existing customers play only a marginal role (one respondent). 57% of insurance companies choose advertisements on TV, leaflets, banners and posters, and door step marketing to promote their products. 43% of the respondents in this category use joint programmes with other institutions and cross selling with other products (more than other two categories). As a conclusion it can be mentioned that respondents generally refer to the marketing strategies of their overall business. It is not clear whether all the above mentioned methods are utilised to promote microfinance products. In fact, the instruments cited are too costly to be employed for microfinance activities. But it can be assumed that the microfinance business can only benefit from a positive image of the company, even if no direct marketing of microfinance products is done. Another possible explanation is that companies promote their microfinance activities as a means of showing corporate social responsibility, microfinance being thus used to promote the image of a company interested in the disadvantaged.

Product development

New product development in the case of the institutions interviewed is mostly performed at central level with inputs from all branches (all insurance companies, 86% of banks and 60% of finance companies). In the case of one bank this is done at individual bank level by an internal team, for a finance company at branch level by the manager. A respondent from a finance company without branches has stated that new product development is done at board level.

The majority of the respondents (80% of leasing companies and 71% of banks and of insurance companies) plan to introduce new products. 80% of the banks planning to introduce new products consider new savings products, while 60% of them loan products, leasing and money transfer services. 75% of finance companies plan to introduce loan products and 50% of them other leasing products. In the case of insurance companies no product was mentioned by more than one respondent, therefore we can conclude that there is a large heterogeneity within this group with regard to product development. Among the products mentioned the following were included: pension products, life insurance, and funeral aid insurance.

During the last two years, six of the seven banks in the sample have introduced between two and 12 microfinance products. The average for this group of institutions is 5.7 products per institution. Finance companies have introduced an average of 2 microfinance products per institution; three of the five respondents have introduced between two and five new products. Six of the seven insurance companies have introduced between one and 10 new microfinance products, an average of 2.6 products per institution. During the same time, a few microfinance products have been withdrawn from the market: two banks have withdrawn three and four products, respectively, and two finance companies have each withdrawn one product. This is an indication that this group of institutions monitors product performance and withdraws unsuccessful products.

The three groups of institutions covered in this chapter have different approaches based on which product development is determined: banks rely mostly on field officer and staff experience (71%) and on formal market surveys (57%), while only few (29%) resort to discussions with customers or look at the products offered by competitors. This last finding is surprising since in practice, products across institutions have a high degree of similarity, which suggests that there might be less innovative behaviour in the market than one could assume from the results of the survey. Finance companies rely heavily on discussions with customers (80%) and on formal market surveys (40%), while only a minority (20%) rely on field officer and staff experience. Insurance companies give more weight to formal market and needs surveys (71%), while only few (29%) rely on staff experience.

6.5 Human Resources

The banks in the sample employ a total of 28,140 staff, but large discrepancies could be observed between the individual respondents. Therefore total staff numbers range from 150 to 10,100 staff. In fact the two largest banks (Bank of Ceylon and People's Bank) alone employ 71% of the total staff mentioned above. As for the staff involved in microfinance activities, the survey has revealed a total number of 1,433 staff for this category of respondents. The staff involved in microfinance in each institution ranges from 14 to 360. On average, a respondent in the sample has 205 staff involved in microfinance activities. If the number of staff involved in microfinance activities is related to the number of branches offering microfinance products, an average of 1.7 staff per branch is obtained. Six of the seven respondents have mentioned that their microfinance staff is involved in other activities as well. Only HNB had staff involved exclusively in microfinance related activities. Of the microfinance staff, 96% had permanent contracts, while 4% were employed for a determined period of time. As for the levels of microfinance staff, 29% have managerial responsibilities, 33% are credit or field officers, 26% performs clerical duties and 11% are support staff.

The five finance companies in the sample have a total of 2,478 staff, ranging from 15 to 1,413 staff. Each institution employs on average 496 staff, but if The Finance Company, the largest employer in the sample is excluded, the average drops to just 266 staff per institution. But only 19% of this number i.e. 460 staff, are involved in microfinance activities. On average, each institution has 92 microfinance staff. Each branch has on average 5.2 microfinance staff. In two of the institutions the microfinance staff is exclusively involved in microfinance activities, while in the remaining three microfinance staff is involved in other activities as well. Of the microfinance staff, 98% had a permanent contract, while 2% of the staff was represented by time bound and casual staff. 18% of the microfinance staff had managerial responsibilities, 42% were credit or field officers, while 29% was represented by clerical and 10% support staff.

The seven insurance companies in the sample employ 8,555 staff, an average of 1,222 staff per institution. But there are significant disparities. The total staff ranges from 100 to 3,500. The two largest institutions in the sample account in fact for 70% of the total staff. As for the staff involved in microfinance activities, two respondents (Janashakthi and Union Assurance) could not provide an estimate. Therefore, the five respondents who have provided the information have reported a total of 5,001 microfinance staff. The number of staff involved in microfinance ranges from 1 (Hayleys AIG) to 3,500 (Ceylinco Insurance). In this case the heterogeneity of the group is accentuated by a diverging understanding of microfinance. The average number of microfinance staff per branch offering microfinance products is rather high at 15.2. But this is also distorted by the assumption that all Ceylinco Insurance staff is partly involved in microfinance activities. All of the microfinance staff of insurance companies are involved in other activities as well. The five respondents who were willing to share information reported that permanent staff represented 79% of their microfinance staff, while the remaining 21% were time bound employees. Regarding the type of positions held by microfinance staff, six respondents who have provided information (Janashakthi Insurance refused to answer) presented the following situation: 28% of the staff held managerial positions, 42% were credit and field officers, 24% clerical and 7% support staff.

To summarise, the three subgroups employed a total of 39,173 staff, out of which 6,894 staff are said to be involved in microfinance. The microfinance staff total is clearly distorted by the figures of the insurance sub section, which accounts for 72% of the total. This may seem surprising, especially against the backdrop that insurance companies are among the last to have entered the microfinance sector. But in this fact may also reside a possible explanation of this situation – an organisational development of the microinsurance within established players has not yet taken place, therefore a large number of staff seems to be involved in providing a rather limited number of policies. Overall, around 18% of the total staff is involved in microfinance. Considering the fact that the respondents estimated that on average 28% of their revenues came from their microfinance activities (see section 8.1), the staff involved in microfinance seems to be quite efficiently employed. But since both figures, the percentage of microfinance activities in terms of revenue and the staff involved in microfinance, are likely to be based on estimates and subject to under- or overestimation, this conclusion needs to be supported through further analysis.

Table 6-6 Minimum qualification requirements for microfinance staff of Banks & OFIs

		Managerial	Credit/Field Officer	Clerical
Banks	Qualification	Graduate (71%), Diploma (29%)	A/L passed (57%), O/L passed (29%), Diploma (14%)	O/L passed (43%), A/L passed (29%), below O/L (14%), not applicable (14%)
	Experience	Yes (86%) / No (14%)	Yes (0%) / No (100%)	Yes (43%) / No (43%) / Not applicable (14%)
Finance Companies	Qualification	A/L passed (40%), Graduate (20%), Diploma (20%), Professional Qualification (20%)	A/L passed (60%), O/L passed (40%)	A/L passed (60%), O/L passed (40%)
	Experience	Yes (100%) / No (0%)	Yes (40%) / No (60%)	Yes (60%) / No (40%)
Insurance Companies	Qualification	Professional Qualification (43%), Graduate (29%), Diploma (14%), A/L passed (14%)	A/L passed (43%), O/L passed (29%), Professional Qualification (14%), Not applicable (14%)	O/L passed (43%), Professional Qualification (29%), A/L passed (14%), Not applicable (14%)
	Experience	Yes (71%) / No (29%)	Yes (43%) / No (43%) / Not applicable (14%)	Yes (57%) / No (29%) / Not applicable (14%)

We can observe that there are considerable differences across the three groups of institutions presented in this chapter, but also within each group. All institutions have stricter minimum qualifications for managerial staff. Between the clerical and field or credit officers, the minimum qualifications are slightly stricter for the first, while experience is required in most cases for the second. Banks seem to have slightly stricter conditions than finance and insurance companies, at least for managerial and clerical staff. Banks require at least a diploma for their managerial staff, compared to finance and insurance companies, which accept A/L as minimum qualification as well. But at the same time, one bank accepts credit or field officers with a qualification below O/L, while all other institutions require at least an O/L as a minimum qualification. For managerial positions, experience is in most cases required. To a lesser extent this is also the case for credit or field officers, a compensation for the not so stringent qualification requirements compared to clerical staff.

Recruitment challenges

In the case of six of the seven banks, the lack of skilled people (ranging from 29% to 43%, depending on the staff category), the lack of people with microfinance experience (29% for all staff groups), unattractive locations (14%) and poor working conditions (14%) have been identified as recruitment challenges. In addition to this, for managerial staff the lack of a pension scheme has been identified by one respondent as an impediment to attracting competent staff. One respondent has reported no difficulties in recruiting suitable staff.

Two finance companies have mentioned they do not have any recruitment issues for clerical, and credit and field officers, while three respondents have stated the same for managerial staff. Of the remaining respondents, each of the following was mentioned by one respondent: the lack of skilled people and of people with microfinance experience, poor working conditions, lack of people in the desired age category and remuneration issues. For clerical staff two of the respondents have identified poor working conditions as an issue, while for credit and field officers another two respondents have mentioned the lack of skilled people as a difficulty in the process of recruitment.

The recruitment challenge mentioned most often by insurance companies was the lack of skilled people (57% for managerial staff and 71% for clerical staff and credit or field officers), followed by finding people in the desired age category (29% to 57% depending on the staff category). In addition to this, for managerial staff the lack of people with microinsurance experience and the fact that microinsurance is not considered an attractive career option compared to traditional insurance were each mentioned by two respondents.

It seems that the recruitment difficulties are related to the minimum recruitment requirements and the prevailing labour market conditions, such as the lack of skilled, experienced people. Another issue is that since microfinance and microinsurance are relatively new business directions, the sector seems to suffer from the lack of an experienced pool of workforce with specific know-how and the career reputation enjoyed by the traditional business of the respondents. It has to be noted that remuneration generally does not seem to be an issue for recruitment in this group of institutions.

Staff retention

In the group of banks, three respondents have identified inadequate remuneration as a retention issue, two respondents have mentioned inadequate incentives, while each of the following have been mentioned by one respondent: difficulty of team work and of field operations, microfinance is not an attractive career option, and the lack of required skills.

Three of the five finance companies have no staff retention issues, two of the respondents have mentioned inadequate remuneration and the lack of operational flexibility as impediments to retaining competent staff, while remuneration, work overload, and difficulty of team work and field operations were each identified by one respondent.

Following staff retention issues were identified each by three insurance companies: inadequate remuneration, inadequate incentives, work overload and difficult nature of field operations. In addition to this, two respondents considered that the fact that microinsurance is not considered an attractive career option is an impediment to retaining competent staff.

The inadequacy of remuneration as a staff retention issue is unexpected, especially since it was hardly mentioned to be a recruitment issue.

Incentives

All banks offer training opportunities as incentives for their staff. Other incentives mentioned by banks include: performance appraisals and rewards (six banks), overtime pay and staff loans at concessionary rates (five respondents), remunerative and moral incentives, reimbursement of medical expenses (four banks).

All finance companies offer remunerative incentives and performance appraisals and rewards. Other incentives offered by finance companies include: staff training, reimbursement of medical expenses, and staff loans at concessionary rates (four respondents), workman compensation in case of sickness or accident (three finance companies).

Six of the seven insurance companies in the sample offer remunerative incentives and performance appraisals and rewards for their staff. Overtime pay is mentioned as an incentive by four insurance companies. It is important to notice that training doesn't seem to be an important incentive for this group of institutions.

Staff training

Staff of the institutions covered in this chapter undergo a broad training programme. While this is true for all categories of staff, it is especially so for the managerial staff. For managers of banks and finance companies training in the field of marketing was the most cited course. For insurance companies this was client servicing and customer care. It is interesting to notice that courses like business planning, risk management and project management are less popular among managers compared to the above mentioned courses. HR development training courses for managers were mentioned by 57% of banks, 75% of finance companies and by only 40% of insurance companies.

In the case of clerical staff in banks, courses like customer care and language skills development come before more specific courses like record keeping and accounting skills development. Finance companies seem to have a more targeted approach for their clerical staff: the most offered courses are IT and accounting skills development, followed by record keeping, customer care and language skills development. Most insurance companies offer clerical staff record keeping and customer care courses, followed by IT, language and accounting skills development.

Credit and field officers receive an extensive, broad training in banks and a more focused, specialised training in finance and insurance companies. Top courses for credit and field officers in banks are: customer care, marketing and language skills development training, courses like credit evaluation, risk management and profitability monitoring being cited by less than half of the respondents. A large number of finance companies offer customer care courses, followed by group mobilisation, marketing and IT skills development. In the group of insurance companies the agreement on courses offered is even less: only customer care is offered by more than half of the respondents. Record keeping, as well as IT and language courses are offered each by only two respondents.

On average, bank managers receive the highest number of training courses: 33.1 courses per institution are organised yearly, followed by clerical staff with 11 courses per institution, and credit and field officers with an average of 9.4 courses yearly. The differences between the number of training sessions are less important for finance companies: managers receive on average 8.25 training sessions per year, clerical staff 7.25 and credit and field officers 6.75. The situation is reversed for insurance companies: here field staff receives the most training sessions: 9.2 per year, clerical staff 5.2 per year and managerial 4.4 sessions a year.

6.6 Financial Performance

Microfinance specific financial statements could not be obtained.

Part II

The Consolidated Sector

1. Microfinance–an overview of the concept among Sri Lankan microfinance providers

Although microfinance has received wide attention in the last decades, it lacks an operational definition that is universally accepted (Khawari, 2004). While it is generally acknowledged that microfinance is about offering financial services to low-income clients, the understanding among researchers and practitioners diverges when it comes to a clearer articulation of the range of services, the target group and the goals to be attained. As Sriram and Upadhyayula (2002) comment: "It appears that what microfinance means is very well understood, but not clearly articulated."

A problem encountered during the survey was the screening and identification of microfinance providers in the absence of a clearly articulated definition of microfinance. This was especially difficult due to the positive image this sector has received in the last decade, which makes traditional financial service providers keen to be associated with this development driven financial tool. Without an operational definition of microfinance generally accepted and implemented by all practitioners, for the present survey it was decided to allow respondents to provide their own definitions of microfinance.

The condition imposed for an activity to be defined as "microfinance", namely to be aimed at lower income groups and micro and small enterprises, was considered too vague. In order to have information on the individual definitions of practitioners, the respondents were asked to define microfinance and microcredit and to provide the income threshold they consider to define a low income household, as well as the number of employees and average annual earnings which define micro and small enterprises.

To further refine the selection of institutions participating in the survey a condition was imposed to ensure the commitment of the respondents to microfinance. This was done by setting a threshold of a minimum of 500 microfinance clients. While this was an efficient filter for NGOs and sorted out of the sample providers with marginal microfinance operations, it didn't work so well for banks and other formal financial institutions. In the absence of specific client information, a considerable number of respondents from this group showed a tendency to equate small size of services accessed (especially with regard to savings and pawning) with low income of the respondents.

The following elements of a microfinance definition could generally be identified in the definitions provided by the respondents:

- Range of financial services. Although microcredit is an important component, the microfinance concept includes a broader range of financial services such as savings, pawning, leasing, and insurance and pension products. Payment services and money transfer services do not seem to be part of the financial package offered to microfinance clients in Sri Lanka. An overview of what type of services the respondents belonging to the different types of institutions include in the definition of microfinance is provided in the table below:

Table 7-1 Range of services included in the microfinance definition

Type of institution	Range of services included
SANASA TCCSs	Loans (67% of the responses); savings (13%)
CRBs	Loans (92% of the respondents); deposits and savings (31%); financial services (17%)
SBSs	Not mentioned
NGOs	Loans (59% of the responses); non-financial services (28%); financial services (15%)
RDBs	Loans (33% of the respondents); financial services (67%)
Banks & OFIs	Banks: Loans (14%); financial services (86%); Finance companies: Loans (20%); financial services (80%)

Note The interview regarding the activities of the Samurdhi Banking Societies was conducted at Samurdhi Authority level and therefore all responses provided herein with regard to the SBSs reflect the views of one respondent (a senior manager of the programme).

An analysis of the responses provided shows that microfinance is largely associated with microcredit, despite the fact that savings mobilisation plays an important role in the Sri Lankan microfinance sector compared to other countries in the region (World Bank, 2006). A large number of respondents has mentioned only loans when asked to define microfinance, especially among cooperatives (TCCSs and CRBs) and NGOs. While NGOs are legally not allowed to take deposits, both SANASA TCCSs and CRBs mobilise large volumes of savings from the lower income population. A possible explanation for this could be that generally microcredit is considered to be the financial service with a strong development component, as access to loans is generally more difficult for the target group than access to savings or pawning, due to the risks for the provider associated with this microfinance product. Respondents from more formal institutions such as RDBs and banks and finance companies seem to have a broader understanding of the concept. On the other hand, definitions provided by respondents from the NGO sector have identified associated non-financial services among the range of services and included in the microfinance concept.

- Target group. When defining the target group of microfinance services, following characteristics were generally considered: gender, income level, economic activity and type of employment.

Table 7-2 Target groups included in the microfinance definition

Type of institution	Target groups included
SANASA TCCSs	Low-income groups (36%); small enterprises (32%)
CRBs	Low-income groups (39%); small enterprises (32%); rural population / farmers (17%)
SBSs	Low-income groups
NGOs	Low-income groups (59%); small enterprises (18%); rural population / farmers (13%); women (6%)
RDBs	Small enterprises (50%)
Banks & OFIs	Low income groups (47%); small enterprises (32%); rural population / farmers (26%)

To further specify the understanding of the target group among respondents we have asked them to define a threshold for a low-income household, as well as the number of employees of a micro and small enterprise. The results are summarised in the table below:

Table 7-3 Income and employee threshold for microfinance definition

Type of institution	Average income of a low-income HH* (Rs./month)	Average number of employees in a microenterprise	Average number of employees in a small enterprise
SANASA TCCSs	3,042	3	7
CRBs	3,362	2	7
SBSs	1,500	n/a	n/a
NGOs	4,149	3	9
RDBs	4,417	2	8
Banks & OFIs	8,438	6	25

n/a not available

Note *Although the respondents were explicitly asked to refer to household income, in view of the low figures cited it is likely that some of them provided information regarding individual income.

Analysis of the table above allows us to observe the important heterogeneity in understanding of the microfinance concept. The difference between traditional MFIs such as co-operatives and NGOs and the formal institutions such as banks is striking: the income threshold doubles, as well as the average number of employees of a microenterprise, while the average number of employees in a small enterprise is on average three times higher for banks and other financial institutions compared to the rest of the institutional types. This suggests that the formal financial institutions have a broader understanding of the concept and address their products to a wider target group, perhaps concentrating more on the higher end of the low-income group and micro/small enterprises.

- Purpose of financial intermediation. Some of the respondents mentioned a development goal in their definition as can be observed in the table below:

Table 7-4 Development goals in the microfinance definition

Type of institution	Percentage of respondents who mentioned a development goal in their microfinance definition
SANASA TCCSs	61%
CRBs	15%
SBSs	Yes (single respondent)
NGOs	61%
RDBs	50%
Banks & OFIs	5%

Among the development goals mentioned by the respondents the following were specified: empowering the target group, improving their standards of living or, more generally, contributing to economic development. Although this element of the microfinance definition is a very subjective one as it deals with the declared intentions of the institution, which are hard to measure against a benchmark in terms of results, it is interesting to observe the large differences in the percentage of respondents from each group of institutions who have mentioned it in their microfinance definitions. While almost two thirds of the respondents from the SANASA TCCSs and from NGO MFIs view microfinance as a development tool, the same is true for only 5% of the respondents from banks and other formal financial institutions.

- Size of service. A characteristic feature of microfinance is the comparatively small volume of services offered. This element was mentioned by some of the respondents from each institutional group:

Table 7-5 Size of microfinance services

Type of institution	Percentage of respondents who mentioned small volumes in their microfinance definition	Percentage of respondents who mentioned small volumes in their microcredit definition
SANASA TCCSs	14%	18%
CRBs	15%	32%
SBSs	Not mentioned	Yes
NGOs	10%	41%
RDBs	17%	33%
Banks & OFIs	11%	37%

It can be easily observed that the small size of services was more often mentioned in the definition of microcredit than in the broader definition of microfinance within each group of institutions. Around a third of the respondents have defined microcredit as a small scale loan.

We can conclude that the microfinance perception among practitioners in Sri Lanka varies considerably. This should be born in mind by the reader of the present report. Difficulties and issues arising from this situation are emphasised throughout the report.

2. Governance issues in the microfinance sector

The rapid development of microfinance in the last decades, characterised by increasing value of assets and extensive outreach raises significant regulation, ownership and governance issues. A sustainable development of the microfinance sector and its inclusion in the financial system depend on the efforts to adopt best practices and to ensure a regulatory environment conducive to growth.

Regulation and supervision

The role of regulation and supervision is to ensure an efficient capital accumulation and resource allocation, while at the same time protecting the soundness of the financial system and the interests of depositors. An overview of the current financial regulation and supervision regimes governing microfinance providers in Sri Lanka is presented in the following table:

Table 7-6 Regulation and supervision of microfinance institutions

Type of institution	Regulatory Authority	Supervisory Authority	Legislation
SANASA TCCSs	Department of Co-operative Development	Department of Co-operative Development	Cooperative Societies Act No. 5 (1972) and subsequent amendments
CRBs	Department of Co-operative Development	Department of Co-operative Development	Cooperative Societies Act No. 5 (1972) and subsequent amendments
SBSs	Samurdhi Authority (self-regulation)	Samurdhi Authority (self-supervision)	Samurdhi Authority Act No. 30 of 1995
NGOs	-	-	no microfinance specific legislation
RDBs	Central Bank of Sri Lanka	Central Bank of Sri Lanka	Regional Development Banks Act No. 6 of 1997
Banks & OFIs	Banks & Finance companies: Central Bank of Sri Lanka Insurance companies: Insurance Board of Sri Lanka	Banks & Finance companies: Central Bank of Sri Lanka Insurance companies: Insurance Board of Sri Lanka	Banking Act No. 30 of 1988 and subsequent amendments Finance Companies Act No. 78 of 1988 and subsequent amendements Finance Leasing Act No. 56 of 2000 Insurance Industry Act No. 43 of 2000

A number of issues can be identified regarding the regulatory and supervisory framework:

- A considerable group of microfinance providers (NGOs) escapes financial regulation and supervision. Since most NGOs which are engaged in microfinance mobilise savings either directly as deposits or disguised as member shares, there is a need for them to be monitored by an external independent authority, in order to protect the interests of depositors. While it is true that the supervision of a large number of small institutions is characterised by greater costs than benefits, there is no justification to exclude large NGOs from the regulatory and supervisory framework. An attempt to remedy this issue was made through the Microfinance Institutions Act drafted by the Central Bank of Sri Lanka, which is currently withheld for restructuring. At the time of writing this report, neither the final form of regulation and supervision proposed for microfinance institutions, nor the date when it will be presented to the Parliament, are known.

- The government microfinance scheme (Samurdhi) is self-regulated and self-supervised. In the absence of an independent regulator and supervisor the scheme risks being used to pursue political objectives to the detriment of long term sustainability and sound financial development.

- Dispersion of regulatory and supervisory responsibilities for the microfinance sector. Different authorities are responsible for the regulation and supervision of different groups of microfinance providers. Considering that all these groups offer similar products targeted at the same market, the lack of coordination and coherence of measures can result in considerable distortions of the competition.

- Low quality of supervision. International best practices regarding regulation and supervision are not adhered to in the case of the cooperative sector.[22] Although efforts have been made to introduce international monitoring standards to the sector , the results remain modest.

- Lack of microfinance specific regulation and supervision. The existing regulatory and supervisory framework has been created with a broader view of financial services and is not adapted to microfinance specificities. For example, RDBs, although involved to a great extent in microfinance, are regulated and supervised similarly to commercial banks. Considering the fact that, for example, microfinance portfolio management differs significantly from that performed by banks, prudential requirements should be different as well. Extending current legislation to encompass microfinance providers is not an option, since institutional structures of microfinance service providers are different from those of traditional providers of financial services (banks, finance companies etc.)

The need of a coherent regulatory and supervisory framework adapted to the necessities of the microfinance sector seems vital. A conducive environment, characterised by uniform standards, would support a sound growth of the microfinance sector.

Another worrying issue which has emerged from the survey is the lack of knowledge among respondents regarding whether or not they are regulated and supervised, and who the responsible authorities are. Considering the fact that the interviews were conducted at senior and middle management levels, this is a puzzling finding. The table below offers an overview of the perception of the respondents.

22 The Department of Co-operative Development introduced COOP-RUPEES, an instrument to rate CRBs and SANASA primary societies. A mix of financial and non-financial indicators (C-Compliance; O – Organisation; O – Operations & Management; P – Plans, Programmes & Performance; R – Risk Management; U – Utilisation and Sources of Capital; P – Provisions for Liquidity; E – Efficiency of Operations; E – Equity & Stability; S – Signs of Growth) are used to score each institution. However, with the exception of some SANASA TCCSs, this standard is not widely used.

Table 7-7 Perceived regulatory / supervisory authority

Type of institution	Regulation		Supervision	
	Yes	Authority	Yes	Authority
SANASA TCCSs	75%	Department of Cooperative Development (62%)	-	Department of Cooperative Development (86%)
CRBs	77%	Director Board (44%); Department of Cooperative Development (41%)	96%	Department of Cooperative Development (84%);
SBSs*	Yes	Samurdhi Authority	Yes	Samurdhi Authority
NGOs	23%	Registrar of Companies (26%); NGO Secretariat (21%)	72%	Auditor General Office (20%); Funding agencies (18%)
RDBs	83%	CBSL (60%); Government (20%); Ministry of Finance (20%)	100%	CBSL (100%)
Banks & OFIs	95%	Banks & FCs: CBSL (92%); Government (8%) Insurance Companies (ICs): IBSL (100%)	95%	Banks & FCs: CBSL (92%); Audit and Rating Agencies (8%) ICs: IBSL (83%); CBSL (17%)

From the answers provided it is clear that not all respondents have a clear understanding of what regulation and supervision involve. Regulatory and supervisory authorities might consider improving their communication with regulated and supervised entities in order to correct these deficiencies. On the other hand, managers of microfinance institutions need to be aware of the legal environment in which they operate in order to better exploit business opportunities and develop institutions viable in the long term.

Audit

The audit of microfinance activities is crucial for ensuring long term sustainability of operations and building institutional confidence. Both internal and external audit are generally performed by most large and medium sized microfinance providers. An overview of the percentage of respondents having their accounts audited internally, externally or both, as well as the responsible external auditors is presented in the table below:

Table 7-8 Audit of microfinance institutions

Type of institution	Internal audit only	External audit only	Both	External auditors
SANASA TCCSs	18% of secondary unions and 11% of primary societies	18% of secondary unions and 25% of primary societies	61% of secondary unions and 64% of primary societies	Department of Co-operative Development
SBSs	-	Yes	From Maha Sangam level upward; SBSs not directly audited internally	Auditor General's Department for Samurdhi Authority; accountants of the Divisional Secretariat offices for SBSs
CRBs	29%	9%	62%	Department of Co-operative Development
NGOs	1%	20%	77%	-
RDBs	-	-	100%	CBSL approved auditors
Banks & OFIs	-	Finance companies: 40%	Banks: 100% Finance companies: 60% Insurance companies: 100%	CBSL approved auditors

A first observation is that although CRBs and SANASA TCCSs are required to be audited by the Department of Co-operative Development, a significant number of them (29% of CRBs, 18% of secondary unions and 11% of primary societies) are reported to be audited only internally. SBSs, which are required to be audited by the accountants of Divisional Secretariat offices, also lack a meaningful external audit. Even when audit is performed in the case of these institutions, resource constraints have a bearing on its quality and on its timely release. Furthermore, most auditors lack microfinance specific knowledge, which has an impact on the quality of the analysis.

A high percentage of NGOs are audited both externally and internally, while a further significant share is subjected to external audit only. This has to be positively acknowledged since most of the NGOs are not legally required to do so. According to the survey, only 24% of NGOs are registered under the Companies Act, being thus required by law to be audited annually. The fact that such a large number of NGOs are audited externally can be attributed to the influence of donors, which often link their support to the availability of meaningful audited information and offer funding to support the costs thus incurred.

Decision making process

The organisational structure of a microfinance institution impacts its efficiency and its potential to reach its objectives. An overview of the decision making process within each institutional group can provide useful insights.

Respondents were asked at which level decisions on the overall operating policies of the institution are taken. An overview of the answers is provided in the table below.

Table 7-9 Decision making in microfinance institutions

Type of institution	Board of Directors	Management
SANASA TCCSs	n/a	n/a
CRBs	95%	4%
SBSs	BoD of Samurdhi Authority	-
NGOs	67%	29%
RDBs	83%	17%
Banks & OFIs	63%	21%

The majority of institutions seem to entrust the Board of Directors with these types of decision. The highest centralisation is found in the case of SBSs, where all operating policy decisions are taken at the Board of Directors level of the Samurdhi Authority. The respondents were further asked at which level strategic decisions are taken regarding specific matters such as products, interest rates, human resources and target group. The results are briefly commented in the following table:

Table 7-10 Characteristics of the decision making process

Type of institution	Characteristics of the decision making process
SANASA TCCSs	Participatory decision process – group decision involving management, board members, staff and affiliated institutions (over ¾ of the respondents); a minority strictly follows the guidelines of the National Federation and does not make use of their right of self determination.
CRBs	Participatory decision process – group decision involving management, board members, staff and affiliated institutions (around 90% of the respondents).
SBSs	Highly centralized process; political decision - responsible Ministry is involved in setting interest rates, HR policies, target group definition.

Table 7-10 continued on next page

Type of institution	Characteristics of the decision making process
NGOs	Centralised decision making process (head office or parent organisation level, board members involved); however, most MFIs in this group are small size institutions, almost half of them having no branches at all.
RDBs	Centralised decision making process (senior management at head office level).
Banks & OFIs	Strategic decisions taken centrally but at management level.

3. Clients

A considerable problem encountered in the process of collecting and analysing the survey data was due to the fact that most MFIs do not gather information regarding their clients. Therefore the following section mainly draws on estimates provided by the respondents and less on statistical information collected at MFI level.

Outreach

The overall outreach of the microfinance sector in Sri Lanka is difficult to estimate with a high degree of accuracy. During the survey following difficulties were encountered:

- The majority of microfinance providers (CRBs, commercial banks) do not collect client information, only account data. For some of the large players in the sector (CRBs, People's Bank) not even an estimate could be provided.
- Some of the respondents do not collect separate information on their microfinance business.
- Some microfinance providers maintain client information only for loans, the outreach of other microfinance products (savings, pawning) is mostly estimated.
- Member based MFIs keep evidence of their members, some of which are no longer active clients.
- Different understandings of the microfinance concept influence the estimation of the client base by the respondents. The respondents adhering to a broader definition of microfinance will tend to overestimate the number of microfinance clients.

The following table provides an overview of the information provided by the respondents based on which the client base of microfinance has been estimated. The first column is based on the estimation of the client base provided by the respondents. The second column presents the total number of accounts provided by the respondents for all products offered, while the last column focuses on the number of loan accounts only.

Table 7-11 Client base and number of accounts

Type of institution	Client base / members	Total number of accounts	Total number of loan accounts
SANASA TCCSs	860,611 registered members; overestimated, since a large proportion of PTCCSs are inactive	251,355 (savings and deposits, loans and pawning) – data available for a limited number of outlets, therefore not representative	214,803 – account information provided by the Federation for 4,500 PTCCSs*
CRBs	Not available	13,885,211 (savings and deposits, loans and pawning) – account information for CRBs of between 190 and194 MPCSs	2,783,000 – account information for CRBs of 188 MPCSs
SBSs	2,300,000 members + 227,000 non-member clients	8,951,950 (voluntary & compulsory savings, shares and loans)	656,330

Table 7-11 continued on next page

Type of institution	Client base / members	Total number of accounts	Total number of loan accounts
NGOs	956,000	1,705,046	375,156
RDBs	1,850,000	2,876,043	311,204
Banks & OFIs	Banks: 706,600 (excluding microfinance clients of People's Bank); Finance companies: 85,583; Insurance companies: 142,550 Total: 934,733	Banks: 6,991,003 (savings and deposits, loans, pawning, leasing, pension products and insurance) Finance Companies: 105,540 (leasing, loans, savings and deposits, hire purchase and pawning) Insurance companies: 100,279 policies Total: 7,196,822	Banks: 225,147 Finance companies: 10,486 Total: 235,633
Total	7,128,344	34,866,427	4,576,126

Note: *Account information could not be obtained for all outlets directly from the respondents. A total number of 112,460 accounts were reported for 1,100 outlets.

If the number of loan accounts of CRBs is excluded (since client information for this group was not available) the proportion of loan accounts to the total number of clients is extremely low (one loan to every fourth client). The causes behind this situation remain largely unknown and a subject for further research. Possible explanations for this situation could be a shortage of funding in the case of certain institutions (such as NGOs) coupled with the investment of the savings received by large deposit takers (such as CRBs, SBSs) in activities other than lending. Some respondents have also mentioned the low absorption capacity of the target group for such loans. Despite microcredit being essentially a non-collateralized lending business, the survey found that many providers of microcredit do impose collateral and other conditions which can have a restrictive effect on the utilisation of the credit facilities on offer.

Despite the shortcomings mentioned above and the consequent impossibility of clearly estimating the overall outreach of microfinance services in Sri Lanka, its breadth seems to be considerable. Member based MFIs seem to have the broadest outreach, with CRBs, SBSs and TCCSs reaching a large number of clients.

Target group

One of the defining elements of microfinance is the target group whose needs are addressed. The table that follows offers an overview of the percentage of institutions in each group which have set themselves a target group, as well as the particular groups on which they focus.

Table 7-12 Target group for microfinance

Type of institution	Yes	Of those who focus on target groups				
		Low-income	Women	Entrepreneurs	Farmers	Other
SANASA TCCSs	71%	70%	90%	65%	80%	Youth: 65%
CRBs	63%	77%	75%	62%	71%	Youth: 54%
SBSs	All SBSs (target group set at central level)	Households with < Rs. 1,500 monthly income	-	-	-	-
NGOs	93%	71%	78%	40%	47%	Disabled: 29%
RDBs	83%	100%	80%	80%	80%	Youth: 80%

Table 7-12 continued on next page

Type of institution	Yes	Of those who focus on target groups				
		Low-income	Women	Entrepreneurs	Farmers	Other
Banks & OFIs	Banks: 71% Finance Companies (FC): 80%; Insurance Companies (IC): 29%	Banks: 60%; FC: 50%; IC: 50%	Banks: 40% FC: 50%; IC: 50%	Banks: 100%; FC: 50%; IC: 50%	Banks: 80%; IC: 50%	Banks: Youth: 40%; Disabled: 40%;

Among the different types of microfinance providers, NGO MFIs seem to be the group with the most focused approach, with 93% of them having specific target groups. Considering their social mission and their stronger focus on development, this is not surprising. At the other end of the spectrum, insurance companies seem to be the group with the weakest target group orientation. Only 29% of the respondents from this group have stated they focus on specific customer groups.

RDBs and a large number of CRBs focus predominantly on lower-income households, banks on entrepreneurs, and SANASA TCCSs and NGOs on women.

Gender focus

Since the modern microfinance movement has been characterised by a special focus on women, respondents were asked to estimate the percentage of female customers in their overall microfinance clientele. As mentioned in the brief introduction to this section, the majority of respondents do not collect client level information; therefore the figures presented below are based on estimates.

Table 7-13 Gender composition of clients

Type of institution	Percentage of female customers
SANASA TCCSs	Over 75% - 11% of respondents; Between 50% and 75% - 64% of respondents; Under 25% - 4% of respondents.
CRBs	Over 50% - 51% of respondents; Between 25% and 50% - 38% of respondents; Under 25% - 9% of respondents.
SBSs	65%
NGOs	Over 75% - 73% of respondents; Between 50% and 75% - 22% of respondents; Between 25% and 50% - 4% of respondents; Under 25% - 1% of respondents.
RDBs	Over 75% - 17% of respondents; Between 50% and 75% - 50% of respondents; Between 25% and 50% - 33% of respondents.
Banks & OFIs	Banks: less than 50% - 71% of the respondents; Finance companies: less than 50% - all four respondents which provided information; Insurance companies: less than 50% - 80% of respondents which provided information.

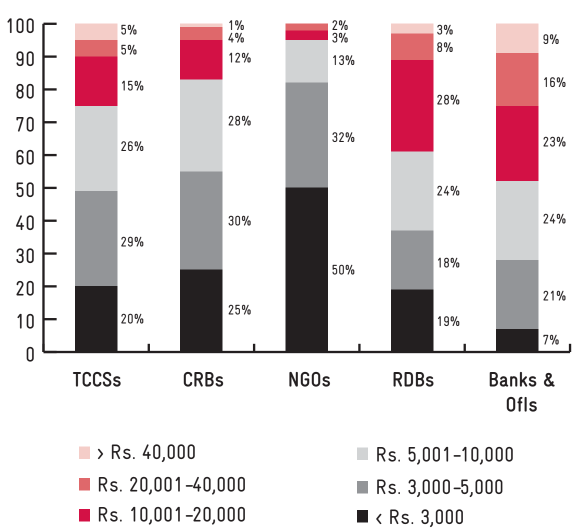
Among the groups of microfinance providers included in the survey, NGOs seem to have the largest share of female microfinance customers – only 5% of the respondents have stated their share of female customers is below 50%, while 73% of the respondents claim that more than three quarters of their customers are women. At the other end of the scale, formal financial institutions have the lowest shares of female customers – all finance companies which have provided information on the gender profile of their clients, 80% of insurance companies and 71% of banks have declared their microfinance customers to be mostly male.

Differences in income and activity profile of clients across institutions

An overview of the income and activity profile of microfinance clients was considered to bring interesting insight regarding the direction of supply of microfinance services in Sri Lanka. The results of the survey show considerable disparities between the different groups of institutions.

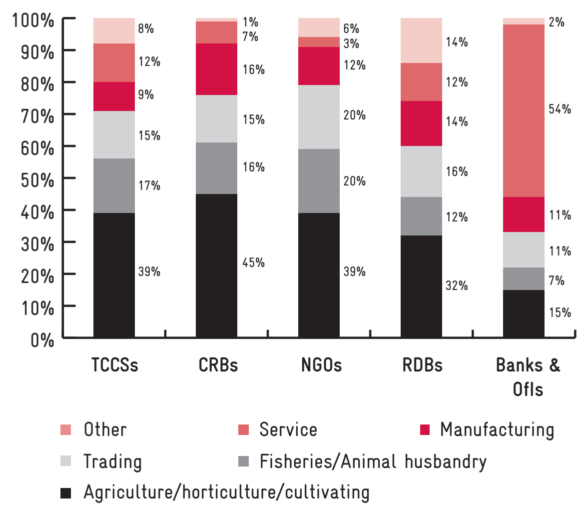
SBSs were not included in the analysis of this section. Statistical information regarding the profile of customers was not available at national level, the level at which the interview was conducted. Considering the distance to the grass-root level of the respondent and the conclusions of studies of international organisations (World Bank, 2003 and ILO, 2000), the official estimate that 85% SBS clients have a household income below Rs. 1,500 could present an over-statement. Similarly, the estimate that 15% of SBS clients are involved in agriculture, while the balance 85% are self employed in different fields of activity, is too vague to be compared to the estimates of other institutional groups.

Figure 7-1 – Income profile of clients



The group with the highest outreach among the poorest clients are NGO MFIs, half of their clients having, according to the estimates of the respondents, a monthly household income less than Rs. 3,000. Clients belonging to this group (< Rs. 3,000), constitute 25%, 20% and 19% of the clients of CRBs SANASA TCCSs and RDBs respectively. As expected, banks and other financial institutions involved in microfinance have the lowest outreach among the poorest layer of clients: only 7% of their clients have a monthly household income below Rs. 3,000. The same ranking in terms of outreach to the lowest income group is maintained even if the threshold income level is raised to Rs. 5,000.

Figure 7-2 Activity profile of clients

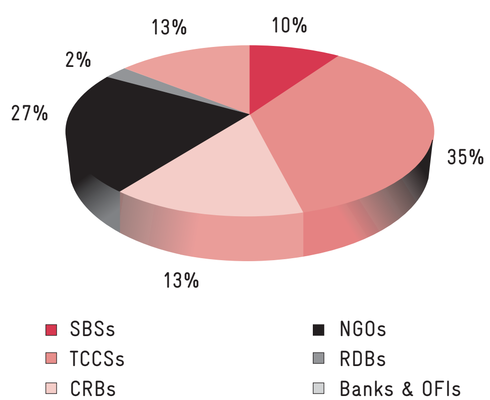


The discrepancies between the different groups of institutions are less marked in terms of the activity profile of their clients. With the exception of banks and other formal financial institutions, the clients of other institutional groups have a similar activity structure: the largest share is involved in agriculture (between 38% and 45%), followed by similar proportions of clients (12% to 20%) involved in other primary activities such as fisheries and animal husbandry. Between 9% and 20% of the clients of this group are engaged in manufacturing and trading. The highest heterogeneity is displayed by the proportion of clients involved in the service sector: here the share of the total client base varies from 3% in the case of NGOs and 54% in banks and other financial institutions.

4. Microfinance outlet network

Based on the information gathered in the survey, the regional and sectoral distribution of microfinance outlets was determined. The survey coverage in the conflict affected districts of the Northern Province was limited for most institutional groups and a threshold of 500 microfinance clients (100 microfinance clients in the Northern and Eastern provinces) was set in order to restrict the survey to those with significant microfinance operations. However, all efforts were been made to ensure an extensive coverage of all types of institutions, and there are good reasons to believe this objective was achieved. All RDBs and all SBSs were covered, together with 3,794 active SANASA societies, as well as a large number of CRBs (1,452). Figure 7-3 depicts the distribution of the 10,907 outlets covered by the survey according to the type of institution.

Figure 7-3 Number of outlets by type of institution

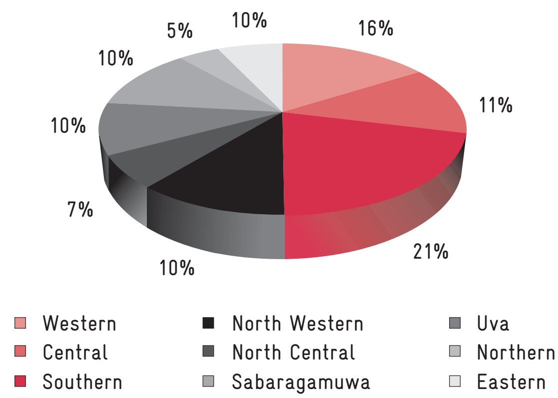


It is observed that in terms of number of outlets, SANASA TCCSs have the widest coverage (35% of total outlets), followed closely by NGOs (27%). Together these two groups of institutions hold almost two thirds of the total number of outlets. The group with the most modest outlet coverage is the group of RDBs. With 215 outlets they represent only 2% of the total number of outlets covered in this survey.

Regional coverage

Detailed information regarding the regional distribution of outlets is provided in Figure 7-4

Figure 7-4 Regional distribution of microfinance outlets



The Southern Province has by far the largest number of microfinance outlets (21%), followed by the Western Province (16%). At the other end of the spectrum, the Northern Province is the province with the lowest number of microfinance outlets (5% of the total), followed by the North Central Province (7%). In view of the conflict affecting the Northern Province, this is not a surprising finding. On the one hand, the ongoing instability in the area is a barrier to the development of microfinance institutions in the area, and on the other hand, even the few institutions still operating in districts such as Kilinochchi, Mullaitivu and Mannar could not be covered by the survey.

Sectoral coverage

The sectoral coverage of microfinance outlets is presented in the table and figure below. It should be mentioned that the sectoral breakdown of 965 TCCSs and 2,341 NGO outlets was not available; therefore the data in this section covers around 70% of the total sample.

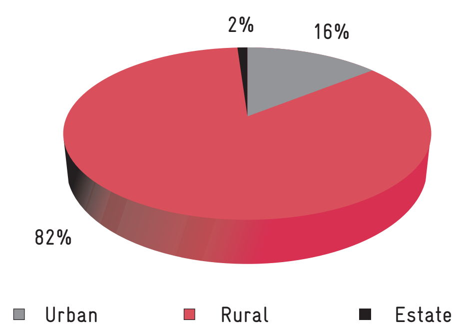
Table 7-14 Sectoral coverage of microfinance outlets

Sector	SANASA TCCSs*	CRBs	SBSs	NGOs**	RDBs	Banks & OFIs	Total
Urban	124	207	54	169	40	637	1,231
Rural	2,669	1,237	982	465	170	695	6,218
Estate	36	8	2	8	5	83	142
Total	2,829	1,452	1,038	642	215	1,415	7,591

Note * For Western, Southern and Uva Provinces, the total number of branches does not tally with the subtotals of urban, rural and estate branches, as the breakdown for the districts of Colombo (350 PTCCSs), Galle (255 PTCCSs) and Badulla (360 PTCCSs) was not provided by the respondents.

**The sectoral breakdown was not available for the 2,315 active societies and for 26 service centres of SEEDS.

Figure 7-5 Sectoral distribution of microfinance outlets



The rural sector has the largest coverage (82%), which is not surprising considering the fact that 80% of the total population live in rural areas. The estate sector is the least covered by microfinance institutions: only 2% of the outlets are located in this sector compared to 5.4% of the population living there.

Correlation outlets – poverty

Considering the development and poverty alleviation aspects of microfinance, it is of interest to analyse how well does the distribution of outlets correlates with that of the distribution of the population below the poverty line (PBPL). Since poverty figures were not available for the Northern Province and only some districts of the Eastern Province, the analysis of this section excludes these two provinces. The tables below summarise the regional and sectoral distribution of outlets versus the distribution of PBPL, as well as the correlation coefficients by group of microfinance providers.

Table 7-15

Province	Outlets (%)	PBPL* (%)
Western	19%	17%
Central	13%	17%
Southern	25%	17%
North Western	12%	15%
North Central	8%	6%
Uva	11%	11%
Sabaragamuwa	12%	16%
Total	100%	100%

Table 7-16

Province	Outlets (%)	PBPL* (%)
Urban	16%	7%
Rural	82%	82%
Estate	2%	11%
Total	100%	100%

Note * PBPL figures were obtained from the Department of Census and Statistics Household Income and Expenditure Survey 2002.

The Southern Province is largely over-served also in terms of poverty distribution while the Central and Sabaragamuwa provinces are considerably underserved by microfinance providers.

Table 7-17

Province	Correlation by province	Correlation by sector
SANASA TCCSs*	0.700959	0.999011
CRBs	0.737680	0.986036
SBSs	0.723488	0.997716
NGOs	0.274874	0.913991
RDBs	0.628024	0.977110
Banks & OFIs	0.413547	0.470277

Note * The total poverty figures (people below the poverty line) used to calculate the correlation between SANASA outlet distribution and poverty by province were adjusted to account for the districts which were not covered during this survey (Gampaha, Puttalam, Anuradhapura).

The tightest correlation between the regional distribution of outlets and the regional distribution of poverty is displayed by CRBs, followed closely by SBSs and TCCSs. Therefore it seems the outlet network of the co-operative sector, as well as that of the Samurdhi programme is in a good position to reach the country's poor. A surprisingly low degree of correlation is displayed by NGO MFIs, a situation which can be explained by the high concentration of this sector in the Southern and North-Central provinces relative to their corresponding PBPL share, and the low presence in provinces with high poverty incidence such as Uva and Sabaragamuwa.

All groups of institutions with the exception of banks and other financial institutions display strong correlations between the sectoral distribution of outlets and the sectoral distribution of poverty. Since this group of institutions uses the same outlet network for their microfinance services as for their traditional business, it is not surprising that this is only weakly correlated to the incidence of poverty.

5. Operations

An extensive part of the questionnaire was aimed at finding out how different microfinance providers have organised their operations. This section presents and analyses the findings of the survey concerning client relations and portfolio management and closes with an assessment of the operational challenges as identified by the respondents.

Client identification

Having procedures in place to ensure a good screening of potential clients is vital to maintaining the quality of the loan portfolio. An overview of the methods used to identify potential clients is presented in the table below:

Table 7-18 Identification of potential clients

Identification method	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
Inspections / field visits	89%	81%	yes	93%	100%	63%
Past transaction performance	68%	57%	yes	n/a	100%	42%
Third party recommendations (reliable customers, officials and institutions)	54%	57%	yes	76%	50%	63%
Opportunities arising out of non-microfinance activities	36%	21%	-	51%	50%	37%
Employing an agency for sourcing	-	12%	-	-	33%	16%

One of the most used methods to identify and screen potential clients is through field visits and inspections. This method is utilised by all RDBs, 93% of NGOs, and also by almost two thirds of banks and other financial institutions. Considering the target group of microfinance institutions, it is important that MFIs assess potential clients at the field level itself in order to evaluate their social and economic situation and gain an understanding of their business activities. Reaching out is also important in microfinance where potential clients may not only be physically isolated but may also be unaware of the financial services available to them and may feel intimidated by financial institutions and reluctant to approach them. This applies particularly in the case of traditional financial service providers such as banks. Closeness to client is especially important in microfinance to prevent moral hazard issues which could arise in the absence of collateral.

Evaluation of past transaction performance relies mostly on informal sources, as microfinance institutions and clients are not integrated into the system of the Credit Information Bureau of Sri Lanka (CRIB). Surprisingly, the lowest response rate for this option came from the formal sector – banks and other financial institutions. This might be explained by the fact that the credit extended to microfinance clients consists of small amounts and represents a minor proportion of the total loan portfolio of the institution, a situation which does not justify the relatively high investigation costs incurred by such an evaluation. On the other hand, all RDBs have mentioned they evaluate past transaction performance of potential clients. Considering that microfinance activities are estimated to account for an average of 86% of their revenue earned, the need for a thorough appraisal of new clients is acknowledged.

Recommendations from a trustworthy third party (reliable customers, officials, institutions) play an important role in new client identification for the majority of institutions covered by the survey. At the same time, opportunities arising out of non-microfinance activities do not seem to be fully exploited, despite the fact that most institutions are involved in a wide range of other activities.

Lending terms and conditions

An overview of the formal requirements of the different groups of microfinance providers for granting a loan is presented in the table below:

Table 7-19 Loan conditions

Formal requirements	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & FCs
Guarantors (individuals / groups)	93%	94%	yes	92%	100%	92%
Membership	100%	96%	yes	82%	n/a	n/a
Minimum deposit / bank balance / share value	93%	80%	yes	75%	67%	58%
Proof of established residency	79%	80%	-	40%	100%	92%
Proof of income	71%	86%	-	55%	83%	83%
Insurance cover	32%	12%	-	16%	17%	58%
Collateral	61%	63%	-	8%	67%	58%
Group member/ leader / third party recommendation	29%	36%	yes	36%	17%	42%

There is a strong reliance on guarantors to secure the microfinance loans granted. Depending on the prevailing lending methodology some rely on group guarantees (especially from the NGO sector), while the majority requires personal guarantees. In addition to this and for a similar purpose, a large majority of respondents require loan applicants to have a minimum deposit or bank balance or, as in the case of Samurdhi, to build up a certain share value. Member-based organisations (CRBs, TCCSs, SBSs and some NGOs) also require membership in the organization in order to have access to loans.

A worrying finding of the survey is that, with the exception of NGOs and SBSs, a large number of respondents require physical collateral to secure a loan. This suggests that although microfinance seems to be widely available, a considerable number of people from the bottom layer of the income distribution may still face significant barriers to accessing loans. The innovative approach of microfinance compared to traditional finance rested in its reliance on collateral substituting mechanisms. However, the findings of the present survey indicate that a large proportion of microfinance institutions impose collateral and collateral substitutes as conditions for obtaining a loan. It may well be that these collateral requirements are reduced as compared to traditional finance, but they may still exclude some of the most vulnerable clients.

The low reliance on insurance cover and on third party recommendations should be noted. This shows that there is considerable scope for development of the micro insurance market. At the same time, social relationships could be better exploited to ensure high repayment rates.

Lending methodology

The provision of microfinance services in Sri Lanka seems to be mainly oriented towards individual clients although the group mechanism is relied on to secure the loans. The Samurdhi programme was designed to function based on joint-liability mechanisms, but it is agreed that in practice group formation is arbitrarily decided by Samurdhi Development Officers, which creates frictions in the group dynamic. The system thus does not seem to fully exploit social relations to ensure repayment of loans.

Group mechanisms seem to be used at a wider scale in the provision of insurance services to microfinance clients. A large share of the traditional insurance companies involved in microfinance had group policies.

Wholesale lending is, with the exception of secondary unions of Thrift and Credit Co-operative Societies belonging to the SANASA movement and of some NGOs, a marginal activity.

Table 7-20 Lending methodology

Type of institution		Individual lending	Group lending	Wholesale lending
SANASA TCCSs	SUs	34%	6%	60%
	PTCCSs	92%	8%	<1%
CRBs		95%	5%	<1%
SBSs		-	100%	-
NGOs		45%	39.5%	15.5%
RDBs		91%	9%	<1%
Banks & OFIs		Banks: 79.5%; FCs: 98.75%; ICs: 56% (individual insurance policies)	Banks: 11.75%; FCs: 0.25%; ICs: 44% (group insurance policies)	Banks: 8.75%; FCs: 1%

Processing time

The processing time for the principal products offered by microfinance providers is displayed in the table below.

Table 7-21 Processing time

Processing time (days)	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & FCs
Loans	23	18	14	19	26	Banks:8; FCs:2
Savings and Deposits	1	1	1	1	1	Banks:1; FCs:1
Leasing	14	19	-	1	6	Banks:6; FCs:4
Pawning	1	1	-	1	1	Banks:1; FCs:1
Insurance	3	17	-	8	-	Banks:1; FCs:1

It is interesting to notice that for loans, both the shortest and the longest average processing times in days are found among formal providers of financial services. Finance companies with an average of two days and commercial banks with an average of eight days seem to be the quickest in processing loans, while RDBs require 26 days for the same activity.

A possible explanation could be that for the former group, microfinance operations represent an insignificant share of their total loan portfolio, therefore there is little risk for the overall performance of the banks in case of non-repayment of microfinance loans. For the latter group (RDBs), microfinance loans represent the majority of their portfolio, therefore they are more inclined to bear the cost of a lengthier and more complex loan assessment procedure in order to reduce the risk of default.

The lack of computerisation of operations in most microfinance providers (with the exception of those belonging to the formal financial system) has a negative impact on the processing time of loan applications.

However, loan processing times should, in general, be improved as low-income individuals and micro/small enterprises often do not have the resources to tide them over a lengthy loan approval period and this can have the undesired outcome of leaving them with little alternative but to seek funding from expensive informal funding sources.

Loan approval procedure

Loan approval procedures involve in most cases (with the exception of banks and finance companies) a credit committee or regional level body. This explains also the long average processing time for loans. With the exception of RDBs, the Board of Directors does not seem to play an important role in approving loans. However, even in this group, the Board's approval is required only for loans above a certain value.

Table 7-22 Loan approval

Loan approval procedure	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & FCs
Approval by credit committee / regional level body	93%	85%	yes	64%	100%	25%
Manager approval up to a maximum loan value	36%	41%	–	53%	67%	67%
Board of Directors	7%	9%	–	8%	33%	8%

Access to technology

The table below focuses on the access of microfinance institutions to modern information and communication technology, such as internet and email facilities and on the degree to which computerisation of operations and processes permeates the sector.

Table 7-23 Access to technology

Type of institution	Access to internet	Access to email	Operations and processes		
			Manual	Computerised	Mix
SANASA TCCSs	11%	11%	61%	–	39%
CRBs	6%	7%	74%	1%	25%
SBSs	n/a	n/a	100%	–	–
NGOs	63%	73%	37%	5%	58%
RDBs	83%	100%	–	–	100%
Banks & OFIs	100%	100%	–	43%	57%

The survey reveals one of the main weaknesses of the microfinance sector in Sri Lanka. Member-based societies such as SANASA TCCSs and CRBs almost entirely lack access to modern communication technologies (email, internet facilities). Combined with the lack of language skills among staff this represents a significant barrier to the dissemination of best practices within the sector.

The survey also reveals that in over two-thirds of member-based institutions such as SBSs, SANASA TCCSs and CRBs, operations and processes are performed manually. Over half of NGOs and banks and other financial institutions, as well as all RDBs employ a mix of manual and computerised operations. With the exception of the group of banks and other financial institutions, fully computerised operations are almost entirely absent.

Defaulting clients

A variety of measures are employed in dealing with defaulting clients. These are presented in the table below:

Table 7-24 Dealing with defaulting clients

Measures taken	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & FCs
Legal action	89%	83%	-	40%	83%	100%
Group or social pressure	54%	44%	yes	84%	67%	33%
Penalties/ fine	61%	57%	yes	29%	50%	67%
Freezing savings/deposit accounts	39%	44%	yes	51%	67%	42%
Arbitration	43%	28%	yes	53%	33%	25%
Confiscating/ seizing property	11%	16%	-	4%	83%	50%
Recovery from guarantors	4%	2%	-	33%	17%	-

With the exception of NGO MFIs, engaging in legal action against defaulting clients was cited by over 80% of the respondents. This is a rather surprising finding as microfinance loans are mostly so small in value that it seems hardly probable that the cost of legal action is justified. From this perspective, arbitration seems to be under-utilised. It could be that engaging in legal action is considered by MFIs a deterrent for other clients who would otherwise be tempted to default, thus offering a justification for such a costly and lengthy action.

NGO MFIs seem to have a different approach from the rest of the MFIs, with more emphasis placed on group or social pressure (84% of the respondents), arbitration (53%) and recovery from guarantors (33%). This approach is more appropriate in the case of microfinance loans, as it functions also in the case of low-income clients, from whom little can be recovered through legal action, seizing of property or other collateral.

Portfolio management

The survey reveals a widespread lack of understanding of principles and best practices with respect to portfolio management and maintaining portfolio quality. This is cause for concern, since the respondents in the survey were all members of the senior management of their respective institutions. A large number of respondents could not distinguish between portfolio management measures and actions employed to deal with defaulting clients.

Portfolio-at-Risk

The majority of respondents (see table below) claimed that their respective institutions use Portfolio-at-Risk in order to monitor the quality of their loan portfolio, the percentage of respondents being higher among the formal financial institutions (RDBs, banks and finance companies involved in microfinance). NGO MFIs, which do not fall under specific financial regulation, have the lowest incidence of PaR monitoring.

Table 7-25 Monitoring portfolio quality

Type of institution	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & FCs
Monitoring PaR	57%	65%	yes	51%	100%	91%

However, even among the respondents who stated that their institutions monitor Portfolio-at-Risk, the understanding of the concept varied considerably. Only a minority of them could offer a correct definition (see the individual institutional chapters for more details on the different definitions of PaR provided by the respondents).

Proper monitoring of the loan portfolio is also hampered by lack of technology. The table below documents the extensive reliance of the majority of microfinance providers on a manual system of record keeping.

Table 7-26 Portfolio tracking

Formal requirements	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & FCs
Log books/ other manual records	94%	91%	yes	86%	83%	30%
Computerized financial statements/ client records	33%	17%	-	71%	100%	90%
Field visit records	63%	-	-	74%	-	80%

Non-performing loans

The concept of non-performing loans seemed to be better understood by the respondents. The majority related this to an age classification of overdue loans but there were large differences in the classification e.g. the number of overdue instalments considered for the definition of a non-performing loan. This large heterogeneity was manifested even within the different institutional groups and was highest among institutions which are not regulated or supervised and therefore lack common guidelines in this respect. Most of the classifications adopted are similar to those of banks and not adjusted to take into account the specific nature of microfinance operations. They are generally more lenient both in the definition and classification of non-performing loans, as well as in the subsequent provisioning policy.

Provisioning policy

Other than RDBs, banks and finance companies which are regulated by the CBSL, the number of microfinance providers which have provisioning policies in place is quite modest.

Table 7-27 Provisioning for non-performing loans

Type of institution	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs
Provision for non-performing loans	54%	58%	yes	42%	100%

The responses provided reveal that provisioning is often linked to the total loan portfolio or revenue, rather than with non-performing loans or portfolio-at-risk.

Operational challenges

Difficulties in ensuring repayment of loans, strong competition, and difficulties in obtaining funding for their microfinance operations, as well as inadequate technology and equipment are the operational challenges mentioned most often by the respondents across the different groups of institutions. An overview is offered in the table below.

Table 7-28 Main operational challenges

Challenges	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
Delayed /non-repayment of loans	79%	58%	-	64%	50%	26%
Strong competition	68%	55%	-	33%	67%	21%
Inadequate MIS/poor technology/ lack of equipment	71%	65%	-	32%	39%	-
Difficulties in obtaining adequate funding	64%	46%	-	77%	17%	5%
Difficulties in staff recruitment	25%	30%	-	25%	50%	21%
Low profitability of MF operations	39%	29%	-	23%	-	-
Poor local infrastructure	32%	23%	-	25%	-	-
Lack of MF experience among staff	-	-	-	20%	33%	11%
Inadequate demand for products/services	14%	7%	yes	10%	17%	16%
Difficult outreach of the target group	-	8%	-	14%	-	21%
Security situation in the country	11%	8%	-	4%	-	-
Regulatory environment	4%	3%	-	7%	-	11%
Political influence	4%	10%	-	-	-	5%
Fraud	4%	3%	yes	2%	-	-

With the exception of the group of banks and other financial institutions, where the operational challenges identified were quite diverse and less marked, which is not surprising considering that these are strong institutions with experience in the provision of financial services, for the other groups there seems to be a large degree of consensus as to the challenges faced. The most often mentioned issue was Delayed repayment of loans was the issue most mentioned by SANASA TCCSs, while RDBs mostly cited strong competition, CRBs poor technology and NGOs difficulties in obtaining adequate funding.

6. Products and Markets

The Sri Lankan microfinance market seems to be, to a certain extent conservative, focusing more on a proliferation of variations of the same traditional products and lacking innovative approaches which could overcome the inherent barriers in access to microfinance. Increasing competition in the sector might provide the necessary incentive for MFIs to innovate more in terms of products offered, as well as in their marketing strategies.

Products

The most common products offered by microfinance providers in Sri Lanka are savings and deposits, loans and pawning. The figures provided in this section are as they were reported in the survey. This section therefore reflects the understanding of microfinance of the respondents and their willingness to provide information. While in the case of banks and other financial institutions a tendency to overestimate their involvement in microfinance activities is reflected in the data provided, in the case of TCCSs and SUs belonging to SANASA, the data reported certainly underestimates the involvement and importance of this group of microfinance providers.

Savings

All SBSs, TCCSs, CRBs, RDBs and banks, as well as 89% of the NGO MFIs and 60% of finance companies offer savings and deposit products. An overview of the volumes reported, number of accounts and other details such as the interest rate on these products is presented in the table below.

A significant problem encountered during the survey is that respondents were not able to distinguish between the savings and deposits of their microfinance clients. Therefore the size of the microfinance savings portfolio was in most cases estimated by the respondents, thus depending on the perceptions of the respondents. Most of them defined microfinance savings as small scale savings, without taking the income level of the saver into consideration.

Table 7-29 Savings portfolio

Type of institution	Volume outstanding ('000 Rs.)	Number of accounts	Average outstanding balance	Annual interest rate (%)	Minimum value required (Rs.)
SANASA TCCSs*	981,674	134,344	8,093	4-18	20-500
CRBs	19,500,033	10,356,388	1,881	3-20	5-500
SBSs	17,614,360	5,873,224	2,999	5.64-8.5	n/a
NGOs	4,106,677	1,276,683	4,321	0-19.5	5-2,500
RDBs	13,329,144	2,063,988	6,458	3-15	10-500
Banks & OFIs	70,486,008	6,514,439	n/a	4-17	100-2,500
Total	126,017,896	26,219,066	-	0-20	5-2,500

Note *Information regarding the savings and deposits offered by TCCSs was available for only 8% of the PTCCSs covered by the survey, therefore it cannot be considered to offer a representative overview of this group of MFI providers.

According to the survey, banks and finance companies hold the largest share (56%) of the savings portfolio of the microfinance providers in the sample. This is almost entirely due to the savings portfolio of the People's Bank, and it would have been even larger if information regarding the microfinance savings volume of the Bank of Ceylon had been available. This finding supports the findings of a household-level survey commissioned and published by GTZ: Outreach of Financial Services in Sri Lanka, 2008 according to which around 70% of the households in the first and second income quintiles (the lowest income quintiles) save with the state banks.

Figure 7-6 Volume of savings

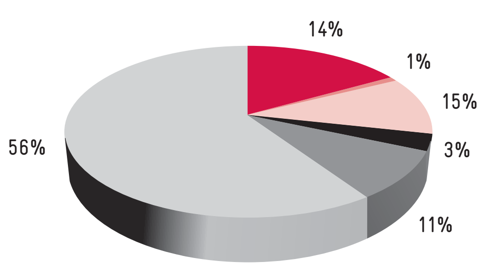
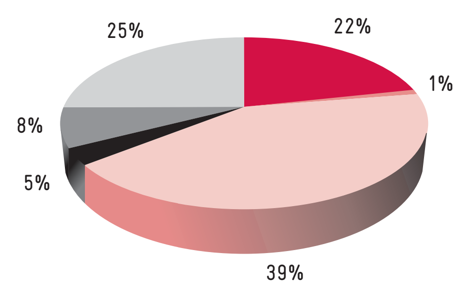


Figure 7-7 Number of savings accounts



The largest number of savings accounts (39%) in the sample was reported by CRB but due to the lower saving capacities of their clients, they represent only 15% of the total volume outstanding. NGO MFIs hold only a marginal share both in terms of number of accounts (5%), as well as of volume outstanding (3%). This is explained by the fact that NGOs are not allowed to mobilise savings under prevailing law although it is clear that many of them do accept some deposits, primarily as security for loans.

Loans

All SBSs, TCCSs, RDBs and banks, as well as 99% of CRBs, NGOs and 80% of finance companies offer a wide range of loan products, the main characteristics of which are presented in table 7-30

Table 7-30 Loan portfolio

Type of institution	Volume outstanding ('000 Rs.)	Number of accounts	Average outstanding balance (Rs.)	Annual interest rate (%)	Maximum loan value available (Rs.)	Repayment period (months)
SANASA TCCSs*	824,151	112,460	25,825	4-18	1,000,000	1-96
CRBs	10,829,698	2,783,000	3,631	2-24	5,000,000	1-180
SBSs	7,785,071	656,330	11,862	14-18	100,000	3-60
NGOs	9,876,316	375,156	32,175	0-36	500,000	1-60
RDBs	9,426,380	311,204	30,290	6-24	3,000,000	1-60
Banks	8,849,072	225,147	39,304	8-24	1,000,000	0-120
FCs	573,100	10,486	54,654	15-29	500,000	6-60
Total	48,163,788	4,473,783	-	0-36	100,000-5,000,000	0-180

Note *Information on the volume of loans outstanding and the number of loan accounts was available for only 7% and 29% respectively of SANASA TCCSs covered by the survey, therefore the figures cannot be considered to be representative of this group of MF providers.

The largest share of the total loan portfolio in terms of volume outstanding is held by CRBs (22%), followed closely by NGOs (21%), RDBs (20%) and banks (18%). In terms of the number of microfinance loans, again CRBs have a clear lead, having in their portfolio 62% of the total number of loans. SBSs come a distant 2nd with 15% of the total number of loans.

Figure 7-8 Volume of loans

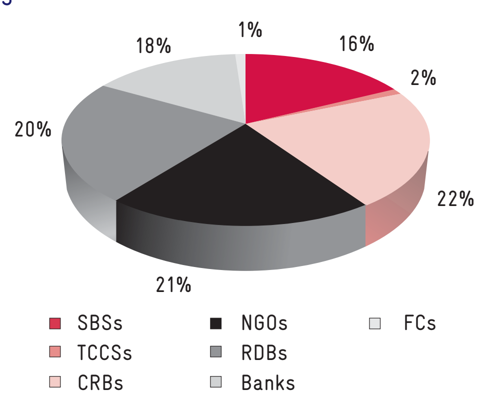
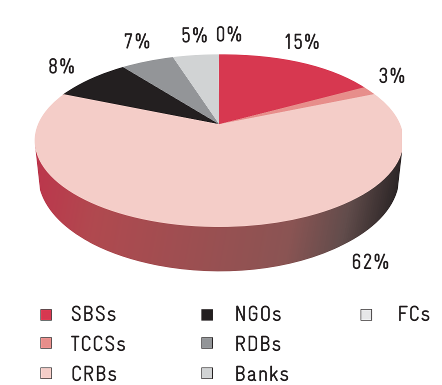


Figure 7-9 Number of loan accounts



With the exception of finance companies, the majority of microfinance providers require the borrowers to have some quantum of savings in order to qualify for a loan. Most microfinance providers calculate the loan interest on the reducing balance method. With the exception of NGOs, most loan providers charge a service fee for processing the loan application.

Table 7-31 Other loan conditions and calculation of interest

Type of institution	Compulsory savings	Service charge	Interest calculation – reducing balance
SANASA TCCSs	61%	96%	100%
CRBs	97%	62%	98%
SBSs	yes	no	yes
NGOs	90%	40%	65%
RDBs	100%	83%	100%
Banks	71%	71%	100%
FCs	0%	50%	50%

Pawning

Pawning is a widespread microfinance product offered by different types of providers of microfinance services in Sri Lanka. Pawning is offered by all RDBs, 82% of CRBs, 71% of banks, 40% of finance companies, 36% of TCCSs, but only 1% of NGOs.

Table 7-32 Pawing portfolio

Type of institution	Volume outstanding ('000 Rs.)	Number of accounts	Average outstanding balance	Annual interest rate (%)	Maximum value available required (Rs.)
SANASA TCCSs	45,249	4,551	2,807	15-21	300,000
CRBs	4,272,482	715,823	5,819	14-24	350,000
SBSs	-	-	-	-	-
NGOs	n/a	n/a	n/a	21	100,000
RDBs	4,041,562	485,084	8,332	14-20	50,000
Banks	6,663,642	238,875	2,415	17-23	900,000
FCs	900,000	62,533	14,392	23.5	-
Total	15,922,935	1,506,866	-	14-24	50,000-900,000

Except for CRBs, the average outstanding balance on pawning accounts is considerably lower than that of loans. Pawning is used by most clients as a means of quickly securing cash in exchange for unproductive assets (jewellery, gold). Pawning has advantages for both parties involved in the contract – it is simple and has low transaction costs for the borrower and it implies very low risks for the lender. But at the same time, clients who have no assets of value are excluded from access to financing through pawning.

Figure 7-10 Pawning volume

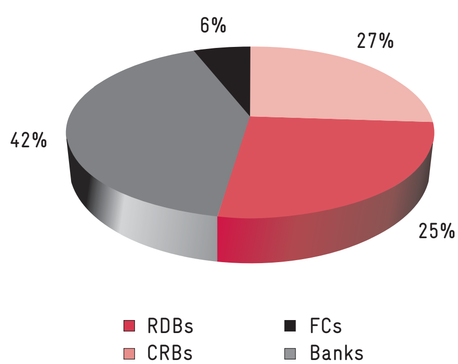
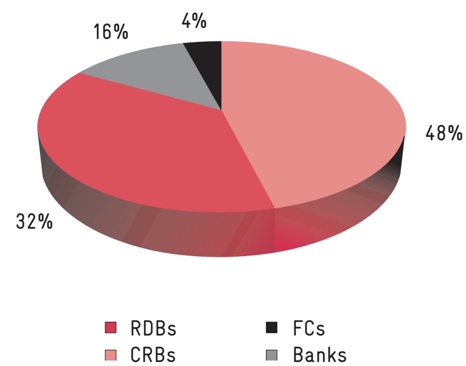


Figure 7-11 Number of pawning accounts



Banks have the highest share of the total outstanding volume of pawns (42%), followed by CRBs (27%) and RDBs (25%). But in terms of number of accounts, banks have a share of only 16%, being surpassed by both CRBs (48%) and RDBs (32%).

Leasing

With the exception of finance companies, for all other institutional groups covered in the survey, leasing represents only a niche product. It is offered by all finance companies, 50% of RDBs, 29% of banks, 4% of TCCSs, and 1% of CRBs and NGOs. The average outstanding lease balance is considerably higher than that of loans.

Table 7-33 Leasing portfolio

Type of institution	Volume outstanding ('000 Rs.)	Number of accounts	Average outstanding balance (Rs.)	Annual interest rate (%)	Maximum value available (Rs.)
SANASA TCCSs	n/a	n/a	n/a	15-19	500,000
CRBs	19,268	202	95,385	12-18	165,000
SBSs	-	-	-	-	-
NGOs	n/a	n/a	n/a	n/a	n/a
RDBs	86,344	1,282	67,351	11.9-16	1,500,000
Banks	1,057,586	9,868	107,173	8-34	200,000
FCs	4,314,000	20,190	213,670	15-29	500,000
Total	5,477,198	31,542	-	8-34	165,000-1,500,000

Insurance

As in the case of leasing, with the exception of insurance companies, this product is hardly offered by any other institutional group: 28% of NGOs, 18% of TCCSs, two CRBs, one finance company, and one bank. Considering the fact that micro insurance is of very recent date, an increase in its importance is expected. Around a fifth of respondents in most institutional groups have reported they plan to add insurance products to their microfinance product portfolio. It is not clear whether they plan to offer their own products (which they are not legally allowed to do) or retail the products of registered insurance companies.

Table 7-34 Insurance portfolio

Type of institution	Volume outstanding ('000 Rs.)	No. of policies	Average outstanding balance (Rs.)
SANASA TCCSs	406	30,319	1.336
CRBs	27,122	4,878	5,560
SBSs	-	-	-
NGOs	39,630	53,207	1,373
RDBs	-	-	-
Banks	6,000	400	15,000
FCs	-	-	-
ICs	127,200	100,279	1,268
Total	200,358	189,083	-

Product development

Product development is mostly performed at a central level with inputs from the staff of the branches. Collecting inputs from the local branches is important in designing products which correspond to the needs of the customers. Although the survey reveals a widespread practice of consultation, the weight associated by each respondent to the inputs received from their local representatives is not known.

Table 7-35 Product development process

Product development	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
At central (head office) level with inputs from all branches	61%	72%	yes	64%	50%	74%
At individual branch level by an internal team	46%	15%	-	13%	33%	5%
At individual branch level by the manager	25%	11%	-	19%	33%	5%
By an external consultant	14%	1%	-	10%	-	-
Board of Directors	-	1%	-	7%	-	5%

In the case of all groups of institutions, considerably more products have been introduced than withdrawn from the market within the last two years. SBSs and RDBs seem to have been most active in introducing new products to the market, while at the same time keeping all existing products as well. This shows a tendency towards product proliferation, with little attention given to the profitability of individual products.

Table 7-36 Products introduced / withdrawn

Type of institution	New products in the last 2 years (average)	Withdrawn products in the last 2 years (average)	New products planned (yes)
SANASA TCCSs	2.4	0.3	79%
CRBs	1.6	0.1	77%
SBSs	4	0	yes
NGOs	2.2	0.2	83%
RDBs	4.3	0	83%
Banks & OFIs	3.6	0.5	74%

Around 80% of the respondents from each group of institutions have stated they plan to add new products to their microfinance product portfolio. However, when asked to elaborate on the type of products to be introduced, the majority of them cited traditional products, with only a minority quoting money transfer services, pension products or leasing. This suggests a low level of innovation among most respondents.

Table 7-37 Planned new products

New products planned	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
Savings products	73%	85%	-	49%	80%	36%
Loan products	95%	83%	-	83%	100%	43%
Fixed deposits	55%	33%	yes	7%	20%	14%
Pawning	41%	48%	yes	4%	20%	14%
Leasing	14%	6%	yes	6%	20%	29%
Insurance	18%	6%	-	23%	20%	29%
Pension products	14%	10%	-	6%	-	14%
Money transfer services	9%	3%	yes	1%	-	21%
Bill payments	-	3%	-	-	-	-

Product delivery and marketing

Product delivery

Microfinance products are mainly delivered through the branch network of the MFIs. A considerable number utilise their field officers for delivery at the field level itself, which has the advantage of reducing the barriers to access for low-income clients who might be less mobile and find it difficult to bear the cost of travel to the branch. Links with other institutions also play an important role in product delivery for NGOs and RDBs.

Table 7-38 Product delivery mechanisms

Product delivery	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
Direct delivery through own outlets	86%	96%	yes	61%	100%	84%
Delivery through field officers	29%	23%	yes	43%	33%	53%
Delivery through links with other institutions	11%	9%	-	42%	33%	21%

Marketing tools and strategies

The marketing instruments most widely employed by microfinance providers are printed material such as leaflets, banners and posters and also hoardings. Around two thirds of respondents from all institutional groups with the exception of NGO MFIs, have stated that these are their most used marketing tools. The most preferred marketing strategy depends on the particular characteristics of the institutions. NGO MFIs and SANASA TCCSs rely mostly on clients or members to promote their products to potential clients, while CRBs use printed leaflets and also work through the non-microfinance activities of MPCSs, RDBs, and banks and other financial institutions rely mostly on printed material as well as on door step marketing by field officers.

Table 7-39 Product marketing strategies

Marketing strategies	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
Leaflets	71%	76%	yes	31%	100%	68%
Banners/ posters/ hoardings	54%	68%	yes	25%	100%	68%
Door step marketing by field/ community development officers	46%	30%	yes	30%	83%	68%
Promotion through clients/ members	100%	67%	yes	89%	-	11%
Through the non-MF activities of your organization	64%	73%	yes	42%	-	-
Joint programs with other institutions	36%	20%	-	36%	50%	42%
Advertised in news papers/ magazines/ newsletters	21%	10%	yes	13%	50%	58%
Advertised on radio	-	-	yes	4%	17%	63%
Advertised on TV	-	-	yes	4%	17%	58%
Cross selling with other bank products	-	-	-	-	33%	42%

7. Human Resources

Given the door-step banking approach typical of microfinance, human resources play an important role in the provision of microfinance services. This section presents the data collected on the human resource profile of microfinance providers and addresses issues faced by the sector in relation to recruitment, retention and training of microfinance staff.

Staff figures

In terms of the total staff employed within each institutional group, banks and other financial institutions are by far the group with the most number of staff. This is an expected result, since banks serve a large number of clients, most of which do not fall under the microfinance classification. However, when considering the staff allocated to the microfinance activities of these institutions, CRBs have the lead, followed by NGOs. As CRBs have the largest reported number of microfinance accounts (both savings and loans) the large number of staff may be justifiable. The large number of staff in NGO MFIs may be explained in part by the attention given by this group of institutions to non-financial, 'credit plus' services which are generally staff intensive.

Table 7-40 Staff complement

Type of institution		Total staff	Of which, microfinance staff		Exclusively involved in microfinance activities
			No.	% of total staff	
SANASA TCCSs	SUs	657	657	100%	n/a
	PTCCSs	2,797	2,797	100%	n/a
CRBs		20,077	20,077	100%	12%
SBSs		14,500	6,500	45%	n/a
NGOs		8,856	7,273	82%	28%
RDBs		1,926	1,554	81%	17%
Banks & OFIs		39,173	6,894	18%	16%
Total		67,909	45,752	67%	–

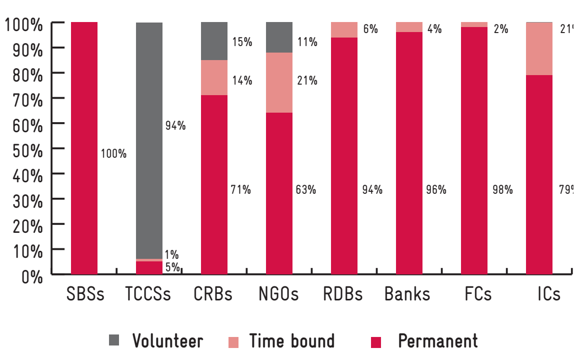
n/a – not available;

An interesting finding of the survey is that only a minority of the respondents (between 12 and 28%) who provided this information have reported their microfinance staff are exclusively involved in their microfinance operations. A stricter delimitation of the different activities and a higher degree of specialisation within the institution could increase the productivity of microfinance staff.

Composition of staff

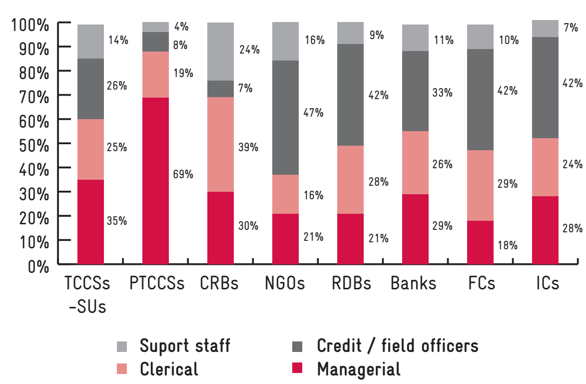
There are significant differences in the type of employment offered to microfinance staff across the different groups of institutions. While in the more traditional finance institutions, such as banks, finance companies, and regional development banks, the majority of microfinance staff is employed on a permanent basis, member-owned institutions rely more on temporary staff and on volunteers. The percentage of volunteer staff (amounting to 94% of the microfinance staff) is highest in the SANASA TCCSs.

Figure 7-12 Type of employment



With the exception of SANASA TCCSs, between a fifth and a third of the microfinance staff of other institutional types holds managerial positions. The case of the SANASA TCCSs is a special one, with 69% of the microfinance staff reported to hold managerial positions. This could be explained by the small size of the majority of TCCSs, which suggests that managerial staff is involved in a broader range of operational activities, which are traditionally performed by non-managerial staff in larger organisations. Another explanation could be linked to the large share of volunteer staff to which these positions are awarded more liberally, having also the function of a non-pecuniary reward.

Figure 7-13 Composition of microfinance staff



The proportion of credit and field officers varies significantly across institutions (from 7% to 47%), depending on the particular mechanisms of product delivery and on the procedures in place for loan assessment and approval.

Challenges

One of the purposes of the survey was to identify the challenges faced by microfinance providers regarding staff recruitment and retention. This section highlights the main findings in this respect.

Recruitment

The respondents have identified similar recruitment challenges for all three types of positions – managerial, clerical and credit / field officer. The absence of retirement benefits, the difficulty of finding people with the necessary skills and with microfinance experience, as well as operating in unattractive locations have been identified by most respondents to be major challenges in the recruitment of staff for their microfinance operations.

Table 7-41 Requirement Issues

HR recruitment issues		SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
Absence of a pension scheme (retirement benefits)	M**	50%	yes	63%	27%	33%	11%
	C**	43%	–	60%	17%	33%	–
	C/FO**	36%	–	61%	24%	33%	11%
Finding skilled people	M	50%	yes	52%	53%	17%	37%
	C	39%	–	49%	39%	17%	47%
	C/FO	36%	–	51%	50%	17%	50%
Finding people with microfinance experience	M	46%	yes	29%	36%	17%	26%
	C	46%	–	29%	28%	17%	16%
	C/FO	39%	–	34%	32%	17%	17%
Unattractive locations	M	36%	–	44%	19%	17%	5%
	C	25%	–	43%	13%	17%	5%
	C/FO	18%	–	42%	19%	17%	11%
Attractive packages offered in other companies	M	57%	yes	51%	41%	–	–
	C	46%	–	51%	27%	–	–
	C/FO	46%	–	55%	36%	–	–
Microfinance not considered an attractive career option	M	25%	–	20%	10%	17%	11%
	C	14%	–	21%	5%	17%	–
	C/FO	21%	–	20%	–	17%	–
Finding people in the desired age category	M	25%	–	16%	8%	–	37%
	C	21%	–	18%	10%	–	11%
	C/FO	14%	–	22%	5%	–	17%
Employment conditions (probation, contract etc.)	M	21%	–	6%	11%	–	–
	C	25%	–	6%	8%	–	–
	C /FO	14%	–	7%	11%	–	–
Poor working conditions	M	18%	yes	13%	1%	–	11%
	C	21%	–	16%	1%	–	16%
	C/FO	18%	–	15%	–	–	11%
Nepotism / Political interference	M	18%	–	14%	–	33%	–
	C	18%	–	12%	–	33%	–
	C/FO	14%	–	10%	–	33%	–

Note * The respondent reported no difficulties in the recruitment of Samurdhi Development Officers
** M – managerial; C – clerical; C/FO – credit / field officer.

Retention

Inadequate remuneration and incentives, together with the lack of technology were the main challenges mentioned by TCCSs, CRBs and NGOs when it comes to retaining qualified staff in the organisation. Interestingly, the first two were also mentioned by over a third of banks and other financial institutions who are normally known to offer attractive remuneration and incentive packages to their staff. The difficult nature of field operations was mentioned by half of the RDBs and by a quarter of banks and other financial institutions.

Table 7-42 Retention Issues

HR retention issues	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
Inadequate remuneration	64%	71%	-	64%	-	37%
Inadequate incentives	64%	63%	-	40%	17%	37%
Lack of technology	61%	78%	yes	30%	-	-
Difficulty nature of field operations	32%	17%	-	41%	50%	26%
Incompatibility with new technology	39%	29%	-	14%	-	-
Work overload	21%	36%	-	23%	-	21%
Lack of operational flexibility	14%	12%	-	5%	-	11%
Microfinance not considered an attractive career option	14%	13%	-	5%	17%	16%
Difficulty of teamwork	4%	7%	-	10%	17%	11%

Incentives

Almost all respondents have cited training opportunities to be one of the most important incentives offered to their microfinance staff. In addition to this, the majority of respondents have mentioned the existence of performance appraisals and performance linked rewards schemes as incentives offered to their microfinance staff. However, considering the retention challenges mentioned above, it would seem that the incentive structures offered do not meet the needs of the staff.

Table 7-43 Incentives offered

Incentives	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
Training opportunities	93%	93%	yes	81%	100%	68%
Performance appraisals and rewards	50%	56%	-	52%	100%	89%
Remunerative incentives	57%	68%	yes	52%	83%	79%
Other subsidies (funeral assistance, work uniforms etc.)	43%	34%	-	33%	33%	42%
Distribution of revenue (stock, shares etc)	43%	35%	yes	18%	67%	26%
Staff loans at concessionary rates	-	67%	-	2%	100%	58%
Moral incentive (the right thing to do)	36%	26%	-	59%	50%	47%
Overtime pay	39%	66%	-	22%	83%	58%
Workman compensation for sickness, accidents	36%	19%	yes	24%	50%	42%
Free or subsidised meals	11%	13%	-	14%	50%	5%
Free or subsidised transportation	18%	13%	-	39%		5%
Reimbursement of medical expenses	7%	9%	-	20%	100%	58%

Staff development – Training

Microfinance providers offer their staff training opportunities covering different key areas. The following table depicts the main training areas offered to managerial staff.

Table 7-44 Training

Key training areas – managerial staff	SANASA TCCSs	CRBs	SBSs	NGOs	RDBs	Banks & OFIs
Human resource development/ people & productivity	81%	67%	yes	81%	83%	50%
Project management	81%	62%	yes	80%	100%	50%
Business Planning	81%	52%	yes	67%	100%	67%
Customer care	73%	60%	-	52%	67%	61%
Marketing / promotional	58%	54%	yes	41%	100%	61%
Risk management	58%	38%	yes	53%	100%	61%
Profitability monitoring	69%	44%	yes	52%	100%	56%
Record keeping	69%	44%	yes	51%	83%	17%
Costing	69%	36%	-	45%	100%	33%
Credit evaluation	65%	48%	-	48%	100%	11%
IT skills	50%	28%	yes	43%	67%	56%

Managerial staff receives a broad range of courses n a variety of subjects, which hints to a lack of focus on relevant issues corresponding to their activities and responsibilities. Courses such as customer care, record keeping and marketing are more relevant for other staff categories than for managers. The lack of focus on training relevant to the nature of duties is also manifested in the training offered to other staff categories (clerical, field / credit officers). Microfinance providers should strive to achieve better correlation between the training needs of their staff and the training offered to them in order to improve the capabilities of their staff to address current issues and challenges.

Managers also benefit from the largest average number of training sessions a year across all microfinance institutional groups. Banks and other financial institutions have by far the highest number of training sessions per institution, while CRBs seem to offer the least training opportunities to their microfinance staff.

Table 7-45 Number of training programs

Average number of training courses	SANASA TCCSs		CRBs	SBSs	NGOs	RDBs	Banks & OFIs
	SUs	PTCCSs					
Managerial staff	5	7	3	n/a	6	7	16
Clerical staff	4	4	3	n/a	4	5	8
Credit / field officers	3	3	3	n/a	7	5	9
Support staff	2	2	2	n/a	3	3	4

8. Financial Performance

Despite efforts to gather information regarding the financial performance of microfinance providers in Sri Lanka, a clear picture in this regard could not be obtained. The situation with regard to the availability and quality of financial information on the different types of microfinance institutions has been presented in the individual chapters in the report. However, in general, the main issues encountered can be summarised as follows:

Lack of transparency. Reluctance to disclose financial information was widespread. The general perception seems to be that keeping this kind of information private represents an advantage over competitors. Donor can play an important role in stimulating more transparency among microfinance providers.

Lack of microfinance specific data. Many of the institutions covered by the survey are not engaged exclusively in microfinance and the majority of them do not gather specific information pertaining to their microfinance operations. This is also true of regulated and supervised microfinance providers, such as RDBs, banks and other financial institutions, for which overall financial information is periodically published.

Poor data quality. Even when microfinance specific data was available and was disclosed, there were serious quality issues. This was especially the case with smaller institutions – some CRBs, TCCSs and NGOs.

Lack of comparability. Even when financial data was available, a lack of standardisation in the classification of financial data and different definitions of certain concepts made the computation of financial performance indicators of little practical value, as they lacked comparability.

We conclude that there is substantial room for improvement in the processes of financial data collection, monitoring and disclosure in the microfinance sector in Sri Lanka. All stakeholders should commit to this objective in order to ensure the long-term viability of the sector.

Conclusions

From the information gathered in the survey, a complex, yet fragmented picture of the microfinance sector in Sri Lanka emerges. The outreach of microfinance services, especially savings and deposits is considerable, financial services being often accompanied by non-financial facilities. Access to loans remains under its potential, with barriers remaining for the lower income groups. The microfinance market seems to be characterised by a proliferation of traditional products (savings, loans) and little innovation. The growth of the microfinance sector is hampered by the lack of a coherent regulatory and supervisory framework, governance issues, inadequate use of modern technology and staff related issues.

Main strengths

Extensive geographical coverage. Microfinance providers have an extensive network in the country with over 10,800 outlets covered during the present survey. The SANASA movement has the largest number of active outlets, followed by NGOs (with over 2,000 CBOs affiliated to SEEDS). The largest share of these outlets is found in the Southern Province and in the rural sector.

All groups of institutions with the exception of banks and other financial institutions display strong correlations between the sectoral distribution of outlets and poverty distribution. The tightest correlation between the regional distribution of outlets and poverty distributions is displayed by CRBs, followed closely by SBSs and TCCSs. Therefore it seems the outlet network of the co-operative sector, as well as that of the Samurdhi programme is in a good position to reach the country's poor. A surprisingly low degree of correlation is displayed by NGO MFIs, a situation which can be explained by the high concentration of this sector in the Southern and North-Central provinces compared to their corresponding PBPL share, and the low presence in provinces with high poverty incidence such as Uva and Sabaragamuwa.

Traditional microfinance products are offered by a large number of MFIs. Although microcredit is an important component, a broader range of financial services is offered such as savings, pawning, leasing, and insurance and pension products. All SBSs, TCCSs, CRBs, RDBs and banks, as well as 89% of the NGO MFIs and 60% of finance companies offer savings and deposit products. All SBSs, TCCSs, RDBs and banks, as well as 99% of CRBs, NGOs and 80% of finance companies offer a wide range of loan products. Pawning is offered by all RDBs, 82% of CRBs, 71% of banks and 40% of finance companies, while leasing and insurance products represent only niche products except for the finance and insurance companies, respectively. The microfinance market seems to be characterised by a high degree of competition, especially in the savings and deposits segment.

Credit-plus services. A large number of microfinance providers (95% of NGOs, 92% of CRBs, 86% of TCCSs and banks, 83% of RDBs and 64% of SANASA secondary unions) have stated they offer complementary non-financial services to their microfinance clients. These services mainly include training and skills development, financial advisory services, group formation and mobilisation, business development services and marketing assistance.

Significant savings culture. Microfinance providers covered by the present survey have reported a total of over Rs. 126 billion in volume outstanding of savings and deposits and over 26 million savings accounts. While these figures are likely to be slightly overestimated since some of the respondents have included all small size savings irrespective of the income of the saver, they nevertheless point to a significant savings culture in Sri Lanka.

Major challenges

For microfinance providers

Outreach to the lower income groups. Only a small share of the microfinance clients falls within the definition of lower income groups, even though a large majority of microfinance providers mentioned that they specifically target this group. Even in the case of NGO MFIs, only half of their clients have a monthly household income not exceeding Rs. 3,000. This group of borrowers accounts for 25% of the clients of CRBs, 20% of the clients of SANASA TCCSs and 19% of the clients of RDBs. As expected, banks and other financial institutions involved in microfinance have the lowest outreach among the poorest layer of clients: only 7% of their customers have a monthly household income below Rs. 3,000. The same ranking in terms of outreach to the lower income group is maintained even if the threshold income level is raised to Rs. 5,000.

Expanding lending activity. Many microfinance providers focus extensively on savings and do not fully exploit the resources thus mobilised to extend credit to finance the income generating activities of their microfinance clients. The ratio of loans to savings is one to 2.6 in terms of volume outstanding and one to 5.9 in terms of number of accounts. If the number of clients is considered, excluding the number of loan accounts of CRBs (since client information for this group was not available), the proportion of loan accounts to the total number of clients is extremely low (one loan to every fourth client).

The causes behind this situation remain largely unknown and a subject for further research. Possible explanations for this situation could be a shortage of deposit funding due to legal restrictions coupled with reduced donor funding in the case of certain institutions (such as NGOs) coupled with the investment of the savings received by large deposit takers (such as CRBs, SBSs) in other activities besides lending. Some respondents have also mentioned the low absorption capacity of the target group for such loans. Despite microcredit being essentially a non-collateralized lending business, the survey found that many providers of microcredit do impose collateral and other conditions which can have a restrictive effect on the utilisation of the credit facilities on offer.

Bring innovative products to the market. The Sri Lankan microfinance market seems to be to a certain extent conservative, focusing more on the proliferation of variations of the same traditional products, lacking innovative approaches which could overcome the inherent barriers in access to microfinance.

Staff recruitment and retention. Most of the microfinance providers covered by the present survey have reported difficulties in recruiting and retaining experienced staff. The absence of retirement benefits, inadequate remuneration and incentives, operating in unattractive locations, mostly lacking modern technology, as well as the difficult nature of field operations, were mentioned as reasons.

Financial performance monitoring. The majority of the microfinance practitioners interviewed do not have an adequate mechanism in place to monitor the financial performance of their microfinance activities. A considerable number of them do not keep separate records for their microfinance activities, or if they do, not all microfinance related costs are attributed to the activities which have generated them. The lack of comprehensive performance monitoring is a significant barrier to the achievement of long term sustainability.

Governance. Interference of political interests in the appointments of Directors and senior management and in the day to day management of MFIs can endanger their viability. This is particularly applicable in the case of government owned/controlled microfinance providers. Furthermore, microfinance activities in the case of a large number of institutions are intertwined with other types of activities (CRBs with the activities of Multi-Purpose Cooperative Societies, SBSs with welfare schemes, NGOs with social activities), which can result in conflict of interests and objectives.

For policy makers

Regulation and supervision of microfinance institutions. The absence of a coherent regulatory and supervisory framework for the microfinance sector represents a barrier to its development. A number of issues can be identified:

- Coverage is not comprehensive. A large group of microfinance providers (NGOs) escapes financial regulation and supervision. Since most of the NGOs mobilise savings either directly as deposits or disguised as member shares, they should be monitored by an external independent authority in order to protect the interest of depositors.

- Not always independent. The government microfinance scheme (Samurdhi) is self-regulated and self-supervised. In the absence of an independent regulator and supervisor the scheme risks being used to pursue political objectives to the detriment of long term sustainability and sound financial development.

- Dispersed responsibilities. A number of different authorities (Central Bank of Sri Lanka, Department of Cooperative Development, Samurdhi Authority etc) are responsible for the regulation and supervision of various microfinance providers. Considering that all these groups offer similar products targeted at the same market, the lack of coordination and coherence of measures can result in considerable distortions of the competition.

- Doubtful quality. International best practices regarding regulation and supervision are not always adhered to, especially in the case of the cooperative sector.

- Not adapted to microfinance specificities. The existing regulatory and supervisory framework has been created with a broader view of financial services and is not adapted to microfinance specificities. The need for a coherent regulatory and supervisory framework adapted to the necessities of the microfinance sector is vital.

- Lack of visibility (awareness). A surprising finding of the survey is the lack of knowledge among respondents (representatives of senior and middle management of the MFIs interviewed) regarding their regulatory status and the responsible authority for regulation and supervision of their operations.

Sectoral strategies and policies. The microfinance sector in Sri Lanka is characterised by significant fragmentation and lack of coherence. The operating MFIs, especially in the cooperative sector, have a large unexploited potential which could be channelled in the right direction through the adoption of an articulate development strategy.

International best practices. In terms of governance, portfolio management, human resource management and financial performance monitoring, standard international practices are not observed in the case of a large majority of the microfinance providers. Policy makers should focus on creating the right incentives for the adoption of such best practices.

For donors

Support transparency and information disclosure. One of the main difficulties encountered in conducting the survey for this report, was the reluctance of microfinance providers to disclose even non-sensitive information about their operations. Most MFIs are not willing to share any information among themselves, even when they are not direct competitors. Donors can play an important role in stimulating transparency in the sector.

Support access to technology. The lack of information is also a consequence of the lack of modern technology in a large proportion of microfinance providers. Member-based societies such as SANASA TCCSs and CRBs almost entirely lack access to modern communication technologies (email, internet facilities). Together with the lack of language skills among staff this represents an important barrier to best practice dissemination within the sector.

Support capacity development measures. Microfinance practitioners have often mentioned staff related issues among the challenges faced. The minimum education and experience requirements are low for most MFIs. A large proportion of the microfinance staff does not have the necessary language skills and access to technology in order to be informed on international best practices.

This report aimed to fill the information gap in the sector and to shed more light on the supply of microfinance services in Sri Lanka. Its broad coverage of the sector makes it a useful tool for all stakeholders. However, the present report has several limitations:

- An important area which could not be covered despite our best efforts was that related to the financial performance of the sector. Financial information could either not be obtained from the respondents or, when obtained, it was not usable (no microfinance specific information or low quality of data).

- For the SBSs the interview was conducted at the Samurdhi Authority level, which makes comparison with information obtained at a more decentralised level (e.g. for SANASA, CRBs) difficult.

- In the case of the SANASA movement, the information available at secondary union level (especially quantitative information) was limited. Most TCCSs do not report client and product data to secondary unions.

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