

3 Challenges to Microfinance Commercialization

Negative perceptions of microfinance commercialization pose perhaps the biggest challenge to microfinance commercialization. Government policies and interventions also discourage new entrants into microfinance and hinder the commercialization of existing MFIs.

The underdeveloped legal and regulatory framework further impedes commercialization in a variety of ways. It fails to enforce laws against microfinance NGOs mobilizing savings deposits and offers no clear legal path for those institutions to become formal financial institutions subject to prudent supervision. The cooperatives, which are the largest suppliers of microcredit as well as significant savings mobilizers, are not adequately regulated and supervised. The lack of a sound legal and regulatory framework for microfinance NGOs and cooperatives places clients' savings at risk. If one of these key institutions were to become insolvent, this lack would put the reputation of the entire microfinance industry at risk. In addition, there are several internal constraints to MFI commercialization, such as weak ownership and governance and low institutional capacity. Lack of several key support institutions, such as microfinance training institutions, a strong microfinance network, and a functioning credit information bureau also hamper commercialization of the microfinance industry.

NEGATIVE PERCEPTIONS OF COMMERCIALIZATION

Concerns of Practitioners and Funding Agencies for the Poor

Many of the key stakeholders in microfinance in Sri Lanka including government officials, microfinance practitioners, and funding agencies,

have somewhat negative perceptions of microfinance commercialization. While many are beginning to see the importance of MFIs becoming sustainable, most are concerned that microfinance commercialization would neglect the needs of the “ultra poor” and other populations groups just below the poverty line (Box 3.1). Many Sri Lankans see commercial microfinance’s dual objectives of profitability and poverty reduction as conflicting rather than mutually supportive. While an increasing number of microfinance NGOs are charging cost-recovery interest rates and are moving toward sustainability in their programs, some microfinance NGO managers perceive that commercialization would lead to a shift away from targeting the poorer clients.

It is widely believed that for the poorest clients, social intermediation and “credit plus” services are necessary for microenterprise development, which implies continued subsidization. Discussions around microfinance commercialization tend to focus primarily on microcredit and lump the ultra poor together with other poor and near-poor groups. The poor do not seem to be segregated by strata (such as those identified in Figure 4.1, Chapter 4). Many of these negative perceptions of commercial microfinance have been translated into policies, laws, and regulations that are adverse to the commercialization of microfinance, as discussed next.

IMPEDIMENTS IN THE POLICY ENVIRONMENT

The Government’s commitment to economic development and poverty reduction has had a significant positive impact on the development of the microfinance industry in terms of outreach

Box 3.1

**Perceptions of Microfinance
Commercialization by Selected
Government Officials**

The researchers posed several questions to elicit perceptions of senior managers on major government programs on microfinance and its commercialization. Two are listed below along with selected responses:

1) What is your definition or understanding of microfinance and the commercialization of microfinance?

Small-scale loans for income-generating activities, sized SLRs5,000–40,000 (\$56–444). Commercialization entails serving enterprises being economically viable and sustainable with future potential; interest rates should be at market, and lending operations should be on a viable basis.

2) Do you believe that microfinance commercialization will increase or decrease the services of your organization extended to the poor?

It will increase the services. However, there will be a tendency to neglect the ultra poor. As such, they need some sort of subsidy until they become "potential poor" (near poor).

Increased microfinance commercialization without supporting services will decrease services to the poor.

Source: Responses to country study questionnaire.

to low-income borrowers and savers. The two state banks (People's Bank and Bank of Ceylon), combined with the SBSs, serve 37.6% of the total microcredit market, with 620,477 active microloans at the end of 2000. In addition, CBSL implements or supervises 18 different rural credit programs that overlap with the microfinance market. This active engagement by the Government and CBSL discourages commercial entrants to microfinance and hinders the commercialization of existing MFIs, creating market distortions via ad hoc debt relief and subsidized microfinance programs.

Debt Relief

Many private MFI practitioners cited recurrent debt forgiveness as the chief impediment to their achieving and sustaining high repayment rates. In the most recent instance, cultivation loans of less than SLRs20,000 granted for paddy and banana cultivation during 1999/2000 (*maha* season, October–January) and 2001 (*yala* season, March–July) were written-off by a government decision to provide relief to farmers whose cultivation was adversely affected by drought. Accordingly, the two state banks, the six RDBs, CRBs, and TCCSs in Badulla District wrote-off approximately SLRs187 million (\$2.1 million) of debt.

The last major debt forgiveness was in 1995. However, practitioners noted that the Government had also waived loan repayments for small loans by state commercial banks and some loans under its microfinance programs from time to time. The Farmer's Relief Scheme, introduced by the Government in 1994, had its termination date extended by 6 months from June 1999 to December 1999, and participatory credit institutions were requested to submit their claims on or before 31 March 2000. Under the scheme, banks write-off 25% of the loans on which farmers have defaulted, including both the principal and accumulated interest. The remaining 75% are shared by CBSL (37.5%), lending banks (18.75%), and the Government (18.75%). Further, this package allows farmers to obtain fresh loans as borrowers in good standing.

The Government's relief package required CBSL to relax its credit guarantee rules by waiving requirements that a lending bank should institute legal action against a defaulter in order to be eligible for the full amount of the credit guarantee. In terms of this waiver, CBSL agreed to pay half of the principal amount in loss less the original down payment of 25% by the farmer. The total liability of CBSL under this scheme up to the end of 2000 was SLRs333 million, while the liability of the Government was SLRs235 million.⁴⁷ In addition to debt forgiveness, the Government also introduced other relief packages, such as the forced rescheduling of loans

to small-scale potato farmers in Nuwara Eliya and Badulla districts during the 1995/96 *maha* to 1997/98 *maha* seasons. In this case, the Government again absorbed a large portion of the debt. These findings suggest that debt forgiveness is not only costly to the Government, but also damaging to the enabling environment in which MFIs operate because it communicates to clients that not all loans have to be repaid.

All instances of debt forgiveness, both large and small, affect not only the repayments of clients growing the affected crops, but also general client attitudes toward loan repayment.

Government Credit Programs

The government microfinance programs, and specifically the largest of them—the SBS program—do not operate on a sustainable basis. SBS loans carry an interest rate of 3% per month (on a declining balance basis) over loan terms of 3 months to 2 years. Emergency loans via the SBS program carry an interest rate of half that rate. Neither rate covers the cost of administering the program. Through other Samurdhi loan programs, the Government provides loan capital that is onlent through the state commercial banks and other financial institutions to the final borrowers at highly concessional interest rates (under many programs, the channeling institutions are subsidized to hold the final lending rate down to 10% per annum), which would be insufficient for them were they using their own funds.⁴⁸

Despite the positive perception of microfinance commercialization by several senior managers at the two state-owned commercial banks, these banks have historically been subject to constant political interference and have had little to no autonomy in their management and operations (Box 3.2). Over the years, both banks have even tried to initiate their own microfinance products but had to abandon them under pressure to devote manpower and other resources to implement various government projects.

Despite the positive strides that some funding agencies, such as *Deutsche Gesellschaft für Technische*

Box 3.2

Perceptions of Microfinance Commercialization by Selected Government Officials

Several senior managers from each of the two state-owned commercial banks conceded that microfinance can be profitable, but that they currently do not have a plan or strategy to initiate it. One of the managers remarked, “We would like to introduce suitable microcredit products, apply commercial interest rates, lower our administrative costs, properly appraise projects, identify potential microdepositors, and link deposit schemes to microcredit schemes.” The same manager noted that the binding constraints to acting on these desires were, “lack of awareness of best practices and lack of trained and experienced staff.”

Because of the constraints faced by the state-owned commercial banks, many managers concede that it may not be feasible for them, and for commercial banks in general, to be direct providers of microfinance. Thus, they may need to focus on wholesaling funds. One senior manager commented, “For commercial banks, establishing linkages with self-help groups of microentrepreneurs or NGOs will pave the way for the bank to commercialize its microfinance activities.”

Source: Responses to country study questionnaire..

Zusammenarbeit (German Agency for Technical Cooperation, GTZ) and the United Nations Development Programme (UNDP), have been recently taking to make their microfinance programs more sustainable, there is widespread belief that substantial donor support of MFIs has been one of the main causes for the overriding poverty focus of most donor-supported MFIs. The poverty focus of most donor-supported microfinance projects has come at the expense of financial self-sufficiency. There is clear evidence of this today. Many of the microfinance components of rural credit projects being

implemented through CBSL's Rural Credit Department incorporate the features of subsidized interest rates on loans that carry with them the perception of soft repayment enforcement. The availability of cheap credit through many of the government programs crowds out private MFIs and other microfinance providers that do not have access to such large subsidies.

WEAKNESSES IN THE LEGAL AND REGULATORY FRAMEWORK

Legal Ambiguity Concerning Microfinance NGO Deposit Mobilization

Savings mobilization by microfinance NGOs places clients' savings at risk and threatens to damage the credibility of the microfinance industry. According to law, NGOs are not allowed to mobilize deposits, but many require mandatory deposits and some accept voluntary savings from members. Under the Banking Act and the Finance Companies Act of 1988, an institution must be licensed as a bank or a finance company to collect deposits. This applies to all deposits, whether from members or nonmembers, and includes compulsory savings that may be a precondition for obtaining microcredit. In practice, the prohibition on savings mobilization has generally not been enforced. Indeed, major government programs, such as the NDTF and the Small Farmers and Landless Credit Project, have required microfinance NGOs borrowing from them to establish savings programs.

Lack of Institutional Options for Transformation

Lack of a supportive legal and regulatory framework for MFIs discourages commercial entrants. Legal options are limited for semiformal MFIs (for example, microfinance NGOs) that want to transform themselves into formal institutions. The most commercial of the microfinance NGOs—SEEDS—sees its best option to formalize in becoming a bank. But this

is likely to be a difficult and inappropriate legal form for transformed microfinance NGOs, because of banks' high minimum capital requirements. Commercial banks require minimum initial capital of SLRs500 million (\$5.6 million), the RDBs were launched with initial capital of SLRs150 million (\$1.7 million), and savings and development banks require SLRs100 million (\$1.1 million). The RDBs have their own statute, the 1997 Regional Development Banks Act. Given that the legal status granted to the RDBs was a special case designed to amalgamate the 17 state-dominated regional rural development banks into more independent RDBs, it is unlikely to be a viable institutional form for microfinance NGOs desiring formal status.

The savings and development bank category for regulated financial institutions may be the most appropriate legal form because of its lower initial minimum capitalization. However, exceptions and adaptations to the regulations would need to be made to accommodate the specific needs of microfinance institutions. Standard international prudential guidelines that apply to each of these types of regulated entities are not appropriate to the specialized operations of microfinance providers. For example, reporting requirements, limits on unsecured loans, requirements concerning loan documentation, supervision methods, and branching restrictions are incompatible with successful MFI operations that are based on acceptance of alternative forms of collateral, the use of simplified applications, and other nontraditional lending practices.

Most of these guidelines would need to be less stringent for MFIs, but others, such as provisioning standards, would need to be stricter for MFIs in view of the shorter maturity of their loans. A 60-day delinquency of a 90-day microfinance loan may represent a greater risk than a 90-day delinquency of a 5-year loan.⁴⁹ Currently, CBSL does not require 100% provisioning until loans are more than 18 months past due, whereas most microfinance loans should probably be written-off within a year of the date of their default.

Inadequate Regulation and Supervision of Cooperative Networks

An inadequate regulatory framework for cooperatives puts their clients' savings at risk and hampers commercialization of the cooperative networks. The 1,476 individual CRBs are organized under 306 government-dominated multipurpose cooperative societies and are only loosely supervised by the Cooperative Development Department. Despite the lack of strict supervision, the CRBs collectively had mobilized SLRs 14.8 billion in deposits in over 5.3 million accounts by the end of 2000. A few are regulated by CBSL by virtue of their participation in the national deposit insurance program; however, this regulation is only loosely applied to the participating CRBs.

As with the CRBs, the TCCSs are governed by the Cooperative Societies Law of 1972 and are subject to minimal supervision by the Cooperative Development Department. As a whole, the TCCSs mobilized over SLRs 1.8 billion in savings by the end of 2000. Both the TCCSs and CRBs have federations that are only loose networks, with the success of individual banks (of the CRB network) and primary societies (of the TCCS network) largely dependent on the expertise of their local managers. While the federations are able to provide some leadership, they have no legal means of enforcing standards. The scale of deposit mobilization by cooperatives places substantial savings at risk. Unfortunately, the Cooperative Development Department is not currently equipped to provide prudent regulatory oversight to the thousands of cooperatives under its supervision.

The TCCS Federation is exploring other ways to improve management and enforce standards. The opening of SDB is a step in this direction. The agency relationship that SDB is currently attempting to develop with the primary societies will strengthen their financial position by improving operational and managerial professionalism. CBSL and SDB have agreed upon minimum financial and risk management criteria in order for a primary society to have an agency. Society managers will need to achieve

individual accreditation through the SANASA Education Campus. To qualify as an agent for SDB, a primary society must follow sound business practices in the areas of staffing and training, accounting, record-keeping, financial performance, security, facilities, and hours of operation.⁵⁰

Inadequate Secured Transactions Framework

An inadequate secured transactions framework curtails opportunities for MFIs to diversify their microcredit products and impedes MFI progress toward commercialization. Lenders need a system wherein claims against property can be created (legally defined), perfected (publicly registered), and enforced. The more uncertain and expensive the process, the less willing may be MFIs to lend.⁵¹ State ownership of more than 80% of all land limits its use as a potentially valuable form of collateral. Use of movable property as collateral is blocked by the absence of a legal basis to support it. The lack of a secured transactions framework limits MFIs from using collateral to secure a loan, thereby hindering MFIs from scaling-up and offering larger, individual loans, especially in rural areas.

INTERNAL CONSTRAINTS TO MICROFINANCE INSTITUTION COMMERCIALIZATION

Weak institutional capacity and overemphasis on social mission curtails MFI progress toward commercialization. At least half the current provision of microfinance is by MFIs that have weak institutional capacity and an aversion to commercial principles. In particular, many MFIs suffer from lack of clarity in their mission, weak governance, low levels of technical understanding of banking and finance, inappropriate accounting practices, and inadequate management information systems. Negative perceptions of commercialization prevent much of the industry from striking a balance between their commercial and social missions and becoming more sustainable. Institutional weaknesses and negative

perceptions of commercialization are two of the main challenges to commercialization of the microfinance industry.

Lack of awareness of best practices in microfinance and the need for staff training were given as the key constraints to commercialization of microfinance by five of the eight institutions that responded to the questionnaire used to elicit data for this study. This remains a major issue because very few institutions undertake microfinance training or capacity building. For example, management ability within the SANASA movement (TCCSs, SDB, etc.) varies widely. The autonomy of primary societies is a strong factor in this inconsistency. While the federation is able to provide leadership, it has no legal means of enforcing standards.

Some district unions have been able to bring a level of discipline to their primary societies by using loan conditions to impose standards. For example, a district union may impose management standards as a condition for a primary society to receive a loan. In such a case, the district union is able to intervene directly with the management of the primary society by requesting that a part of the manager's salary be withheld by the district union if the manager fails to achieve certain performance standards agreed upon by the manager and a district field officer.

For the TCCSs at the primary society level, a main reason for not focusing on profitability has been a cultural one: the cooperatives are seen by its leaders as community development organizations to assist members to access credit and to deposit savings and not as profit-making bodies. Very few of the profitable societies distribute profits among members. The attitude of office bearers is also an issue. Most of them consider this to be a social position derived from community service. Most office bearers do not come from the business community and even if they do, they see their role in the societies as providing a social service.

However, the TCCS movement has recently shifted its perceptions, giving much greater emphasis to profitability because of the creation of SDB and the need to make it viable. This has sharply changed operational focus from a mere

growth orientation to a profit orientation. SDB and the TCCSs are now increasingly focusing on ways to make societies more profitable. This may lead to increased centralization of management of primary societies and a more profit orientation at primary society level in the future.

Microfinance NGOs have also progressed greatly since the 1980s when savings and credit work commenced in this sector and most NGOs (as well as their funding agencies) were advocating subsidized interest rates. They also felt that serious action against defaulters was not to be taken for social reasons. The Janasaviya Trust Fund (now NDTF) helped to make the biggest changes by providing funds at interest rates that made it necessary for the recipient microfinance NGOs to charge cost-recovery interest rates.

Reduced grants funds from funding agencies to the NGO sector especially in southern Sri Lanka has also helped microfinance NGOs to move away from a noncommercialized approach to microfinance. Increasing numbers of microfinance NGOs are moving toward creating sustainable programs, or at least wanting to do so. Charging cost-recovery interest rates or higher has become more common and many even try to take legal action against defaulters to instill repayment discipline, especially in the face of frequent government debt relief programs. This is not yet widespread, however. Most microfinance NGOs remain lax on taking legal action against defaulters.

LACK OF SUPPORT INSTITUTIONS

Credit Bureau

Lack of MFI access to a credit bureau impedes credit risk minimization and increases clients' costs of borrowing. Sri Lanka's credit bureau currently does not serve the needs of MFIs. The bureau only reports on loans over SLRs100,000 (\$1,111) and it is accessible only by its shareholders, such as commercial banks, licensed specialized banks, and the RDBs. Lack of a centralized credit information source keeps the

search, monitoring, and enforcement costs incurred by providers of microcredit unnecessarily inflated. It also increases the cost of microcredit to clients. MFI access to a credit bureau could reduce MFIs' lending to bad borrowers and minimize excess debt and default by clients.

Microfinance Networks

Microfinance networks and support programs have several important roles to play to promote sustainable microfinance systems. They can spread awareness of key features of the "financial systems" approach to microfinance among policymakers, the development community, and microfinance practitioners, integrating microfinance more with the general financial sector and ensuring that complementary approaches are considered. In addition, they can collect and disseminate microfinance "best practices" to accelerate the outreach and financial self-sufficiency of their member MFIs in terms of cost-saving technological developments, creation of linkages to expand outreach, and lessons learned from microfinance NGO transformation and other experiences.

There is one microfinance network, the Sri Lanka Microfinance Network, which started in the early 1990s under the initiative of the Swiss Inter Corporation. In 1996, UNDP took over support for this initiative and broadened its membership base to include CBSL, donor organizations, international NGOs, commercial and development banks, cooperatives, and a few prominent consultants and representatives from several major government programs. However, it is still a loose network with no formal mem-

bership and anyone interested is invited for meetings. The members meet monthly and carry out some activities, such as an annual microenterprise fair to promote the marketing of products produced by MFI clients, giving comment on studies done in the microfinance field, and meetings and studies of relevance to the sector. The Microfinance Network suffers from a lack of focus and institutionalization with formal membership and activities.

Microenterprise and Microfinance Training

The limited capacity within Sri Lanka for training in microenterprise development and microfinance is a major issue. The main training institutions are CBSL Centre for Banking Studies, International Center for Training of Rural Leaders (ICRTL), SEEDS Management Training Institute, Rural Development Training Institute (RDTI), and SANASA Training Institute.

Two of these five institutions were established by SEEDS and TCCSs, respectively, to train their own staff and have little capacity to train other persons. Of the three government training institutions active in this field, the Rural Development Training Institute's main strength is social mobilization training. This leaves only CBSL's Centre for Banking Studies and the International Center for Training of Rural Leaders as facilities that could offer microfinance capacity-building training. While the latter is strong at training management and accounting for microfinance at the community-based organization level, both have weak capacity to offer training on local and international microfinance best practices.