5 Positive Approaches to Microfinance Commercialization

Commercialization of microfinance holds the promise of capitalizing on the achievements in outreach that MFIs have made to date. General improvements in MFIs' financial self-sufficiency are promising, but the industry is far from reaching all the potential benefits of microfinance commercialization. Many stakeholders including the Government, funding agencies, MFIs themselves, and support institutions have a role in moving microfinance commercialization further. In the following sections are conclusions and recommendations for each of these key stakeholders, based on information gathered in the present study and the literature.

ROLES OF THE GOVERNMENT

The main roles that the Government should play in commercialization of microfinance are to create and maintain an enabling macroeconomic and sectoral policy environment and an adequate legal, regulatory, and supervisory framework for microfinance. There is a need for the Government to undertake a private-public sector partnership to produce a cohesive national framework for microfinance development and rationalize its pervasive presence in the microfinance market. This entails phasing out several, major, direct government microfinance interventions in favor of more indirect support of the microfinance sector.

Direct financial sector interventions should be minimized to prevent market distortions and to allow the private sector to provide microfinance services using proven methodologies for sustainable microfinance delivery. The Government should also consider complementary, grant-based approaches to reach certain sections of the traditional microfinance market (for example, the lowest rung of the working poor) when the net benefits of offering microfinance directly are exceeded by alternative interventions (for example, investments in training or social services and physical infrastructure). Specific recommendations are provided below that relate to the policy environment, the legal framework, and regulation and supervision.

Create and Maintain an Enabling Policy Environment

Ensure macroeconomic growth and stability

Several measures should be undertaken to ensure positive, stable economic growth that will enable the microfinance industry to expand in a sustainable manner. These include ending the secessionist conflict, which continues to destabilize the population and dampen economic growth by necessitating increased defense expenditures; and curtailing ad hoc policy changes including tax relief measures that cause significant decreases in national income or increased government expenditures related to public sector wage increases, and various smallholder debt relief packages. Such policies may worsen inflationary pressures and dampen economic growth. This would have an adverse impact on effective demand for microfinance and harm efforts of MFIs to progress toward financial sustainability.

Promote agriculture sector growth

Tariff policies should be rationalized and ad hoc changes in them minimized. Poorly targeted agriculture subsidies would be better directed to improvements in agriculture inputs, processing, and marketing facilities. Given that agriculture

production supports more than one third of the Sri Lanka's labor force, these and other measures aimed at increasing the agriculture productivity might go a long way toward providing a large, economically-viable client base for MFIs seeking to commercialize their operations and expand in rural areas.

Strengthen the financial sector

Further efforts to restructure the two state-owned commercial banks are needed to improve their performance. This should be undertaken with an eye toward eventual privatization. Many of the government-sponsored agriculture credit programs currently being implemented by the banks undermine their ability to achieve sustainable outreach, especially in terms of their microfinance portfolios. Consideration should be given at least to allowing the banks more autonomy coupled with accountability, similar to the RDBs. The reported profitability of the RDBs (with an estimated 80% of their portfolio in microfinance) may be a testament to the potential for sustainable microfinance outreach that such changes may bring. However, it is uncertain how profitable the RDBs would be after appropriate adjustments for loan loss provisions, write-offs, and subsidies.

Stop ad hoc debt forgiveness

Many private MFI practitioners cited recurrent debt forgiveness as the chief impediment to their achieving high repayment rates. In the most recent instance, cultivation loans of less than SLRs20,000, granted for paddy and banana cultivation during the1999/2000 *maha* season and 2001 *yala* season) 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). The last major debt forgiveness program, the Farmers' Relief Scheme, began in 1994 (and was extended through December 1999). 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.

Provide quality social services and adequate physical infrastructure

Thus far, macroeconomic growth has boosted the effective demand for microfinance, especially in the service sector. Weaknesses, however, in physical infrastructure (power, telecommunications, water, etc.) and basic health and education services will continue to constrain effective demand for microfinance until there are substantial improvements in these areas.

Minimize Direct Interventions

Phase out government programs

At the end of 2000, some 940 Samurdhi banks had been established, an increase of 75 societies in that year. This significant presence and growth requires a rethinking of their management and operations. Presently, the banks have boards made up primarily of clients, but the staff (about 20,000 total) are from the Samurdhi Authority and, as such, wield great power within the organization. The savings portfolios are entirely client funded and include no government or donor deposits. There is a need to consolidate the gains in outreach achieved under the program and to ensure its sustainability by changing the SBS from public to private, local ownership. In addition, because the Samurdhi Program has been so successful at reaching the bottom end of the market, other government interventions, such as the directed CBSL projects and the state-owned commercial banks, are not needed in the microfinance sector.

Redirect the CBSL Rural Credit Department programs

The implementation of at least a dozen rural credit projects is currently being supervised by CBSL's Rural Credit Department (with at least

two being directly implemented by it). Many of these projects have targeted, subsidized microcredit components. CBSL should not be engaged in direct lending, which conflicts with its ability to provide impartial regulation and supervision of the financial sector. In addition, it uses scarce resources (human and financial) in a way that would be better served by the private sector. Such direct financial sector intervention by the Government undermines the ability of the private sector to provide microfinance. Also, it is not a cost-effective means of microcredit delivery because, as mentioned, repayment under the government projects is not strongly enforced. Indeed, the repayment culture is eroded by debt relief and debt forgiveness programs announced frequently by the Government. The project features of targeting, subsidized onlending interest rates, and weak repayment enforcement should be phased out as soon as possible, because they conflict with efforts to encourage private sector MFIs and MFI sustainability. In addition, responsibility for the provision of microfinance should be shifted from the public sector to private sector MFIs with a strong focus on, and a track record toward achieving, financial self-sufficiency.

Reduce government ownership and control of the RDBs

Although the RDBs were given greater autonomy in 1998, the main shareholder remains CBSL; shares are also held by other government agencies. To minimize adverse political interference in the RDBs and to strengthen their market orientation, CBSL and other government shareholders should progressively reduce their ownership control in these banks. Promotion of private investment in the banks through privatization should be strongly considered in the near future. The RDBs appear to be ripe for privatization: each of them has reported profits in serving their respective rural financial markets in recent years.

Strengthen the Legal Framework

Resolve legal ambiguity regarding microfinance NGO savings mobilization

Savings mobilization by microfinance NGOs without legal authority is placing clients' savings at risk, which in turn places the microfinance industry at risk. There are a number of options that can be considered to resolve this issue. The Government could require that all microfinance NGO savings deposits either be deposited into a formal financial institution and not onlent to microfinance clients, or that all such deposits be covered under the national deposit insurance program. In addition, CBSL could create a new legal structure to accommodate the transformation of informal MFIs into regulated financial institutions subject to its regulation and supervision, or allow exceptions to be made under one of its current regulatory structures, such as for savings and development banks. Regardless, CBSL should enforce its law under the Banking Act and the Finance Companies Act of 1988, requiring all institutions that mobilize savings and use them for onlending to be licensed as formal financial institutions.

Create a new legal structure for microfinance institutions

Consideration should be given to developing a new tier of financial regulation for financial intermediaries specializing in microfinance operations, including voluntary deposit mobilization from the general public. Such regulation and supervision should be tailored to the specialized microfinance operations and reinforce sustainable growth, drawing from recent positive experiences in Africa (e.g., in Uganda[57]) and Latin America (such as in Bolivia). Initial applicants might include a few of the best performing CRBs, TCCSs, and microfinance NGOs. Introduction of such a tier could improve accountability and transparency of MFI operations. It is commonly acknowledged that these are necessary ingredients both for obtaining recognition as financial partners of the formal

financial sector and for ensuring the security of the savings. The ability of these institutions to mobilize deposits and to obtain deposit insurance is crucial for their enhanced financial self-sufficiency and the commercialization of the microfinance industry. Strengthening CBSL to be able to undertake regulation and supervision of the few MFIs that may be suited to such a transformation would be a necessary prerequisite and should be a priority of the Government and donor community.

Improve Regulation and Supervision

Build the capacity of the Central Bank of Sri Lanka

The types of institutions regulated by CBSL should be expanded according to the growth in recent years of several nonbank financial institutions, especially in terms of savings mobilization. It is important that the regulation and supervision practices, as well as the capacity, of CBSL evolve with the growth of these nonbank financial institutions because most of them take part in financial inter-mediation. CBSL has a supervision force of only about 75 persons and they appear to be fully occupied supervising the entities currently subject to its regulation. CBSL personnel should be shifted from direct implementation of microcredit projects to supporting the development of market-friendly and effective microfinance regulation and supervision.

Adopt appropriate regulation and supervision for microfinance

To protect deposits, savings-mobilizing MFIs should be subject to some form of prudential regulation and supervision. Given that CBSL does not currently have the capacity to regulate and supervise all MFIs, alternative forms of oversight should considered, such as the strengthening of the federation for the TCCSs or the development of self-regulatory bodies. Regardless of structure, the regulatory framework should ensure that deposit-mobilizing MFIs have strong governance structures, with qualified, active board members; effective internal control and risk management systems; and thoroughly auditing by an independent third party at least once per year. In addition, the regulatory framework should adopt strict risk classification criteria, requiring higher levels of loan provisioning and quicker write-offs than are required of traditional financial institutions. Minimum standards for performance should be set and key indicators monitored, such as for capital adequacy, asset quality, and liquidity. Box 5.1 offers several common adaptations to traditional bank regulatory and supervisory practices that could be applied.

ROLES OF FUNDING AGENCIES

Support an enabling policy, legal, and regulatory environment

Funding agencies should work with the Government to ensure an enabling environment for microfinance conducive to MFI progress toward commercialization. This includes advising on macroeconomic and sectoral policies, as well as the legal, regulatory, and supervisory framework (specific areas of emphasis are mentioned above). It also entails encouraging the Government to stop granting broad debt relief and supporting refinancing loan programs with subsidized interest rates.

Build MFI Institutional Capacity

Funding agencies should help to build institutional capacity by providing exposure to and training in microfinance best practices, along with performance-based support for capacity building so that MFIs can expand their outreach and develop cost-effective, sustainable operations (through the use of so-called “smart subsidies”). In other words, funding agencies should use technical assistance more than direct subsidies to MFIs to ensure a level playing field for interest rate setting and to avoid creating distortions in the market. If onlending funds are provided at

Box 5.1

Common Adaptations of Traditional Bank Regulations and Supervision

- **Lower capital requirements.** Minimum capital requirements should be low enough to attract new entrants into microfinance, but high enough to ensure the creation of a sound financial intermediary.

- **Risk weighting of assets for unsecured loans.** The type of lending (unsecured or secured and, if secured, by what type of collateral) a bank engages in affects its risk weighting of assets, capital adequacy, and provisioning. Regulators should assess the level of risk of an MFI based on overall portfolio quality and repayment history rather than on the value of traditional guarantees. Historical performance of portfolios, statistical sampling of arrears, the adequacy of management information systems, and the MFI's own policies for dealing with arrears should also be taken into account (CGAP 1996).

- **Higher capital adequacy ratios.** A weighted capital adequacy ratio of 8% of risk-weighted assets is currently recommended by the Basle Accord. Because of their generally lower ability to diversify their risks, MFIs should be subject to even higher capital adequacy ratios as a means to safeguard investor funds. Consideration should be given to application of initial MFI capital adequacy ratios approaching 20%, with potential lowering to the range of 12–15%, based on good performance over time.

- **Stricter provisioning**. Provisioning requirements should be based on the average loan maturity of the portfolio. MFI portfolios tend to have shorter average maturities and, therefore, require more aggressive provisioning. Basle Accord requirements suggest that banks be subject to loan provisioning requirements of 25% for substandard loans, 50% for nonperforming loans, and 100% for loss loans. Stricter provision loan loss requirements for MFIs should be at least:

10% of the unpaid balance	0–30 days in arrears;
25% of the unpaid balance	31–90 days in arrears;
50% of the unpaid balance	91–180 days in arrears; and
100% of the unpaid balance	in arrears more than 180 days.

- **Higher operational costs allowed.** MFIs manage small loans and deposits; thus, they tend to have higher operational costs than traditional banks. Allowing MFIs to offer incentive-based payments to staff; to have flexible hours of operation convenient for clients; and to engage in mobile banking, permitting them to disburse funds and collect payments outside branches, can help MFIs to minimize their operational costs. Permitting incentive-based payments to staff can help MFIs reduce portfolio risk. Regulators should not penalize MFIs for higher operating costs if they can demonstrate a reasonable average return on assets.

- **Customized reporting requirements.** Not all the reporting requirements of traditional banks are applicable to MFIs and microentrepreneurs usually cannot produce the same level of documentation as required of traditional lending. Portfolio reporting formats should take into account the volume, loan size, and term of microfinance loans.

Source: Berenbach and Churchill 1997, p. 43.

all, they should be coupled with time-bound, quantitative performance indicators, the achievement of which determines the timing and amount of subsequent funding within a maximum 2–3 year time horizon on continued funding access.

It will be important for funding agencies to focus also on increasing the domestic availability of microfinance training courses and programs. In addition, opportunities for senior managers of MFIs to be exposed to successful microfinance programs in other countries, such as Indonesia and the Philippines, should be supported. An integral part of this second major role for the donor community is assistance in the development of commonly accepted microfinance industry organizational, operating, financial, and reporting standards.

Support Innovation

Funding agencies should promote the development of innovative microfinance methodologies and products as well as complementary, grant-based social service programs. The responsibility for (pre-microcredit) social mobilization efforts and (post-microcredit) business development services or "credit plus" activities (e.g., business training, setting product standards, and marketing assistance) can be passed to purely socially-oriented NGOs. This will allow microfinance NGOs reaching for sustainability to concentrate on satisfying the financial needs of their clients. In addition, assistance from the donor community will be vital in developing and piloting new or adapted delivery methods and products that can be used to increase access by underserved groups to financial services.

Promote Linkages between the Formal and Semiformal Financial Sectors

Finally, funding agencies should promote linkages between commercial banks and MFIs as a means to increase the latter's access to commercial sources of funds. Greater transparency of MFI performance would help in this regard. The donor community should assist in the development of commonly accepted accounting, performance, and reporting standards with a wide range of stakeholders, drawing on international experience in this field. Donor efforts toward establishing standards and promoting linkages may build and reinforce trust and confidence of banks in MFIs, so that mutually beneficial business relationships can develop between them.

ROLES OF MICROFINANCE INSTITUTIONS

Balance Commercial and Social Objectives

MFIs are vulnerable to social mission risk if they do not have a clearly defined target market and monitoring mechanisms to ensure that they are providing appropriate financial services to the intended clients. MFIs are exposed to commercial mission risk if they do not set interest rates (and fees) high enough to cover costs and if they are not managed as a business. MFIs have pursued their social missions but need to balance these with commercial objectives. In order to expand outreach commensurate with demand in a sustainable manner, it is imperative that Sri Lankan MFIs move toward financial self-sufficiency through a combination of strategic and business planning and adoption of cost-recovery interest rates. The success of SEEDS, the most financially self-sufficient and largest microfinance NGO in Sri Lanka, demonstrates that only through achievements in financial sustainability can outreach be expanded in a substantial and sustainable manner.

Become More Responsive to Clients

To become more client responsive, MFIs need to learn how to collect and analyze data on client preferences and know when to make changes. MFIs should work with skilled and independent market researchers who can help clients identify and articulate their microfinance needs without swaying client responses to survey or focus group questions. As these clients express their interests, new product ideas will undoubtedly emerge.

Microfinance providers should also work to understand the reasons behind client desertion. A few MFIs track client retention, but none have a systematic method for collecting reasons why clients desert. Exit interviews and surveys can help an MFI to understand client desertion and avoid it through client recovery strategies.[59]

Increase Cost Efficiency

In addition to bringing their commercial and social objectives into balance, MFIs should strive for cost-efficient operations. The emphasis on cost efficiency is in line with their social objectives, because increases in cost efficiency allow commensurate reduction in the interest rates. SEEDS' achievements in this regard are proof that cost efficiency can be attained even when serving poor clients. All MFIs have a responsibility to reduce costs in order to provide their clients with the most affordable, demand-driven microfinance services possible.

Improve Institutional Capacity

Institutional and management capacity in the vast majority of MFIs is extremely weak and improvements in several areas should take top priority. Missions should be clarified to incorporate a sustainable view of microfinance provision. Efficiency in operations should be made an institutional priority. Weaknesses in ownership and governance should be acknowledged and minimized through the establishment of clear lines of responsibility, staff incentives that promote sustainable outreach, and adequate systems to monitor progress toward commercialization. Increased attention should be given to building human resource strength in financial analysis and banking—at least to the extent that strategic planning and ways to operationalize such planning can take place. Improving boards of directors by including members who have understanding of business and finance is crucial.

Charging nonsubsidized interest rates linked to cost recovery is also necessary. Interest rates should sustain the MFI operation. The administration of many small loans, including processing and tracking services, is a costly operation. Consequently, MFIs need to charge higher interest rates than those charged by commercial banks but lower than those offered by money lenders. Properly prepared and audited standard income statements and balance sheets will increase the transparency of MFI operations, enable performance improvements, and ultimately lead to access to commercial sources of capital. Following are specific MFI recommendations.

Strengthen the ownership and governance of the CRBs

The ownership and management of the CRBs need to be improved, possibly consolidating the banks at the national or provincial levels and partnering them with other financial institutions. This recommendation is likely to be viable only if the multipurpose credit societies can see that they can have a greater profit potential from such a restructuring. The RDBs or a major commercial bank are the best candidates to partner with the CRBs.

Strengthen the management and information systems of the TCCSs

Lack of central management is a key constraint in shifting either the CRBs or the TCCSs as a whole into sustainable operations. The TCCS movement should consider moving toward greater central management not only at the national level—with SDB serving as an apex body—but also at the district level. For this, a first step should be to strengthen the technical skills of TCCS management at the national and district levels. The TCCS accounting system and management information systems need to be streamlined so that they are compatible at the primary, district, and national levels. Greater computerization must accompany the process. This could start in few districts as a pilot project with a few willing primary societies. Centralization would be a major task and the TCCS movement would likely need the

assistance of funding agencies. The auditing process must also be revamped. TCCS has come a long way since the 1970s under the new management. Millions of people now have their life savings in the movement, and it needs consolidation at this stage to avoid a major crisis because of lack of a central management and appropriate oversight.

Microfinance NGOs should improve transparency of their operations and accounts

Microfinance NGOs should separate their nonfinancial activities from their financial services and work toward defining a generally accepted chart of accounts. Once the chart of accounts is accepted, MFIs should also agree to have their annual financial accounts independently audited. Then, the process of developing financial and reporting standards can gain momentum with a view to eventual (reliable) ratings of microfinance NGOs. Such ratings are prerequisite for access to increasingly commercial sources of funds, "soft" loans from NDTF, loans with deposit collateral or other forms of guarantees from private commercial banks (such as HNB) at "commercial" interest rates, and eventually, loans without guarantees from commercial banks at "market" interest rates.

ROLES OF SUPPORT INSTITUTIONS

Second-tier Lender

NDTF is the main supplier of loan funds to microfinance NGOs, providing loans to 56 of them. However, despite its efforts to have a capacity-building focus, its main attention has been on loan recovery. Although NDTF appears successful at refinancing funds, it is managed by traditional commercial bankers seconded from the People's Bank, who need greater exposure to best practices in microfinance. NDTF should be reorganized to become a strong second-tier and capacity-building agency for MFIs.

Credit Information Bureau

Credit information coverage and quality should be increased to allow MFIs to use this valuable tool in their efforts to commercialize. Thought should be given to expanding coverage to loan amounts less than SLRs100,000 ($1,111), including more information (such as client past delinquencies and defaults, current outstanding balances [with information on guarantees and collateral], and the credit histories of guarantors and co-signers), and making such information more accessible to a greater range of semiformal financial institutions, such as the CRBs and TCCSs.

The Microfinance Network

The Sri Lanka Microfinance Network needs to be more focused on its prime task of developing the country's microfinance market. For this purpose, it needs to concentrate more on the core subject than on "credit plus" work. The Network needs to be institutionalized and have its membership base expanded and categorized by groups such as practitioners, funding agencies, etc. The Network should also require regular statistics from its members (based on a common accounting format) on their financial and nonfinancial programs. This could be a start to establishing standards and a rating system of MFIs. The Network should also organize a working group on appropriate legal and regulatory reforms, especially regarding mobilizing savings by MFIs. In addition, the Network could possibly provide microfinance training and other capacity-building assistance.

The Network should introduce a policy for cost sharing for certain activities as well as a strategy for sustainability, graduating over time from subsidized training to full payment for certain activities, especially technical training. Membership fees from all members and participants in network activities should cover essential costs of learning and sharing seminars. Other funding agencies should support UNDP to strengthen and institutionalize the Network so that it can work toward becoming less donor

dependent. The Network should develop links with strong networks, such as those in the Philippines. The Network could play a significant role in creating a forum for learning and sharing by identifying and promoting examples of good practices from Sri Lanka and abroad.

Training Institutions

There is a dearth of training programs and marketing and technology services in entrepreneurship and small business development. The most common service providers to date have been microfinance NGOs that offer integrated social services; however, the supply is well below the potential demand for business development services. In addition, there are no organizations that specialize in microfinance training; no domestic universities or other training institutions offer courses specific to microfinance on a regular basis. The lack of affordable, high-quality microfinance training prevents MFIs from improving their capacity to move toward commercialization. Donor organizations need to develop the capacity and range of skills of one or two existing training institutions if MFIs are to make any headway in microfinance commercialization. The training hubs in India and the Philippines of the Consultative Group to Assist the Poorest may be helpful in this regard until sufficient domestic training capacity is developed.

CONCLUSION

The microfinance industry in Sri Lanka is at an early stage of commercialization, with at most one third of the industry operating on a commercial basis. The industry is characterized by pockets of microfinance commercialization, owing primarily to the personal vision and capability of a few bank managers who are providing microfinance in more economically active communities.

The pervasive presence of the Government in microfinance has hindered the entry of commercial microfinance providers and will continue to do so until its subsidized programs are phased out. This will require a major shift in mindset on the part of government and funding agencies from seeing microfinance primarily as a poverty reduction tool to adoption of the financial systems view. To advance microfinance commercialization, this change in perception will also need to be adopted by the microfinance practitioners themselves.

Cooperatives have strong potential to make significant contributions to microfinance but are constrained by weak administrative and regulatory structures. The cooperatives need to be disconnected from nonfinancial service activities and should be allowed to become licensed banks. Alternatively, their federations should be strengthened and given the authority to truly supervise them. Efforts must be made to ensure the safety of the vast amount of savings deposits mobilized by the CRBs and TCCSs, through improved regulation and supervision or by allowing their deposits to be covered by the national deposit insurance program.

Given the limited supply of donor funds, the majority of microfinance NGOs would likely collapse if they were no longer able to mobilize savings deposits for onlending (i.e., conduct financial intermediation). Nonetheless, the Government needs to reduce its ambiguity toward the situation and begin enforcing the laws that prohibit microfinance NGOs from engaging in financial intermediation. However, it should simultaneously offer alternatives to microfinance NGOs, such as linkages with commercial banks to safeguard the deposits and provide loan capital, and create a regulatory structure for microfinance NGOs. This will enable them to transform into formal financial institutions, such as savings and development banks, with regulatory adaptations to accommodate the distinctive characteristics of microfinance operations.

Implementation of these recommendations will move Sri Lanka even further along the commercialization continuum, which should result in expanding access to microfinance by the poor as well as by higher-income clients. Clients would be offered a greater variety of products more customized to their specific needs and preferences, resulting in greater customer satisfaction. In turn,

clients' businesses should be able to grow and yield more income. This is a model that is likely to lead to economic growth for Sri Lanka as a whole and create more wealth from which to pay for necessary social services, including those that reach the poorest segments of society.