

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

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## METHODOLOGY AND ORGANIZATION

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

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

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

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

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## UNDERSTANDING “COMMERCIALIZATION” OF MICROFINANCE

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

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

### Microfinance Institution Commercialization

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

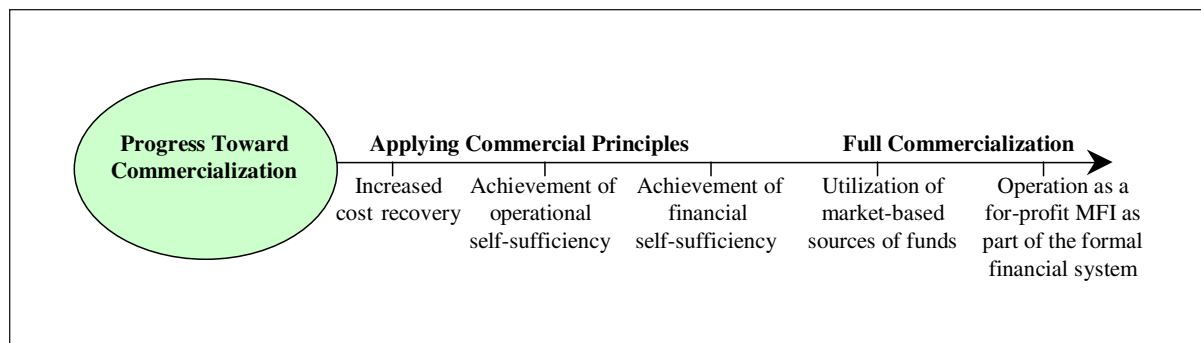
- Adoption of a for-profit orientation in administration and operation, such as developing diversified, demand-driven financial products and applying cost-recovery interest rates.
- Progression toward operational and financial self-sufficiency by increasing cost recovery and cost efficiency, as well as expanding outreach.
- Use of market-based sources of funds, for example, loans from commercial banks, mobilization of voluntary savings, or other nonsubsidized sources.
- Operation as a for-profit, formal<sup>7</sup> financial institution that is subject to prudential

regulation and supervision and able to attract equity investment.

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

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

Figure 1.1: The Microfinance Commercialization Continuum



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

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

### **Commercialization of the Microfinance Industry**

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

#### **1. Policy Environment**

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

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

#### **2. Legal Framework**

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

#### **3. Regulation and Supervision**

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

#### **4. Money Markets and Capital Markets**

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

#### **5. Support Institutions**

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

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### **THE SRI LANKAN CONTEXT**

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

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

### Socioeconomic Indicators

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

Sri Lanka began liberalizing its economy in the late 1970s, ahead of other developing countries. Despite escalation of the secessionist conflict in the 1990s, economic growth has been healthy because of generally good macroeconomic management and progress in trade liberalization, privatization, and financial sector reform. Sri Lanka is now South Asia's most open economy (with total trade accounting for more than 70% of gross domestic product [GDP]), and has a relatively well developed capital market infrastructure. Its per capita income (\$841 in 2000, equal to about \$2,500 on a purchasing power parity basis) remains the highest in South Asia, after the Maldives.<sup>10</sup> The economy has grown at an average rate of just over 5% annually in real terms over the last decade and unemployment and inflation remain at or just above historical lows<sup>11</sup> (See Annex 2 for more economic indicators).

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

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

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

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

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

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

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

### Agriculture Sector Development

The agriculture sector employs 36% of Sri Lanka's labor force and contributed 19.7% of the GDP in 2000.<sup>19</sup> The sector comprises what could be a significant market for MFIs. Agricultural performance was mixed in 2000 and the overall growth rate of the agriculture sector decelerated from 4.5% in 1999 to 1.2% (provisional) in 2000, the lowest since 1996.

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

**Table 1.1: Landownership in Sri Lanka, 1991**

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

Source: Gunetilleke 2001, p. 47.

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

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

### Financial Sector Development

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

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

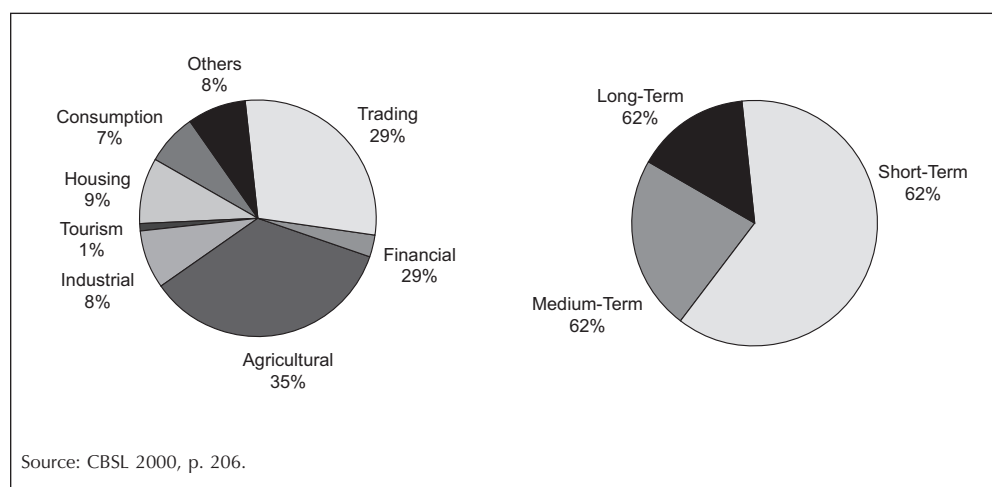
capital of SLRs500 million (\$5.6 million), the regional development banks (RDBs) were launched with initial capital of SLRs150 million (\$1.7 million) each, and savings and development banks each require SLRs100 million (\$1.1 million) initial capital.<sup>22</sup> Standard international directives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

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

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

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

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



**Table 1.2: Interest Rates (%)**

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

Source: CBSL 2000, p. 28, 200.

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

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

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