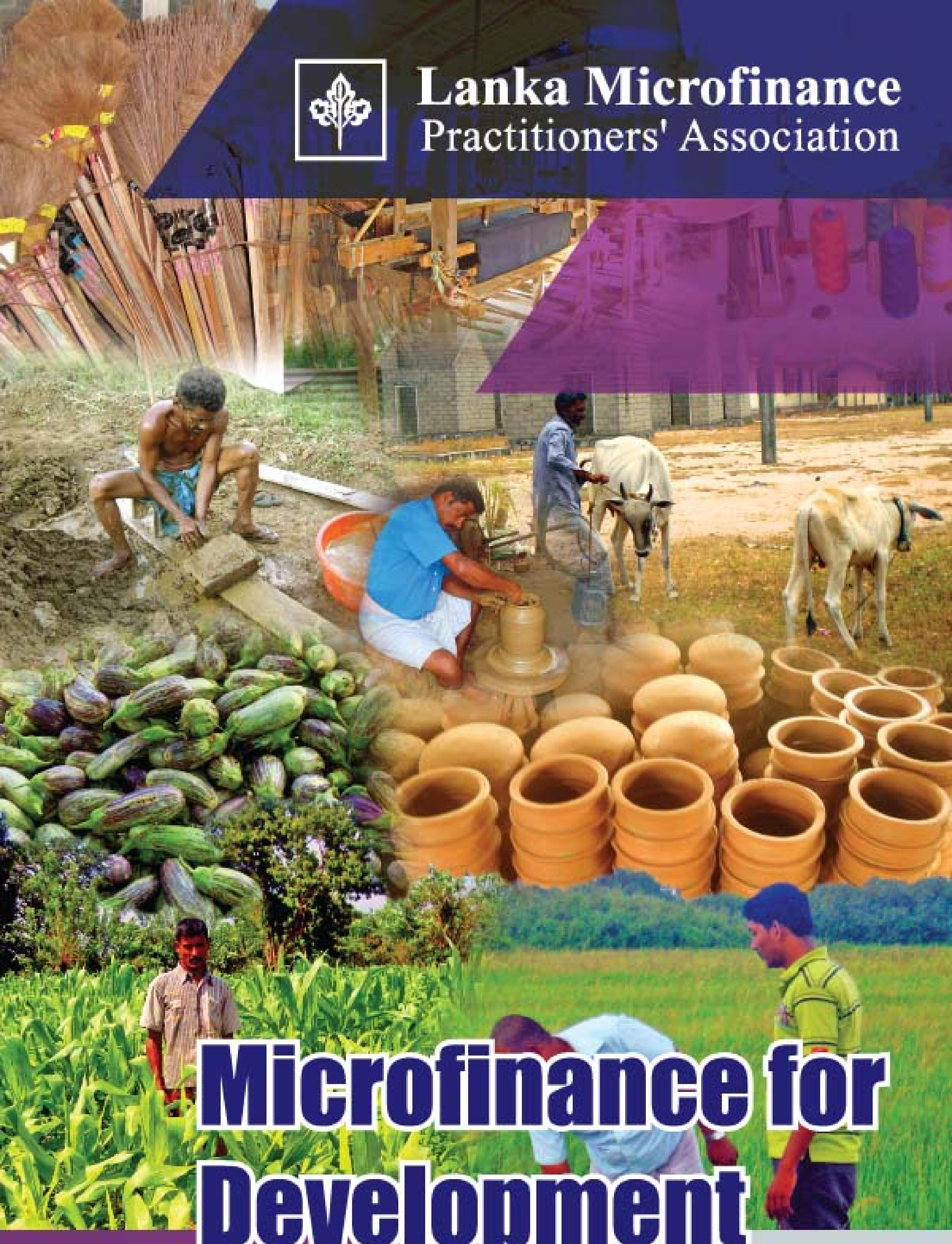
Lanka Microfinance
Practitioners' Association



Microfinance for Development & Equity

Foreword

The Microfinance sector of Sri Lanka has gone through many changes over the past three decades. What started off as a research project in mid 1970's has now turned into a bustling industry. Many financial institutions are now expanding their outreach into the microfinance industry. The concept of Microfinance, however, eludes the knowledge of many people whose perception of it remains as simply financial lending to the poor.

This booklet aims to address that question by introducing the reader to what the role of microfinance is all about in general and in the Sri Lankan context. It highlights the present institutional structure, the national network as well as the general performance of microfinance practitioners.

Another important aspect that this publication wishes to catch the reader's attention is on the regulatory system of the microfinance sector of Sri Lanka which has been a highly sought topic for discussion of late. There had been many discussions among key stakeholders of the sector on the importance of implementing a sound regulatory system for microfinance yet proper action with regards to same being elusive. As the representative body of the microfinance practitioners' of Sri Lanka, Lanka Microfinance Practitioners' Association (LMFPA) sought to address the key issues with regards to this pressing need and hope that this booklet will further enlighten stakeholders who are lobbying for the implementation of a regulatory framework for microfinance. This will be in line with the vision of the Mahinda Chintana manifesto; and LMFPA highly acknowledges and appreciates the involvement of the Finance Minister, His Excellency the President Mahinda Rajapaksha to develop the microfinance sector of Sri Lanka.

I take this opportunity to thank Mr. M. M. Attanayake, Treasurer of LMFPA who was the key backbone behind developing this booklet. I would also like to thank Dr. Nimal Fernando who was kind enough to give his valuable comments on an earlier draft and Dr. G. Uswetarachchi who assisted in editing the booklet. I also extend my appreciation to the board of directors of LMFPA who looked at the draft and the publication of this document. I wish to extend a special thanks to Plan Sri Lanka for providing necessary funding to make this publication a reality.

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Introduction

Microfinance is an effective development tool to reduce poverty and empower the poor and the economically and socially vulnerable segments of a society, especially women. This recognition has transformed what was begun as a small scale action research in a remote village in Bangladesh in the mid 1970s into a global financial service industry targeted at the poor and low income households and their micro enterprises. Policy makers and central bankers pay increasing attention to this new phenomenon in financial markets and to assist Microfinance Institutions (MFIs) to become important players in the industry. Yet, there are many issues to be resolved in this endeavour. Many of these issues vary across the countries, but some appear to be common. One such common issue is establishing a regulatory and a supervisory system that supports and guides the healthy development of the sector, including MFIs. This is a challenging task because the regulatory system needs to fit the specific characteristics of the micro finance market and the heterogeneous nature of the MFIs.

Many countries have taken initiatives to provide a legal framework with the objective of creating a more conducive environment. The success of this task depends, in general, on the extent to which the policy makers understand the industry characteristics. The different nature of microfinance has been repeatedly emphasized by the Nobel Laureate Professor Mohammad Yunus in Bangladesh, the founder of the world famous Grameen Bank in 1983.

The purpose of this booklet is to help Sri Lankan policy makers to get a better understanding of the microfinance sector and the issues that prevail in it. Such an understanding will enable the policy makers to design and implement policies that are more conducive to the sustained development of financial services for the poor and to provide them with opportunities to achieve better and tangible results in their quest to escape from poverty.

This booklet briefly discusses the role of microfinance in poverty reduction, highlights the historical evolution of the microfinance industry in Sri Lanka, the current institutional structure and the sector's achievements. The section on government policy towards development of the microfinance sector in Sri Lanka is followed by a discussion on the issues, particularly issues relating to the introduction of a regulatory system and some conclusions.

Role of microfinance in poverty reduction

Microfinance refers to a diverse range of financial services that target the poor and low income clients who lack access to such services from banks and other conventional financial institutions in the formal sector. These clients are unable to meet the stringent collateral and other conditions imposed by those institutions. A specific characteristic of microfinance services such as credit, savings, payment facilities, insurance etc. is the small-scale of each transaction compared with financial services generally provided by conventional formal financial institutions.

For millions of poor and low income people all over the world, microfinance offers opportunities for improving their livelihoods and family welfare while reducing financial vulnerability. Access to financial services at reasonable prices enables the poor to take advantage of economic opportunities, to build assets and to reduce their vulnerability to external shocks that adversely affect their living standards. The poor do not have much money and precisely because of this they need access to financial services much more than other households.

MFIs provide innovative financial services that match the specific needs of the poor clientele for them to earn, save, and invest in their own chosen ventures. Availability of micro loans to low income people, for example, removes the constraints to access to productive capital. Access to capital helps them to get out of the vicious cycle of poverty caused by low income and resultant low investments to a cycle of more income and more investment.

Cross country microfinance experiences have dispelled some myths relating to financing the poor. The traditional belief has been that the poor is not bankable. This belief has led traditional financial institutions to neglect financing the poor. The other myths are that the poor do not have the skills to make effective use of capital and hence they cannot afford market rates of interest on loans and therefore they should be helped out by offering below market subsidized interest rates. Actual experience in many countries, however, is that the poor are bankable, trustworthy clients, and they have the skill to run business to increase their income with the effective use of credit. They pay up their loans on time regularly. Data show that their repayment records are much better than those of the rich people in general.

Microfinance clients save and borrow in small amounts and cost effective methodologies are being used by the MFIs with suitable financial products. Microfinance services result not only in improving the economy of the poor but also their social standing, nutrition, education, enterprise, growth and stability. Microfinance has also been proved to be an effective means of reaching targeted vulnerable groups including women.

Dominant financial services provided by MFIs are micro credit and micro savings. Savings need to be collected with minimum transaction cost to the saver. Money has to be safe and withdrawals have to be easy. Micro savings enable the poor to save what they can save, even in small amounts, to cope up with irregular incomes and emergencies and protect them from slipping into periods of real deprivation. MFIs, particularly the NGO MFIs, generally require the poor to save in small amounts with a view to inculcating the habit of savings while such savings can also be a form of security for the loans. MFIs offer specific savings products to fit the ability of the poor to save. Loans are to be on trust rather and repayments will have to match their irregular income patterns. A most important aspect is availability of repeat loans for the poor clients to have continuous access to funds.

Microfinance also contributes to the achievement of some of the UN Millennium Development Goals (MDGs), in particular the following:

- halve the proportion of people living on less than $ 1 a day
- provide decent employment to women, men and young people,
- halve the proportion of people who suffer from hunger.

This enhances the value of microfinance as a development tool. MFIs strive to reach the highest number of poor in supporting their livelihoods. Poor women constitute a target group in microfinance operations in consideration of their special characteristics such as lack of mobility due to household responsibilities and taking care of children, their ability to run micro enterprises efficiently and handle financial responsibility. Microfinance improves the decision making role of women within the household and increase self-confidence. Microfinance achieves development and poverty alleviation objectives through wealth creation. Microfinance also creates employment through the micro enterprises. In addition, most people tend to overlook that the MFIs are a significant source of employment to the youth and that a majority of these employees are females.

Microfinance institutions are different from banks and other conventional financial service providers

Micro Finance Institutions differ significantly from banks and other conventional financial institutions in terms of their social mission and the way they provide financial services. To design better policies for microfinance development it is essential to understand these fundamental differences and peculiar characteristics of the microfinance industry.

- Lending is based on trust

The fundamental difference in MFI lending compared to bank lending is that the entire operation is built on the trust rather than taking assets as collateral. The clients do not have assets that can be mortgaged. Trust placed in clients is the prime security for MFI loans. In microfinance it is accepted that the poor is trustworthy and dependable. Microfinance approaches place greater emphasis in developing trust between the client and the MFI.

✦ Innovative methodologies and products

Unlike in normal banking operations, MFIs are compelled to innovate methodologies to achieve the furthest outreach to the poor. In doing so, there are specific challenges to be addressed by the MFIs with adoption of right methodologies. These challenges include:

- Imperfect information about borrowers, which poses a problem for lenders who do not know which borrowers will repay loans;
- Difficulties in enforcing contracts
- High transaction costs of providing financial services

At the same time, demands of the clients have to be met to their satisfaction with appropriate methods and products. Savers expect their savings to be kept in a safe place, low minimum deposits, easy and quick withdrawal, and easy access to the facilities in the neighbourhood. Borrowers expect small loans frequently and promptly at reasonable prices, no collateral requirements for loans, reasonable fees, rules sensitive to the needs of women and the economically vulnerable, and a financial institution managed by people trusted by them and who trust the clientele in turn. In resolving these problems, different methodologies and financial products are developed while ensuring sustainability of the MFI, the provider of these services.

MFIs must take measures to keep transaction costs low. For this purpose, interest on loans must be reasonably low. Fees and charges have to be similarly low. Processing transactions must be fast. The distance from the MFI and the client must be short. The time spent at group meetings must be minimized. These steps will cut down the time spent away from business. Depositors expect low minimum balances, less paper work and fewer restrictions on withdrawal.

✦ Provision of non-financial services

MFIs, through their experience have recognized that poor people need assistance beyond access to financial services, if they are to be truly empowered. Many MFIs adopt what is popularly known as 'credit plus' approaches. Microfinance programmes have been linked to other programmes such as adult literacy and children's education, health education including education on HIV and Malaria, nutrition, financial literacy, language training, legal advice, business training, skills training and leadership training.

✦Emphasis on building networks

Microfinance methodologies emphasize building networks at different levels of operation to compensate for poor information and the absence of assets to be taken as loan security. At the lowest level, there are small groups that depend on mutual-help and working as pressure groups in effective implementation of financial services and maintaining financial discipline among the clients. The small groups are consolidated to village level groups and then to a network of even larger groups. In addition, sustaining the networks through regular meetings, help building social capital that helps the poor in promoting economic prosperity and development.

✦Social Mission

A main difference between general business philosophy and that of microfinance business is that microfinance has an in-built social mission to achieve, in addition to purely financial objectives. The achievement of the social mission of MFIs is evaluated through a set of social performance monitoring indicators. These indicators reflect achievements in:

- Serving increasing numbers of poorer and more excluded people in a sustained manner,
- Improving the quality and appropriateness of financial services available to targeted clients through systematic assessment of their specific needs,
- Creating benefits for clients, their families and communities in terms of increasing social capital and assets, income and access to services,
- Reducing clients' vulnerability to shocks and emergencies,
- Improving the social responsibility of MFIs towards their clients and its employees, and community it serves.

Microfinance Experience in Sri Lanka

Historical evolution

The first attempt to provide microfinance services through an institution was the introduction of Thrift and Credit Cooperatives in 1906. The movement thrived during the early decades mainly due to government sponsorship, but later failed to make a significant impact on rural financial markets. The movement was revamped in the 1980s and now has developed into a widespread network of village level societies operating all over the country. During the period from 1947 to 1990s government took many initiatives to provide rural finance by creating new institutions and by introducing government sponsored rural credit programmes most of which were characterized by subsidized interest rates.

The first rural finance programme of the government was the agricultural loans programme introduced in the late 1940s to provide subsidized credit to small farmers for the cultivation of paddy, and the scheme was implemented through several government departments until 1967. In 1967, this programme was modified with the involvement of the Central Bank. The Central Bank began to provide refinance facilities for the programme and credit guarantees. The responsibility for implementing the programme was entrusted to the Peoples Bank through its branches and the Cooperative Rural Banks created in 1964 which themselves operated under the guidance of the Peoples Bank. The scheme was renamed as Comprehensive Rural Credit Scheme and further expanded in 1973 by including many short term crops other than paddy. The Bank of Ceylon also came into the picture by implementing the cultivation loans programme through its sub-offices in Agricultural Service Centres, the specially created network of offices to extend credit to farmers. Later, the Hatton National Bank, and some other private sector banks started implementing the cultivation loan scheme. The scheme is implemented by the banks even today without Central Bank refinance and credit guarantee but with an interest subsidy from the government.

The Central Bank took leadership in 1980s and 1990s to expand rural credit programmes by introducing medium and long term rural credit programmes to promote the development of non- farm activities, cultivation of long term crops, animal husbandry, and self employment activities. These loan schemes too were characterized by subsidized interest rates. Refinance facilities and credit guarantees were provided to persuade banks to implement these programmes. Funds for lending under many of these programmes came from international organizations including the Asian Development Bank and the World Bank. A dominant feature of these credit schemes was that they were supply-driven, meaning that credit essential for rural development has to be provided on concessional terms to stimulate targeted activities.

There was a marked change in approach to rural finance when the Janasaviya Trust Fund (JTF), backed by the World Bank, was introduced in early 1990s. Under this approach, for the first time, the JTF introduced partnerships with non- bank microfinance institutions. A large number of NGOs embarked on commercial microfinance business and prospered with affiliation to JTF that provided other assistance to build the capacity of the partner MFIs as well. Sarvodaya SEEDS is one such organization that prospered to a national level commercial MFI in this conducive environment. Later JTF became the National Development Trust Fund and an important source of wholesale microfinance to the sector. Presently it operates under the Sri Lanka Savings Bank. Another important land mark is the introduction of the Small Farmers and Landless Credit Programme, widely known as Isuru Programme in 1991. Isuru Project was a deviation from subsidized rural credit programmes and it was a commercial microfinance programme implemented through NGO microfinance institutions at the grass-roots level. Another, feature was that the programme assisted in developing human resources and other needs of the MFIs for them to develop into sustainable and commercially viable institutions.

The government also took initiative to create an institutional structure for implementation of rural credit programmes. Cooperative Rural Banks (CRBs) were created in 1964 to provide a full range of financial services including savings, loans and pawning facilities. In 1985 Regional Rural Development Banks (RRDBs) were established and these banks have now been consolidated to one national level bank, namely Regional Development Bank. Samurdhi Banks were created to serve exclusively the poor. Later, there were sector specific institutions created to implement rural credit programmes and such institutions included Farmers' Banks and Fisheries Banks. The Central Bank opened up Regional Offices to support the banks to implement rural credit programmes. Rural Banking and Staff Training College was established for training staff in rural credit. The Central Bank also created a separate department (Rural Credit Department) to develop rural credit policies and programmes and to coordinate the implementation of rural credit programmes.

Since the 1990s, there has been a rapid increase of private sector commercially oriented NGO MFIs all over the country with large inflows of subsidized funds from international donors. These MFIs drew lessons from international best practices of microfinance in providing financial services to the poor. The local funders for the growth of these MFIs included National Development Trust Fund, Isuru Project and the local offices of international organizations such as Stromme Foundation and Etimos Italy. There were international funders also entering the microfinance market to provide funds to all types of MFIs, including NGOs and SANASA Development Bank. Recently, many finance and leasing companies have also entered the microfinance market with ambitious expansion plans.

Present Institutional Structure of the Industry

Multiple types of MFIs are operating under different legal status

Microfinance sector in Sri Lanka is served by a range of institutions following different methodologies. These institutions are governed by different laws. Further, these MFIs are in different stages of development and their operational areas differ from a small locality to the entire country, operating with a large network of branches and regional offices.

Cooperative Rural Banks

These banks operate mainly in rural areas and focus on providing savings and loan facilities. They have been more effective in mobilizing savings. Their loan portfolios are dominated by pawning loans. These banks have a client base of 6.5 million, but all of them may not be active clients. According to the Central Bank Annual report 2011 there were 2019 CRBs and branches with deposit accounts totalling to 8.9 million with Rs.62,637 million worth of deposits. There were 1.89 million loan accounts with a total loan balance of Rs.38,278 million. Accordingly, the average deposit and loan balances worked out to be Rs.7,036 and Rs.20,281, respectively.

Thrift and Credit Co-operative Societies

These are community-based financial institutions operating at village level. They are affiliated to district and national level federations. They grant loans only to members but deposits are accepted from non-members as well. The total number of societies as of end 2010 stood at 8440 but the number of active societies may be much smaller.

In addition, there are other cooperative societies namely, farmers' cooperatives and fisheries cooperatives granting loans to their members. The financial services offered by these cooperatives are covered under the Cooperative Law.

Samurdhi Banks

Samurdhi banking societies operate all over the country under Samurdhi Banks Law of 1995. They provide financial services to beneficiaries of the Samurdhi Development Programme introduced in 1995, replacing the Janasaviya Programme. According to the Samurdhi Authority Website, at the end of 2011, there were 1042 banks with More than 2.5 million members. Their total savings and loans stood at Rs.41 billion and Rs.11 billion, respectively in 2010.

Licensed Specialized Banks

These banks are licensed to offer financial services by the Central Bank. Two such banks engaged in provision of microfinance services are Regional Development Bank and the SANASA Development Bank. The National Savings Bank also provides micro saving facilities to the public. The post office outlets of the NSB facilitate the savings of low income persons to save in small amounts. The Government introduced the Regional Development Banks under a special act and starting from 1985, 17 Regional Development Banks were established on district basis. In 1998, they were consolidated to 6 banks and in 2010 they were merged to create one national level bank. SANASA Development Bank serves a large number of Primary Thrift and Credit Cooperative Societies (PTCCSs) and has grown into a provider of many financial services to clients directly as well as through PTCCSs.

Commercial Banks, Finance Companies, and Leasing Companies

This category includes commercial banks; registered finance companies; and leasing companies which offer some microfinance services. These institutions operate under licence issued by the Central Bank. Among the banks, government owned Peoples Bank and Bank of Ceylon are the main microfinance providers and they operate cultivation loans programme and other government sponsored programmes mainly, through a large number branches established in rural areas. In the Private commercial banking sector, Hatton National Bank has been playing an important role in microfinance. Recently several other private commercial banks have begun to pay more attention to microfinance services. The most recent development is the surge of interest in microfinance within finance companies. However, there are yet no hard data on the extent of their microfinance operations.

NGO-MFIs

This category includes NGOs engaged in microfinance business and MFIs formed by international and local NGOs as separate microfinance entities. In addition, companies limited by guarantee, public companies, and private companies also fall under this category. Since late 1980s there have emerged several such microfinance institutions but many have combined microfinance with social and community development work. Since about the late 1990s microfinance activities have come to be separated from community development work and MFIs involved in only microfinance have emerged to promote microfinance based on financial and operational efficiency. The number of NGO-MFIs outlets is more than 3750 according to the Central Bank[1]. One distinguishing character of these MFIs is that they are more focused on targeting the poor and women as their clientele. The total number of active borrowers of 49 major MFIs is around 1.4 million[2]. These MFIs operate under different legal identity. Some are Public Limited Liability Companies, some others operate as Guarantees Companies. In addition there are MFIs operating under the laws such as Voluntary Social Service Organizations (1980) and the Societies Ordinance.

1 Presentation by Director of supervision of Non-Bank Financial Institutions on 'Responsible Finance' at the LMFPA seminar on 23.08.2012
2 Microfinance Review Sri Lanka 2011; p 22

It is often thought that NGOs and the non- bank MFIs are the same because they have some element of community development. However, there is a clear difference between the two. NGOs are not necessarily MFIs. MFIs provide financial services to the poor while NGOs concentrate on community development through other means. The MFIs are concerned about two major aspects; namely outreach and sustainability. They have to earn sufficient profits to attain financial and operational sustainability, though their objective is not profit maximization. Community development oriented NGOs mostly depend on donor assistance for their operations. MFIs have to raise funds from the market by way of savings from clients and loans from other sources in the market.

Lanka Microfinance Practitioners' Association (LMFPA)

LMFPA is the networking organization of MFIs. There had been substantial growth in MFIs industry from the mid 1990s, all over the country. They were operating in isolation because there was no umbrella institution to provide coordination among them. There emerged a need for a networking body in the microfinance industry as in many other countries. This need was met through the establishment of the LMFPA in 2006. The principal activities of the network are advocacy and lobbying on issues affecting the sector, creating an environment conducive for sustainable microfinance, and building capacity in member MFIs. The LMFPA is the only network of MFIs in the country. It is a Guarantee Limited Company registered under the Companies Act No.7 of 2007. Presently, its membership includes 74 MFIs. The objectives of the LMFPA are as follows:

- To promote membership among microfinance institutions who provide financial services to the poor for alleviating poverty in all parts of Sri Lanka
- To advocate for a policy environment that is conducive to the growth and development of the microfinance sector through collective action by micro finance institutions and other stake holders.
- To promote adoption and installation of internationally accepted performance standards in microfinance institutions.
- To develop and strengthen systems of information collection, analysis and dissemination through electronic and print media.
- To promote the expansion of the formal financial markets as micro finance services.
- To protect and strengthen the capacity of micro finance institutions to deliver appropriate and sustainable micro finance services to the economically active poor through co-ordination and organization of lateral learning workshops, theoretical debates and linkages with other organizations.
- To develop and operationalize an independent performance monitoring system for
- MFIs that will set standards and increase professionalism in the microfinance industry.
- To mobilize resources and to network with government, donors, funding agencies, investors and commercial loan providers in order to strengthen the development of the microfinance sector.

LMFPA provides coordination for MFIs locally as well as internationally. It is the apex level body in the microfinance sector which works to improve it.

Performance of MFIs in Sri Lanka

Number of microfinance institutions

A study carried out by a team of microfinance experts in 2006 estimated that there were over 14,000 providers of microfinance. These include the network of 8,424 SANASA societies. However, it is believed that more than 50% of these societies remain inactive. In reality, therefore, the number of active providers of microfinance is probably less than 14,000. An island wide survey of microfinance institutions commissioned by GTZ- ProMis programme in 2006/2007 revealed a network of at least 10,000 active outlets across the country. The total number of MFI outlets, according to the Central Bank is more than 16,500[3].

Reaching out to the poor

A prime objective of the microfinance industry is to reach the highest number of poor and low income families who have limited or no access to financial services from banks. In Sri Lanka, the number of people served by NGO- MFIs and the SANASA Development Bank is estimated to be more than 1.4 million. This figure does not include the clients of primary thrift and credit cooperatives.

The sector-wise data on MFI clients shows that, most microfinance clients are in rural areas. According to a study by GIZ ProMiS (a microfinance development project funded by the German government and implemented in association with the Ministry of Finance of the Sri Lanka Government), 90% of microfinance clients are from rural areas. However, there is a dearth of microfinance providers in Estates where no more than 1% of MFIs operate[4]. The same report revealed that the MFIs have mostly granted loans to poor clients and have not reached the majority of the poorest. Particularly, the private sector MFIs grant more than half of their loans to poor persons who earn less than Rs.3,000 per month. Some 82% of the loans have been made to those who earn less than Rs.5,000 per month.

Income profile of microfinance clients

MFI	Monthly income					
	<Rs.3000	Rs.3000-5000	Rs. 5000-10000-	Rs.10000-20000	Rs.20000-40000	>Rs.40000
RDBs	19.3%	18.3%	24.4%	28.3%	7.5%	2.3%
SBSs	85.0%*					
SANASA/PTCCSs	20.1%	29.4	26.3%	14.7%	5.3%	4.3%
Other MFIs	50.4%	31.5%	13.3%	3.0%	1.6%	0.3%

(Table 06 on page 17 of Microfinance Industry Report 2009)

* *Figures for other income categories are not given*

3 Presentation by Director of supervision of Non-Bank Financial Institutions on 'Responsible Finance' at the LMFPA seminar on 23.08.2012

4 GTZ; BWTP- Microfinance Industry Report Updated edition 2010; p17

(RDBs – Regional Development Banks; SBSs – Samurdhi Banking Societies; PTCCSs – Primary Thrift & Credit Co-operatives Societies)

The geographical outreach of microfinance outlets shows that they are present all over the ountry with some concentration of MFIs in the Southern Province with least presence in the North Central province. After the end of the war, MFIs and banks have begun to expand into the war affected areas.

Number of MFI Outlets by province: percentage spread by province

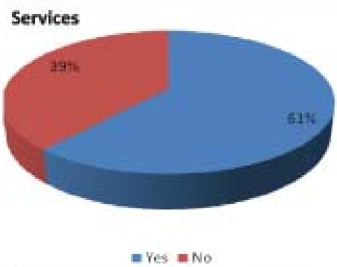
Western Province:	12.2%	Uva Province:	10.8%
Central Province:	10.1%	Sabaragamuwa Province:	11.2%
Southern Province:	24.0%	Northern Province:	5.2%
North Western Province:	10.2%	Eastern Province:	12.3%
North Central Province:	3.9%		

[Figure 01 - MF outlets by province - Microfinance Industry Report 2009 p.15]

Provision of non-financial services

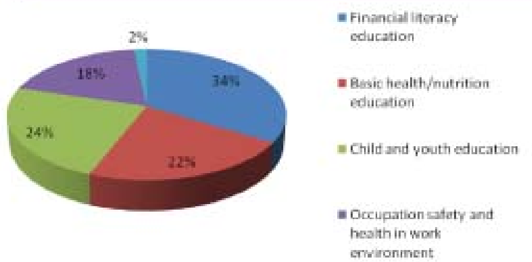
According to the LMFPA's Microfinance Review – Sri Lanka -2011 (p.42) majority of non-bank MFIs offer enterprise development, educational, health, and women's empowerment services to their clients.

Figure 46: Offering Educational Services



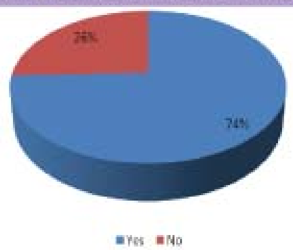
Source: LMFPA Data Collection 2011

Figure 47: Different Educational Services



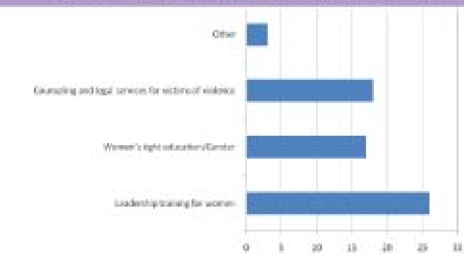
Source: LMFPA Data Collection 2011

Figure 48: Offering Women Empowerment Services



Source: LMFPA Data Collection -2011

Figure 49: Type of women's empowerment service



Source: LMFPA Data Collection 2011

It is believed that these non-finance services contribute effectively to improve the welfare of the clients. For example, increased awareness of business practices increases the return on capital provided by the MFI and reduces poverty while increased awareness on health reduces the household expenses on health, increases productivity in family business and improves household standards of living. Further, credit plus services reduce the risk of mis-utilization of credit and increase borrowing capacity. In empowering women economically and socially these non-financial services can be of immense value because women are usually at a disadvantaged position economically and socially.

Number of clients

There is no comprehensive information about the number of clients served by MFIs. Even available limited data are of questionable quality. There can be overlapping and multiple account ownership. According to the Microfinance Review of LMFPA the number of clients of 49 major MFIs was about 1.4 million[5], not including SANASA Federation, Co-operative Rural Banks, Samurdhi, Gamidiriya and other community based microfinance providers such as Farmer Societies and Fisheries Banks[6]. When the outreach of these organizations is also taken into account, it is evident that the microfinance industry serves a large proportion of the poor in the country.

Total loans disbursed

According to Micro Finance Review of LMFPA, the loan portfolio of all MFIs, excluding SANASA Federation and Cooperatives stood at Rs.60 billion in 2010 of which the highest outstanding amounts were reported by the RDB and the SANASA Development Bank (SDB) accounting for nearly Rs.51 billion rupees[7]. Among the others the highest loan outstanding was reported by Sarvodaya SEEDS which accounted for over Rs. 3 billion. These data suggest that most MFIs in the country are small-scale operators.

5 Lanka Microfinance Practitioners' Association: Performance and Analysis Report 2011 p.22

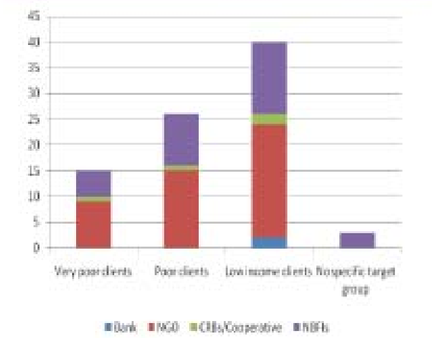
6 If all numbers were added without assuming a percentage for active borrowers the number of clients of all institutions could be as high as 13 million. Ibid.

7 Lanka Microfinance Practitioners' Association: Performance and Analysis Report 2011 p.22

Target groups

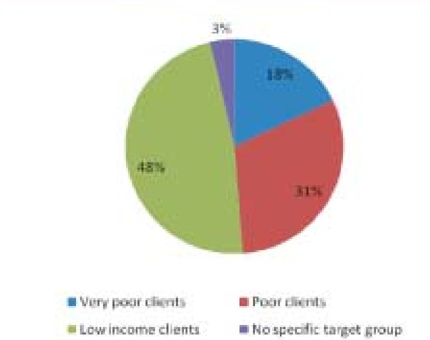
The target groups of MFIs, especially NGO-MFIs are predominantly poor and low income families whose monthly income is below the threshold as defined by each individual MFI. The other factor is that these MFIs mostly target poor women and other economically vulnerable groups mainly in rural areas. Overall, around 72%[8] of MFI clients are from rural areas but here are certain MFIs with 100% of the clientele from among the poor in rural areas.

Poverty level of Clients according to institution type



Source: LMFPA Data Collection-2011

Poverty Level of Clients



Source: LMFPA Data Collection-2011

Female participation

All over the world, MFIs focus more on female borrowers who are the most disadvantaged group even among the poor and Sri Lanka is no exception. In Sri Lanka, 60% of total borrowers are women. However, 23 institutions have more than 90% women borrowers while there are a few MFIs with 100% female borrowers.

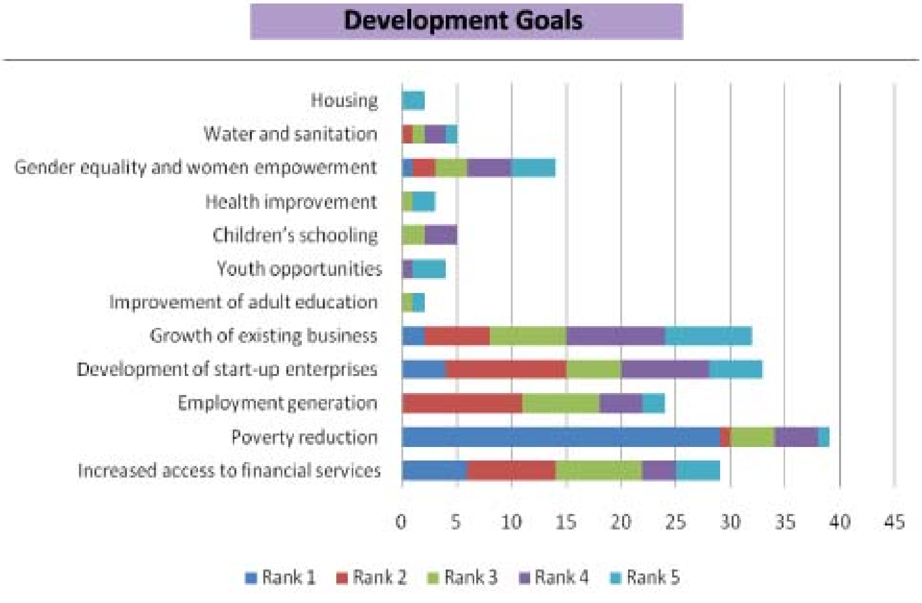
Creation of direct employment

Most people tend to overlook that MFIs are a significant source of direct productive employment to youth. And a majority of the MFI employees are females. The forty nine MFIs that reported to the LMFPA had 12,919 employees as of end of 2010 in different capacities. The percentage of female employees was 59%. In addition, there are large numbers of employees in CRBs, SANASA and PTCCSs. In addition to full time employees the numbers of voluntary workers in SANASA PTCCSs and Unions has been estimated around 66,300 and if the voluntary workers of Gamidiriya and some other entities are included the number may even exceed 100,000.

8 Lanka Microfinance Practitioners' Association: Performance and Analysis Report 2011 p.24

Development goals of MFIs

MFIs address a wide range of development issues by providing financial and non-financial services to the targeted clientele. MFIs have ranked their most common development goals according to their goals. The chart below shows the relative importance of development goals by the number of institutions.



Most MFIs ranked poverty alleviation very high. Financing micro enterprises is seen as a means of poverty reduction. The banks focused on providing increased access to financial services through multiple products such as different savings options, leasing pawning, money transfers and remittances, while NGO-MFIs provided diverse, substantial non-financial services in addition to their focus on providing micro credit facilities.

Regulation of microfinance sector in Sri Lanka

Though there are no specific regulations for the microfinance sector, the MFIs are not completely unregulated. There are certain MFIs, particularly those governed by statute which are subject to some kind of regulation. For example, microfinance operations of commercial banks, licensed specialized banks and finance and leasing companies are regulated by the Central Bank. The operations of Samurdhi Banks are governed by the Samurdhi Authority of Sri Lanka; the CRBs are regulated by the Department of Co-operatives. The extent, methods and standards of regulation and supervision vary significantly depending on the type of law governing regulation of these institutions. There is yet no system of regulation of activities of NGO- MFIs other than the Companies Act which sets out general requirements for all companies registered under the Act.

Government policy

Though the government was supportive of promoting microfinance services by way of creating institutions and implementing government sponsored programmes, there is no specific national policy for the microfinance sector. There is no mechanism to coordinate microfinance activities with other policies aimed at promoting poverty alleviation and rural development. The Mahinda Chinthana Programme[9] recognizes the need for a national policy and strategy. The Mahinda Chinthana document stated that "the absence of a unique policy and supervisory framework has allowed the proliferation of fundamentally unsustainable MFIs, which weaken governance, diminishes the institutional autonomy, exacerbates the lack of enforcement of financial prudence and does not provide for transformation of MFIs and NGOs into depository institutions or recognize their savings activities." While recognizing the need for a policy the Mahinda Chinthana document further states that "Sri Lanka will have a flourishing and strong microfinance sector in the next decade. It will involve the provision of sustainable and poverty focussed financial services, which include loans to micro and small entrepreneurs as well as to poor households for their variegated needs. The mobilization of savings, facilities for money transfers and insurance services will also be undertaken in an effective and efficient manner. "[10] In line with the stated government policy, the Cabinet of Ministers has already recognized the importance of introducing legislation for microfinance development.

9 Mahinda Chinthana: Vision for a New Sri Lanka p.129

10 ibid

Issues relating to microfinance industry in Sri Lanka

There are several major issues relating to the microfinance industry in Sri Lanka and they are inter-related. These issues are related to interest rates of MFI loans, deposit taking and sustainability of MFIs, microfinance policy and a regulatory system.

The interest rates on lans by MFIs

Of all the issues faced by MFIs, interest rates charged by MFIs on their loans are probably the most talked about and dominant issue. Many people who are not familiar with microfinance industry operations generally assume that MFIs charge very high interest rates on their loans and hence are not different from loan sharks. This is not in line with reality. First, interest rates charged by MFIs are much lower than what is charged by commercial money lenders in informal markets. Second, MFIs serve a different and high-cost market segment generally overlooked by banks and most other formal financial institutions.

Interest income is the most important source of income for MFIs. Therefore, setting loan interest rates is a very important aspect of microfinance business. MFI interest rates on loans are high because the per unit cost of providing the larg number of these small loans is higher than the cost of making a few large loans. The operational cost of loans is generally high due to the high personnel cost and administrative costs. Micro lending is a labour intensive operation and therefore a large cadre of field officers has to be deployed. Field officers visit villages regularly for the purpose of making it easier for the client and to minimize their transaction costs. For the MFI it means high operating costs. The price of the loan or the rate of interest should be high enough to cover these costs and earn a margin sufficient to expand on a sustainable basis as in any other business.

Larger commercial banks have lower administrative costs per loan. Their average loan size is much higher than that of an MFI. The administrative cost of a one million rupee loan is proportionately much lower to that of a 10,000 rupee loan granted by an MFI. Secondly, the commercial banks have access to large volumes of cheaper funds including public deposits mobilized at lower deposit rates which enables them to offer lower lending rates. The MFIs are unable to mobilize public deposits due to legal restrictions and even if they mobilize savings that will generally be at a higher deposit rate. Thirdly, there are instances where the lower loan interest rates by commercial banks are supported by subsidies from the government and refinance funds at lower rates under various credit programmes. Further, their risks are reduced by the availability of government guarantees against loan default. MFIs do not get refinance facilities, interest subsidies or enjoy the advantage of loan guarantees.

In a scenario where many poor people are excluded from formal financial services the alternative to MFIs would be in most cases money lender's credit. The rates charged by commercial money lenders are several times higher than the MFI loan rates. Besides, these loans are often granted on tangible security such as land, gold, or household equipment, rather than trust. Commercial money lenders generally charge more than 100% per annum. Because of the inability to pay such high rates, many poor people often are unable to take advantage of economic opportunities to make productive investments. This contributes to the persistence of poverty among them.

Despite the relatively higher loan interest rates, poor people need to borrow money to finance the ventures that improve their livelihoods, and a variety of other purposes such as education and medical expenses. Some people question whether poor and low income households can afford to pay the interest rates charged by the MFIs. According to experience all over the world, the answer is 'yes'. For poor people continuing access to credit is more important than the interest cost of the loan. People are prepared to pay higher interest rates for good services such as quick loan disbursement, low transaction cost, flexible repayment schedules, and appropriate loan products. Besides, the types of enterprises financed by micro entrepreneurs generally generate higher returns per unit of capital in relatively short periods of time compared to larger businesses. Therefore, they can pay higher interest on their loans for shorter repayment periods, because the amount paid as interest is small compared to their earnings from the enterprise.

However, if the interest rates of MFIs are abnormally high it might lead to the denial of access to credit by the poor who cannot afford such credit. Only those businesses such as trading, small restaurants, food preparation, beauty salons, growing commercial crops, small garment manufacturing units can generate sufficient profits to afford such credit. Therefore, the medium and long term objective of MFIs should be to gradually lower the interest rates by reducing their operational costs and increasing productivity.

Policy makers may argue for imposing ceilings on micro loan interest rates. An important negative aspect of ceilings is that the MFIs will not be able to recover their costs and generate sufficient profits for their growth and hence refuse to work in high cost markets such as remote rural areas. In such a scenario interest rate ceilings hurt the poor rather than help.

Sustainability of MFIs and deposit taking

In reaching out to a large number of poor clients, the MFIs need to be financially sound and sustainable. They need not only to cover their operating costs but also to make at least a small profit to ensure their continuity. In early decades, financial sustainability was not a key issue as most of the MFIs thrived on grants or subsidized loans provided by international donors or institutions. But with the decline of resources from these sources, MFIs have been compelled to depend on funds in the market, particularly by raising funds through deposits or loans. Financial sustainability has become a key issue for MFIs. To achieve financial sustainability, extremely high loan recovery rates, retention of clients by undisturbed availability of repeat loans, cost consciousness, and high efficiency and productivity have become key factors. A well defined microfinance policy may help to resolve this issue by discouraging the proliferation of unsustainable MFIs.

Provision of micro savings facilities is considered to be a fundamental feature of microfinance. The small savers need facilities to provide safety to their deposits at least transaction costs. They also need to use these monies in a flexible manner when there is need for funds. For MFIs these small savings form a very important source of funds. These savings are collected by introducing various savings products acceptable to the poor. Some of these savings are compulsory savings and others voluntary.

The present legal system in Sri Lanka has created some problems for the NGO-MFIs, in particular. Under the law it is only institutions licensed by the Central Bank that can mobilize savings from the public. However, the NGO-MFIs have been collecting contributions from members and from borrowers as security for loans which are wholly unsecured. These contributions help the borrowers too because they could be used to pay back the loans in the event they face cash flow problems due to unexpected hardship. They could also use the built up funds when they require lump sum amounts to settle the last few loan instalments. The Finance Business Act enacted in late 2011, prohibited accepting any of these contributions as they were also categorized as deposits under the definition of deposits used in the Act. These MFIs had to pay back accumulated contributions and stop collecting new contributions. As result, all of a sudden, a major source of funds for MFIs dried up and they also faced large outflows of funds. The new situation was responsible for the rapid decline of business and profits in MFIs. Regulations that allow these MFIs to collect micro savings is vital to improve their sustainability.

Lack of a microfinance policy

There is no microfinance policy in the country although this issue has been discussed for long years. As a result, there is no mechanism to coordinate the microfinance operations with the other policies aimed at rural development and poverty alleviation.

Lack of a regulatory system

Other financial institutions have specific regulatory system that protect those institutions and provide guidelines necessary for their long term sustainability and development. Absence of such a regulatory mechanism has created many problems for unregulated MFIs.

Importance of a conducive regulatory system

The regulation of microfinance institutions is a widely discussed subject because of the diverse character of these institutions compared to regulated banks and other formal financial institutions. In some countries like Bolivia, Ethiopia, Ghana, Peru, , Pakistan, Vietnam, Cambodia, Tanzania and Uganda there is direct regulation. In some other countries like Bangladesh, Indonesia, and South Africa there is indirect regulation by other institutions. India recently brought legislation before Parliament to establish a regulatory system. The type of regulation differs according to the needs of the country. Regulatory systems enhance the legal status of the MFI which helps its operations in the market. There have been instances where the legality of even granting loans by these institutions has been questioned in courts when these institutions sought legal assistance to recover their loans. Besides, legal recognition reduces the credit risks of lenders to these institutions. At present the funders in the market are reluctant to extend credit to these institutions as there is no special law that recognizes the operations of the NGO-MFIs.

The Central Bank of Sri Lanka, the regulatory body for the formal financial sector, highlights the importance of regulating MFIs. "To ensure an effective microfinance sector, it is necessary to have a set of sound MFIs to carry out operations in a sound and professional manner. When any institution mobilizes deposits, such institution should be subject to prudential regulation and supervision to safeguard the depositors. With the expansion of such MFIs, the authorities have become more concerned about the safety of the poor people's savings being mobilized, as these MFIs are currently not subject to proper regulation and supervision under any legal statute. Regulation refers to a set of rules that the MFIs would be subject to and supervision is the process of enforcing compliance with the rules. Lack of regulation could also be a reason why some donors/funding agencies are reluctant to provide financial assistance to MFIs as they too believe that effective regulation and supervision is essential, in order to ensure significant outreach of the industry in an effective manner while maintaining sustainability." (Central Bank Annual Report 2010 p.175 & 176)

The Central Bank further states that " ..the presence of an effective regulatory mechanism which would help streamline the operations of MFIs is essential for transforming the real benefits accruing from the operations of MFIs to society effectively. A regulatory mechanism would contribute towards ensuring the soundness of the sector, building up of public confidence and enhancing even wider access to funding sources. This would also discourage the emergence of fraudulent financial activities" (Central Bank Annual Report2010.p.176).

Realizing the importance of the microfinance sector for poverty alleviation and financial inclusion, the Central Bank proposed a regulatory framework for Microfinance Institutions that are not regulated by the Bank. The Cabinet of Ministers has approved the propsed legislation recently. Under the proposed structure the Central Bank will be empowered to set regulations, principles and standards for the microfinance sector. It will be empowered to grant licences to carry on microfinance business, issue directions, and to supervise the operations of the MFIs.

Conclusion

Microfinance is an effective tool for poverty reduction. It also contributes to financial inclusion of the people who have been excluded from the formal financial system for a variety of reasons. Hence, microfinance contributes to both economic development and greater socio-economic equity in the country. If poor people are unable to have easy access financial services, they are most likely to remain in poverty and there will be persistent inequalities in the society. That is unacceptable economically, socially and politically.

Recognizing this factor, policy makers in many countries have introduced measures to promote the sector including the providers of microfinance services or microfinance institutions. MFIs are diverse in their approaches, objectives and their level of maturity. Hence the development of the sector is a challenging task. Sri Lanka also has had a fairly long experience with microfinance, mainly in providing rural credit under various schemes. There has been a rapid growth of NGO type MFIs operating on commercial basis since the 1990s and now they have formed into a network for the coordination of their activities among them as well as with other parties. There are several issues pertaining to the sector. The most important among them is a regulatory system that establishes their legal identity and support smooth functioning. A regulatory system will also improve their position in the market compared to the currently unregulated or inadequately regulated MFIs. Policy makers can make a significant contribution to the development of the microfinance industry and to the overall economic development and equity by extending their fullest support to design and implement a regulatory system within an enabling policy framework that will be conducive to the growth of the microfinance sector.

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