

4 Implications of Microfinance Commercialization

This chapter examines the implications of microfinance commercialization in terms of outreach, competition, and “mission drift.” While this report mainly discusses microfinance commercialization from the perspective that commercialization would have a positive impact on microfinance outreach, some MFIs fear that it could lead to greater competition and make it harder for them to survive in the future. In addition, many Sri Lankans are concerned that increased commercialization could have negative social impact or result in mission drift, such as a reduced focus on reaching the poorest sectors of society, and lead to increased loan sizes. The findings show that while some of these implications are possible, the negative impact on the poor is probably less than some might think.

POTENTIAL FOR GREATER SUPPLY OF DEMAND-DRIVEN PRODUCTS

The basic premise behind microfinance commercialization is that commercial MFIs are more likely to be sustainable and more efficient in the long-run than noncommercial MFIs. Advocates believe that increased commercialization will yield greater outreach, including to the poor, and more product diversity, resulting in more clients served and their diverse needs met over time. This theory has proved true in such countries as Bolivia, where commercial MFIs dominate the market and as a result, low-income clients have multiple choices of financial service providers and products at lower cost than when only noncommercial MFIs dominated the market.⁵² While it is difficult to demonstrate this concept in Sri Lanka, which is at a fairly early stage of commercialization, there are already signs that

indicate the positive effect of commercialization on microfinance outreach.

The MFIs that have achieved the greatest outreach are the cooperatives: the CRBs and the TCCSs. Together these two cooperative networks have reached more than 830,000 clients, representing approximately 46% of the total market, with a combined outstanding loan portfolio of almost SLRs7.8 million (\$87 million) (Table 2.1). They have achieved this level of commercialization and outreach while maintaining a commitment to the poor, as demonstrated by their low average loan size, SLRs9,914 (\$110). The cooperatives that have achieved profitability are the larger and more established ones, with the greatest outreach.

Another manner in which the positive effect of commercialization is demonstrated is the link between savings mobilization and outreach. Some of the MFIs that mobilize the greatest amount of savings—CRBs (SLRs14.8 million), TCCSs (SLRs4.2 million), SBSs (SLRs4.0 million), and SEEDS (SLRs626,000)—have achieved the greatest outreach in terms of number of clients served. While the SBSs and SEEDS are structured to be noncommercial, their role as savings mobilizers and financial intermediaries (i.e., they onlend the savings) represents a commercial approach to microfinance and a commitment to achieving sustainability. One could argue that if these MFIs were commercially structured, with true owners and effective boards to oversee them, they could operate more effectively and efficiently and achieve even greater levels of outreach.

Much of the remaining unmet demand for microcredit in Sri Lanka is a result of both lack of potential clients’ awareness of their options and the need for MFIs to gain a better understanding of client needs and to adopt

products and services to meet those needs. Because microfinance commercialization is still fairly undeveloped, clients largely remain uninformed about potential opportunities for microfinance services. Public awareness and marketing campaigns, such as through radio announcements or billboards, could help to increase the number of microfinance clients. In addition, MFIs should strive to improve their understanding of client needs and preferences and adapt products and services to better respond to clients' requests.

Client perceptions of microfinance commercialization vary widely. All clients and potential clients interviewed in the present study needed clarification on what microfinance commercialization meant, especially what it would potentially mean for them. Most were in favor of lower interest rates being charged. However, if greater and more dependable access meant nonsubsidized interest rates, they were generally willing to pay them. On the savings side, this was even more prominent, with preferences for safety of deposits and liquidity being their chief concerns rather than earning the maximum interest possible. So, while some might argue that commercialization could result in increased interest rates, these and other findings suggest that even poor clients are willing to pay the price required to ensure access, product diversity, and safety of deposits (Box 4.1).

Empirical evidence shows that interest rate increases do not result in decreased demand for loans.⁵³ Information gathered from participant MFIs in the MicroBanking Standards Project⁵⁴ supports this view. Further, "even if below-cost recovery interest rates for borrowers were the most efficient means to reduce poverty, such an approach would create problems for MFIs not participating in donor-funded poverty reduction."⁵⁵

Box 4.1:

Clients Think Commercialization Improves Access

A primary issue for most clients is access to finance, rather than cost or other factors. Clients of the Saravodaya Economic Enterprise Development Services (SEEDS) believe the commercialization process has resulted in an overall improvement in service delivery as well as a wider range of products. There is also growing opinion that commercialization has changed SEEDS' approach, in terms of greater professionalism and more business oriented attitudes. This has also led to greater confidence among clients to invest in SEEDS. Previously, there was some reluctance to invest because SEEDS' traditional NGO image did not instill the confidence required, but its new focus on commercialization has facilitated increased savings mobilization.

LACK OF CLEAR PROFIT POTENTIAL CURTAILS COMPETITION

Some MFI directors are concerned that increased commercialization could lead to more MFIs entering the market, making it more difficult for existing MFIs to expand their markets and increase revenues. They fear that increased competition from commercial microfinance providers could put a financial strain on them, making it more difficult for them to cover their costs over the long term. The success of microfinance commercialization in Bolivia did indeed cause new commercial microfinance providers to enter the market, which squeezed profit margins for other providers and ultimately resulted in the collapse of some MFIs there. However, despite the fact that its microcredit market is fairly saturated, Sri Lanka is far from facing that level of competition.

High liquidity and wide interest rate margins among the commercial banks and licensed, specialized financial institutions indicate that Sri

Lanka's financial market, while largely liberalized, is not yet developed enough (because of lack of technological advances, limited professional commercial banking skills, and other factors) to spur intense competition. Thus, there is little incentive for formal financial institutions to scale down their product offerings based on competitive pressures. There are, however, social concerns and the desire to be a good corporate citizen that have prompted some commercial banks to become more involved in microfinance activities.

Highly significant in terms of total numbers of microcredit loans and total volumes are the semiformal MFIs. True competition has probably not yet arrived in the microfinance market provided by this sector. This view is supported by the continued rapid growth of programs like SBSs, RDBs, SEEDS, and other semiformal MFIs, although several microfinance NGOs complain that the Government's expansion of the SBSs eroded their potential client base. Competitive pressures are further eased in that most semiformal MFIs provide microfinance to different tiers of the microfinance market or in only localized areas. For example, the CRBs and TCCSs can be seen as serving a slightly better-off clientele than the SBSs, SEEDS, or Janashakthi. However, the medium-term prospect (2–3 years) is that competition will begin in at least a few locations if the growth of these types of MFIs continues on the same path.

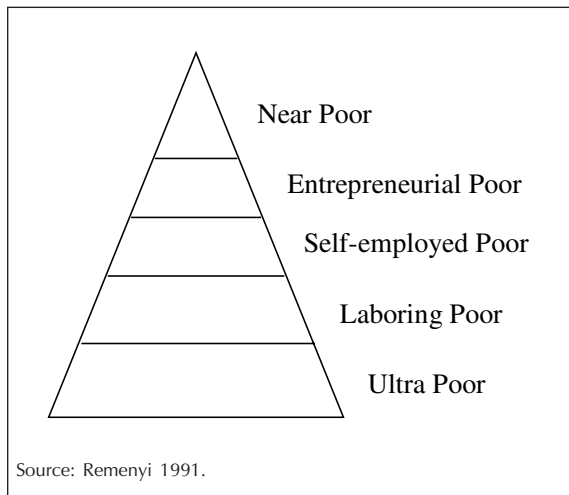
Nonetheless, until the microfinance industry demonstrates more profit potential, new commercial market entrants are unlikely. Profit potential will be difficult to demonstrate until the Government stops promoting its subsidized microfinance and targeted credit programs. Given that a third of microfinance is currently supplied by the Government, this exit from the market would open up a large market for existing MFIs and would encourage new commercial entrants. Only after this market is recaptured would true competition emerge.

POTENTIAL FOR MISSION DRIFT

Increased competition will likely force most, if not all, of the semiformal MFIs to reevaluate their missions in relation to their comparative advantages in serving their target group. Decline in donor support (in all but the North East Region) can also be expected to bring about such introspection. Some of the more poverty-oriented institutions will inevitably leave the microfinance market when their financially unsustainable programs run out of funds; others may shift their focus to nonfinancial activities deemed more directly beneficial to their target group. The institutions that remain in the microfinance business might find that serving the ultra poor is too costly for them to continue on a sustainable basis and that targeting the poverty tiers immediately above that group may afford them the desired balance between outreach and financial self-sufficiency.

Remenyi's poverty pyramid (Figure 4.1) is often used to conceptualize these tiers or gradations of poverty. In Remenyi's classification there are five strata. At the bottom layer are the ultra poor who depend on the earnings of others. Next up, the laboring poor are employed full-time in low-paid, unskilled labor positions. The upper three strata consist of the self-employed poor who work for themselves and may employ up to five others; the entrepreneurial poor whose enterprises employ more than five people; and the near poor who have stable, albeit low wage employment.⁵⁶

Many Sri Lankans are concerned that increased microfinance commercialization could result in mission drift, implying that MFIs will reduce their emphasis on targeting the poorest sectors of society and will gradually increase their loan sizes. In fact, average loan sizes for both HNB and Seylan Bank have drifted higher in recent years. The average loan size for HNB in 1999 was about SLRs26,000 (\$289). By 30 June 2001, it had almost doubled to SLRs40,000 (\$444). Over the same period, Seylan Bank's average outstanding loan size was estimated to grow from SLRs20,000 to SLRs25,000 (from \$222 to \$278). While HNB's average loan size is

Figure 4.1: Poverty Pyramid

expected to continue rising, that of Seylan Bank is likely to remain relatively steady as it keeps its original focus. This trend can be expected to continue until the Government curtails its direct interventions in the microfinance market, because these banks are simply targeting the markets where they see the least competition and the most profit potential.

How much mission drift this entails for various semiformal MFIs and the microfinance market as a whole depends on a variety of factors. One is the extent to which semiformal MFIs seek to become regulated entities, which is a prerequisite to mobilizing significant voluntary savings (to facilitate their substantially increasing outreach on a sustainable basis). SEEDS, the largest NGO, is considering taking this step in the near future. Becoming a formal, regulated financial institution

can result in targeting higher-income clients with larger loans, as a result of profit-seeking pressures from equity shareholders. However, the industry will have to wait for at least one such transformation to take place in order to gather the empirical evidence to support or contradict this potentiality.

Mission drift will also depend on the nature of the prevailing regulatory and supervisory framework. For example, certain prudential standards applied to commercial banks are not appropriate for formal MFIs (such as reporting requirements, limits on unsecured loans, requirements concerning loan documentation, supervision methods, and branching restrictions), and might cause the institutions to shift focus up market to ensure compliance. No regulatory and supervisory framework for microfinance exists yet and this represents a great opportunity to learn from successful experiences elsewhere, such as in Bolivia, in designing a framework that will minimize mission drift.

Mission drift may remain low in those semiformal MFIs that are content with serving a localized market on a competitive basis (i.e., the majority of small NGOs, such as Janashakthi). Such institutions will likely enjoy fewer opportunities to diversify their risks and will not be able to take advantage of economies of scale in their operations. Despite the advantage of proximity to their target market, these institutions can be expected to remain weaker than formal MFIs. In other words, some diversification of target markets can be beneficial to MFIs to minimize risks and improve their ability to recover costs.