2 Progress Toward Microfinance Commercialization

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

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

DEVELOPMENT OF THE INDUSTRY

Importance of the Cooperative Movement

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

The cooperative rural banking movement was initially closely linked to the People's Bank. The CRBs were an important source of liquidity for the People's Bank, which was the state bank that acted as their handling institution for many years.[23] This link ceased in late 1992 and the CRBs now operate under the Cooperative Development Department. The first CRB began in Kandy in 1964. By end of 2000, there were 1,476 CRBs operating throughout the country.

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

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

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

Strong Social Orientation

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

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

Pervasive Presence of the Government

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

The Government's advent into the area of microfinance explicitly as a poverty reduction strategy is relatively recent. There have been two major initiatives. First, the National Development Trust Fund (NDTF—formerly known as the Janasaviya Trust Fund) was established in 1991 as an apex lending institution for MFIs to onlend to the poor. NDTF was created in an attempt to move away from established forms of credit delivery, such as through the state-owned commercial banks. Second, in contrast, SBSs were started in 1995 by the Government to help people establish sustainable self-help groups to promote savings and disburse credit. Government microcredit or microfinance programs have entailed heavy subsidies and generated large losses because of high administration costs and, in the case of almost all agricultural microcredit projects, poor repayment.

EVIDENCE OF MICROCREDIT MARKET SATURATION

Microcredit market saturation is high. Based on household data and the current average outstanding microloan amount of SLRs17,339 ($193), the maximum potential demand among low-income households and their microenterprises is estimated to be around SLRs22.9 billion[25] ($254.9 million), equivalent to 2.3 million microloans. At the end of 2000, MFIs in Sri Lanka had approximately SLRs18.2 billion ($202.3 million) outstanding in 1.65 million microloans. Current supply represents about 80% of the maximum potential demand for microcredit, in terms of overall amount and number of microloans, as calculated in Annex 4.

COMMERCIALIZATION OF MICROFINANCE PROVIDERS

Despite its broad outreach and level of market saturation, the microfinance industry is at a fairly early stage of commercialization. Cooperatives have made the most progress toward commercialization, although the performance of individual institutions within each of these categories has been highly mixed. The most commercial providers, in terms of achievements in financial self-sufficiency and access to commercial sources of funds, such as savings, are together estimated to provide only about one third of the microfinance services. The noncommercial providers of microfinance include numerous unsustainable government microfinance programs, several hundred poorly performing CRBs and TCCSs, and around 200 weak, small, and medium-sized microfinance NGOs.

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

Cooperatives Dominate the Market, but Many Are Unsustainable

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

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

Each CRB covers many villages as well as urban areas. The SLRs2.3 billion ($26 million) in loans disbursed in 2000[27] is the highest volume of loans issued by any microfinance organization in the country. Total outstanding loans amounted to SLRs4.9 billion ($55 million) by the end of 2000 (self-reported data). Average loan size was about SLRs8,500 ($95). Loan funds are provided entirely from deposits. Savings deposits alone in the CRBs grew by 14% or SLRs1.3 billion ($14.8 million) in 2000 from SLRs9.546 billion ($106.1 million) to SLRs10.876 billion ($120.8 million). The Cooperative Development Department reports that 1,174 of the 1,476 banks (79.5%) are profitable. The CRBs have never received grants or foreign aid; they are fully financially self-sufficient.

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

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

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

Table 2.1: Supply of Microcredit as of end-2000[a]

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

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

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

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

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

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

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

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

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

Government Programs Hinder Commercialization

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

Table 2.2: SANASA Development Bank Microfinance Performance Highlights

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

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

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

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

State-owned Commercial Banks

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

The Bank of Ceylon started providing microcredit in 1973. At the same time, rural savings mobilization was also encouraged. Both activities were initiated in accordance with government directives rather than by an internal decision to explore the microfinance market for its profit potential. As of 30 June 2001, the Bank of Ceylon estimated that the outstanding loans in the range SLRs5,000–50,000 ($56–556) each (its definition of microcredit) numbered 100,241, with a total value of SLRs1,831 million ($20.3 million), an average loan of SLRs18,266 ($203). The Bank is apparently shifting away from microfinance lending. The number and amount of microfinance loans outstanding steadily declined from 1999 to 2001, while average loan sizes increased (Table 2.3).

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

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

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

Table 2.3: Bank of Ceylon Microfinance Performance Highlights

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

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

Table 2.4: People's Bank Microfinance Performance Highlights

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

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

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

The Central Bank of Sri Lanka's Rural Credit Department

CBSL's Rural Credit Department has several functions: supervision of about 10 donor-funded and government-sponsored rural credit programs, implementation of the CBSL credit guarantee program, liaising with foreign lending agencies and government agencies on behalf of CBSL, coordination of the bank-financed cultivation scheme, implementation of interest subsidy programs, developing linkages with participating financial institutions and microfinance NGOs in credit disbursement activities, and conducting credit awareness programs. The various projects, including microfinance projects, being implemented or supervised by the Rural Credit Department are listed in Box 2.1. More detailed information on some of these programs and their terms and conditions is given in Annex 3.

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

Box 2.1

CBSL Rural Credit Department Projects, as of July 2000[a]

Donor-funded Projects

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

Government-sponsored Projects

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

CBSL-sponsored Projects

Inland Bill Scheme
Forward Market Contract System for Agricultural Produce

Credit Guarantee Scheme

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

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

Samurdhi Program

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

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

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

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

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

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

Source: CBSL 2000, p. 220.

active loans. The on-time loan recovery rate was an impressive 104%, as members in some districts paid in advance of their repayment schedules (due in part to the use of future welfare payments as quasi-collateral).[34] Nearly all the loans are issued for self-employment and cultivation, as reported by the borrowers. Most SBS loans charge 3% interest per month on a declining balance, on 3-month to 2-year terms, and pay 9% annual interest on member deposits, which should be enough spread to more than cover all operating costs.[35] However, while the recovery rate for the SBSs as a whole is good, recovery rates are uneven among the SBSs and had sunk below 50% in distressed regions, such as Ampara, at the end of 1999.[36] The system also has in place one credit guarantee scheme and two insurance schemes to secure its operations.

In areas where SBSs have been established and the poor have managed to purchase their shares, the system is an important source of emergency credit for small loans (about SLRs300 [$3.34]).[37] Around one third of shareholders stated that the SBS would be their principal source of emergency credit, while 40% said they still relied on friends and relatives. SBSs are also useful sources of credit for larger loans (SLRs1,000–3,000 [$11–33]) that are not required immediately. One third of SBS members regard them as the principal source for such loans, whereas only 20% continue to depend on friends and relatives. But shopkeepers and moneylenders retained a large share of this market: approximately 40% of SBS members regarded them as their principle source of credit.[38] Despite the success of the SBSs in terms of outreach, their expansion continues to discourage commercial entrants in microfinance, as do other government programs.

Regional Development Banks: Quasi-Governmental MFIs

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

CBSL notes that the RDBs are profitable, with approximately 80% of their loan portfolio made up of microcredit loans under SLRs100,000 or $1,111 (Table 2.6). It is not clear, however, whether these profits are adjusted for the direct and indirect subsidies that the RDBs receive. Total disbursement of microcredit by the RDBs in 2000 was estimated to be SLRs4,043 million ($44.9 million). Self-reported data indicated that total loans outstanding as of the end of 2000 were SLRs5,244 million ($58.3 million). The total loan portfolio of the RDBs grew by SLRs697 million ($7.7 million), an increase of 21% in 2000. Savings grew by a massive SLRs1,427 million ($15.9 million) to SLRs3,937 ($43.7 million), a growth rate of 40% in one year.

Table 2.6: Reported Annual Profits of RDBs for 2001

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

Source: CBSL Research Division.

Plethora of Small, Weak Microfinance NGOs

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

The vast majority of smaller and less-established microfinance NGOs, which number around 200, are not operating on a very sound basis.[39] Fewer than five are said to have profitable microfinance operations, although lack of transparency and standardized financial reporting impede a detailed assessment of their financial soundness.

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

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

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

SEEDS provides loans in the range SLRs10,000–50,000 ($111–556) with a very few loans of amounts close to SLRs500,000 ($5,556). As of the end of 2000, SEEDS had 81,464 active loan clients and an outstanding loan portfolio of SLRs650.8 million ($7.2 million). SEEDS' performance must be seen in the light of its massive "credit plus" operations, through which 55,698 people have received training in social mobilization, credit management, leadership management, accounting, entrepreneurship, and a range of technical subjects. If SEEDS were to separate its financial service activities from its nonfinancial service activities, it would likely be able to report full financial self-sufficiency. SEEDS societies measure profitability closely, because this is one of the criteria for graduation to a SEEDS Bank. All the SEEDS societies that become banks (507) are profitable and are audited by external accountants.

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

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

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

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

Box 2.2

Gender Issues

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

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

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

Limited Involvement of Private Commercial Banks in Microfinance

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

A few notable exceptions exist. Some private domestic banks—Seylan Bank, Hatton National Bank (HNB), and Sampath Bank—together with the two state-owned commercial banks participate in the Government's New Comprehensive Rural Credit Scheme to provide subsidized loans to farmers, nearly all smallholders, requiring microcredit. However, apart from the limited role of Sampath Bank in the New Comprehensive Rural Credit Scheme, only HNB and Seylan Bank have shown any significant interest in microfinance. Nonetheless, the outreach of these two banks still represents just over 1% of the microfinance market (see Table 2.1).

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

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

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

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

Box 2.3

Hatton National Bank's Barefoot Banking Model

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

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

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

Source: UNDP 2000a, p. 13–14.

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

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

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

Seylan Bank

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

Table 2.7: HNB Microfinance Performance Highlights

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

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

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

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

Box 2.4

Seylan Bank's *Govisarupatha* Credit Card for Farmers

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

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

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

Table 2.8: Seylan Bank's Performance Highlights

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

NDTF = National Development Trust Fund.
Source: Self-reported data provided in response to the country study questionnaire.

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

ACCESS TO COMMERCIAL SOURCES OF FUNDS

Heavy Reliance on Savings Mobilization

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

With more than SLRs14.8 billion of deposits in 5.3 million-plus individual accounts, the CRBs are the most active organizations in mobilizing deposits, receiving in excess of four times the amount that the system lends out (see Table 2.1). In fact, according to CBSL, the total deposits mobilized by the CRBs are 26% of the total deposits mobilized by the entire commercial banking system of SLRs56 billion as of the end of 2000. The low share of lending by the CRBs in relation to their deposits indicates that despite having a wide bank network (1,476 banks at the end of 2000), the system is less effective in lending than in savings mobilization. This is not surprising given its historical purpose of creating liquidity for the People's Bank, its former handling agency. The TCCSs are also active savings mobilizers and together with the SDB, the cooperatives' apex institution, they lend over half of the deposits mobilized by the SANASA network.

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

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

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

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

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

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

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

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

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

National Development Trust Fund

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

Originally established to support the Government's income transfer program—Janasaviya Program—NDTF began in 1992, through a $35 million revolving fund provided by the International Development Association of the World Bank ($20 million), *Kreditanstalt für Wiederaufbau* (German Development Bank) ($10 million), and the Government ($5 million). Funds are lent to participating organizations, such as microfinance NGOs and financial institutions, to onlend to the poor.

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

Most of NDTF's operations were wound down in 1998, but its credit and microenterprise development component is now being run by the People's Bank. Current activities include lending to participating organizations with good repayment histories and recovering funds from those that have defaulted. As of 30 June 2001, NDTF had 120 participating organizations and outstanding loans totaling SLRs540.8 million ($6.0 million). NDTF estimates that its current on-time loan repayment rate is about 88%, based on the amount paid as a percentage of the amount payable for the month.

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

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