

# Executive Summary

---

This report analyzes the progress toward commercialization made to date in Sri Lanka's microfinance industry,<sup>i</sup> which is relatively large and diverse in terms of outreach and institutional types compared to that in other countries in the region. The report also explores the remaining challenges and the implications for a wide variety of stakeholders including microfinance clients, practitioners, government officials, and funding agencies. In addition, it recommends positive approaches to the commercialization of microfinance while preserving the traditional social objective of microfinance institutions (MFIs)<sup>ii</sup> of expanding access by the poor to financial services.

---

## UNDERSTANDING MICROFINANCE COMMERCIALIZATION

---

Microfinance commercialization is a new concept and the term carries with it a negative connotation among many domestic microfinance stakeholders, who equate it with exploitation of the poor. Microfinance professionals worldwide, however, are increasingly using the term to include "the application of market-based principles to microfinance," with the realization that only through achievements in sustainability can MFIs achieve levels of outreach commensurate with demand. There is a growing realization that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services.

This report considers commercialization of microfinance at both micro and macro levels. At the micro level, MFI commercialization implies institutional progress along a continuum, as follows.

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

At the macro level, commercialization of the microfinance industry means the increased provision of microfinance by MFIs sharing the above characteristics in an enabling environment. Commercialization of the microfinance industry involves several factors, including the degree to which the policy environment and legal and regulatory framework are conducive to the proliferation of commercialized MFIs, the availability and access of commercialized MFIs to market-based sources of funds, and the existence of institutions that support microfinance such as apex institutions, credit information bureaus, microfinance trade associations, microfinance technical training, and providers of business development services.

---

## PROGRESS TOWARD MFI COMMERCIALIZATION

---

- **The microfinance industry in Sri Lanka is at a fairly early stage of commercialization.**

Organizations based on the cooperative model, such as the cooperative rural banks (CRBs), the thrift and credit cooperative societies (TCCSs), and a few nongovernment organizations offering microfinance (microfinance NGOs) 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 of these providers, in terms of their achievements in financial self-sufficiency and access to commercial sources of funds, are together estimated to provide about one third of the microfinance services.<sup>iii</sup> 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.

- **Microcredit market saturation appears high at about 80%.**

Based on household data and the current average outstanding microloan amount of SLRs17,339 (\$193), the upper bound on potential demand among low-income households and their microenterprises is estimated to be around SLRs22.9 billion<sup>iv</sup> (\$254.9 million) in 2.3 million microloans. At the end of 2000, MFIs had approximately SLRs18.2 billion (\$202.3 million) outstanding in 1.65 million microloans. This current supply represents about 80% of the total potential demand for microcredit, in terms of overall amount and number of microloans.

- **Cooperatives are the dominant microfinance providers and the movement continues to influence how NGOs deliver microfinance.**

Microfinance in Sri Lanka has its roots in the cooperative movement, which was formalized in 1911 with the passage of the Cooperative Societies Ordinance. Today the market is pluralistic, with high penetration by many different types of institutions employing a wide range of microfinance models and methods. Given the continued dominance of the cooperative model, however, it is not surprising that MFIs rely heavily on savings mobilization to fund their loan portfolios. The CRB and TCCS networks together mobilize almost SLRs20 billion of deposits, more than enough to satisfy their needs for lending.

- **While many cooperatives are sustainable, their performance varies.**

Among the more commercialized microfinance providers are about three quarters of the 1,476 CRBs that are estimated by the Cooperative Development Department to supply profitably about one third of the country's total microcredit, among other types of loans. The CRBs fund these loans entirely from deposits. Because of the lack of standard accounting and reporting practices among CRBs, it is not clear how many would be profitable after appropriately adjusting for loan loss provisions, write-offs, and subsidies. However, far fewer TCCSs are believed to have commercially viable operations.

- **More than one third of the supply is provided through government programs that can be considered supply-led and not commercially viable.**

More than a third of the total number of outstanding microloans is supplied through a large government microfinance program that promotes the Samurdhi Banking Societies (SBSs) and numerous directed credit programs. Most of these government microfinance programs are narrowly targeted, feature subsidized interest rates, have weak repayment enforcement, and entail large recurrent costs. They are generally considered to be unsustainable. The microcredit supplied through the bulk of these government-sponsored programs is akin to disguised grants, which provide disincentives for the private sector to develop commercial microfinance operations.

- **A few microfinance NGOs are attempting to commercialize their operations but most remain unsustainable.**

The largest NGO in Sri Lanka—Sarvodaya Economic Enterprises Development Services (SEEDS)—provides 5% 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 a few other leading NGOs, such as Janashakthi (Women's Development Foundation),

may also be approaching financial self-sufficiency, although a substantial portion of their income is from interest earned on fixed deposits. The vast majority of smaller and lesser-established NGOs, which number around 200, are not operating on a very sound basis.<sup>v</sup> The number of small NGOs with profitable microfinance operations is widely believed to be less than five; lack of transparency and standardized financial reporting impede a detailed assessment of their financial soundness.

- **There is limited involvement in microfinance by commercial banks.**

The country's financial system remains characterized by a gap in the demand for microfinance and the supply by formal, private sector providers. Private commercial banks largely concentrate on short-term lending to medium- and large-sized enterprises and salaried employees in the formal sector. A few notable exceptions exist, including the Hatton National Bank, Seylan Bank, and Sampath Bank; however, their combined number of microloans outstanding was only 1.2% of the industry total at the end of 2000. None of their microfinance programs are profitable, despite their adoption of nontraditional delivery methods.

---

### COMMERCIALIZATION OF THE MICROFINANCE INDUSTRY

---

- **MFI**s rely heavily on savings mobilization to fund their loan portfolios, indicating a fairly high level of commercialization in terms of access to funding sources.

Collectively, MFIs mobilize over SLRs29.8 billion in total deposits, of which SLRs19.1 billion is savings. It is not surprising that cooperatives are the largest mobilizers of small savings accounts, given their membership and governance structures. The CRB and TCCS networks mobilize almost SLRs20 billion from their members. The SBSs and regional development banks (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.

- **Government policies and interventions discourage new entrants into microfinance and hinder the commercialization of existing MFIs.**

The 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 transform into 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 and thus threatens the reputation of the entire microfinance industry.

---

### MICROFINANCE COMMERCIALIZATION CHALLENGES

---

- **Weak institutional capacity and over-emphasis 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 applying commercial principles. In particular, many MFIs suffer from weak governance, lack of clarity in their mission, low levels of 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 commercial and social missions and from becoming sustainable. Institutional weaknesses and negative perceptions of commercialization are two of the main challenges to commercialization of the microfinance industry.

- **Pervasive government presence in microfinance with subsidized, directed credit programs hampers progress toward commercialization.**

The government microfinance programs, and specifically the largest of them—the SBS program—do not operate on a sustainable basis. While SBS loans carry a respectable interest rate of 3% per month (on a declining balance basis) with loan terms of 3 months to 2 years, the program’s administrative expenses exceed its revenues. Emergency loans via the SBS program carry lower interest rates and also have high administrative expenses. Thus, neither loan type covers its full operational costs. 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 (for example, under many programs, the channeling institutions are subsidized to keep the final lending rate down to 10% per annum). These rates would be insufficient for them to operate the program on a commercial basis if they were using their own funds.<sup>vi</sup> The availability of cheap credit through many of the government programs crowds out private microfinance NGOs and other microfinance providers that do not have access to such large subsidies.

- **Ad hoc debt forgiveness damages the repayment culture necessary for commercialization.**

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, loans below SLRs20,000 granted for paddy and banana cultivation during 1999/2000 (*maha* season, October–January) and 2001 (*yala* season, March–July) were written-off as a result of 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, Farmers’ Relief Scheme, began in 1994 (and was extended

through December 1999); however, practitioners noted that the Government had also waived repayments for small loans by state commercial banks and some loans under its microfinance programs. All instances of debt forgiveness, both large and small, affect not only repayments by clients growing the affected crops but also general client attitudes toward repayment.

- **An inadequate regulatory framework for cooperatives puts 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 SLRs10.9 billion in savings in 5.5 million accounts by the end of 2000. A few are regulated by the Central Bank of Sri Lanka (CBSL)<sup>vii</sup> by virtue of their participation in the national deposit insurance program; however, this regulation and supervision is only loosely applied to the CRBs that may be subject to it. 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 savings of over SLRs1.7 billion by the end of 2000. Both the TCCSs and CRBs have federations that are only loose networks with no management authority to supervise the cooperatives. The lack of strong supporting federations for the cooperatives leaves clients’ deposits at risk if the individual banks (of the CRB network) and the primary societies (of the TCCS network) are not properly managed. Unfortunately, the Cooperative Development Department is not currently equipped to provide prudent regulatory oversight to the thousands of cooperatives under its supervision.

- **Savings mobilization by microfinance NGOs places clients’ savings at risk and threatens to damage the credibility of the industry.**

Under the Banking Act of 1988 and the Finance Companies Act of 1988, an institution must be

licensed as a bank or a finance company in order 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. However, in practice, the prohibition on savings mobilization has generally not been enforced; virtually all microfinance NGOs mobilize mandatory and voluntary savings from members. This practice without legal authority places clients' savings at risk, which in turn places the microfinance industry's reputation at risk should a microfinance NGO fail and depositors lose their savings.

- **Lack of a supportive legal and regulatory framework for MFIs discourages commercial entrants.**

The legal options are limited for semiformal MFIs (for example, microfinance NGOs) that want to transform themselves into formal institutions. Sarvodaya Economic Enterprise Development Services (SEEDS), the most commercial of the microfinance NGOs, sees its best option to formalize is by 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 of SLRs500 million (\$5.6 million). The savings and development bank category for regulated financial institutions may be the most appropriate legal form given its lower initial minimum capitalization of SLRs100 million (\$1.1 million). However, exceptions and adaptations to the regulations would need to be made to accommodate the specific needs of microfinance institutions. The prudential standards applied to banks, such as reporting requirements, limits on unsecured loans, requirements concerning loan documentation, supervision methods, and branching restrictions are incompatible with successful MFI operations, which accept alternative forms of collateral and use simplified application forms, among other nontraditional lending practices.

- **A strong microfinance network is needed.**

There is one microfinance network, the Sri Lanka Microfinance Network, which started in the early

1990s and is still a loose network with no formal membership; anyone interested is invited for meetings. The members meet monthly and have few activities—an annual microenterprise fair to promote the marketing of products produced by MFI clients, commentaries 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 needs to be institutionalized with formal membership and activities.

- **Provide training centers for microentrepreneurs and microfinance.**

There is a dearth of training programs and marketing and technology services for 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 regular courses specific to microfinance. The lack of training opportunities may be traced back to the dearth of personnel qualified to teach local and international best practices in microfinance.

---

## IMPLICATIONS OF COMMERCIALIZATION

---

- **Potential for more demand-driven outreach.**

The basic premise behind microfinance commercialization is that commercial MFIs are more likely to be sustainable and become 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 better met over time. This theory has proved true in such countries as Bolivia, where commercial MFIs dominate the market. 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.<sup>viii</sup> Much of the remaining unmet demand for microcredit in Sri Lanka is a result of both lack of potential clients' awareness of their options as well as the need for MFIs to gain a better understanding of client needs and to adopt products and services to meet those needs. As microfinance commercialization and competition develop, MFIs will need to improve their understanding of client needs and preferences and adapt products and services to better respond to clients' requests.

- **Lack of clear profit potential, which curtails competitive pressures.**

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, its exit from the market would open up a large market for existing MFIs to expand and would encourage new commercial entrants. Only after this market is recaptured will the potential for competition emerge.

- **Potential for mission drift.**<sup>ix</sup>

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 loans sizes for both the Hatton National Bank (HNB) and Seylan Bank have risen in recent years. This trend can be expected to continue until the Government curtails its direct interventions in the microfinance market. These banks are simply targeting the markets where they see the least competition and the most profit potential. How much mission drift this entails depends on a variety of factors. One factor is the extent to which semiformal MFIs seek to transform into regulated entities as a prerequisite to mobilizing significant voluntary savings (to help them substantially increase their outreach on a sustainable basis, e.g., SEEDS). Becoming a formal, regulated financial institution

can result in targeting higher-income clients with larger loans, as a result of profit pressures from equity shareholders. Another factor is the prevailing regulatory and supervisory framework. Prudential standards applied to commercial banks may not be appropriate for formal MFIs and may require the latter to shift their focus up-market to ensure compliance. Mission drift may remain low in semiformal MFIs that are content with serving a localized market on a competitive basis (e.g., Janashakthi). Such institutions will likely enjoy fewer opportunities to diversify their risks and not be able to take advantage of economies of scale in their operations.

---

### POSITIVE APPROACHES TO MICROFINANCE COMMERCIALIZATION

---

The array of challenges to the commercialization of microfinance in Sri Lanka implies specific roles for several key stakeholders including the Government, the donor community, the MFIs, and microfinance support institutions. Recommendations on the roles of these actors follow.

#### **Roles of the Government**

The main roles the Government should play in commercialization of microfinance are to create and maintain an enabling 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 programs in favor of more indirect support of the microfinance sector. Direct financial sector interventions should be minimized to prevent market distortions and to allow private sector provision of microfinance services, using proven methodologies for sustainable microfinance delivery. The Government should also consider complementary, grant-based approaches, such as

social services and training, to reach certain sections of the microenterprise market (for example, the lowest rung of the working poor, as well as the “hard core” poor). Investments in physical infrastructure and provision of social services should be undertaken, especially in rural areas, to improve the business environment and to improve effective demand for microfinance. Specific recommendations follow.

*Create and Maintain an Enabling Policy Environment*

- **Ensure macroeconomic growth and stability.** Several measures should be undertaken to ensure positive economic growth that enables the provision of microfinance to expand in a sustainable manner. These include resolving the secessionist conflict, which continues to destabilize the population and dampens economic growth by necessitating high defense expenditures. Further, curtail ad hoc policy changes, including tax relief measures that cause significant decreases in national income or increased government expenditures related to the public sector wage increases and various smallholder debt relief packages. Such policies can worsen inflationary pressures and dampen economic growth.
- **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 labor force, these and other measures aimed at increasing agriculture productivity might go a long way toward providing a large, economically-viable client base for MFIs seeking to commercialize their operations.
- **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 a view toward

eventual privatization. Many of the government-sponsored agricultural 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 to allowing the banks more autonomy coupled with accountability, similar to the situation with RDBs. The reported profitability of the RDBs (with an estimated 80% of their portfolio considered as microfinance) may be a testament to the potential for sustainable microfinance outreach that such changes may bring. However, it is uncertain how profitable RDBs would be after appropriately adjusting for loan loss provisions, write-offs and subsidies.

*Minimize Direct Interventions*

- **Stop ad hoc debt relief.** Many private MFI practitioners cited recurrent debt forgiveness as the chief impediment to their achieving and sustaining high repayment rates.
- **Phase out government programs.** By the end of 2000, some 940 Samurdhi Banks had been established, an increase of 75 over 1999. This significant growth and presence require 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 microcredit and savings are funded entirely by the clients and not by the Government/ Authority or by funding agencies. There is a need to consolidate the gains in outreach achieved under the program, by moving 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.

- **Curtail the implementation of microfinance programs by the Central Bank's Rural Credit Department.** The implementation of at least a dozen rural credit projects is currently being supervised by the CBSL's Rural Credit Department (and at least two are directly implemented by them). Many of these projects have targeted, subsidized microcredit components. The project features of targeting certain segments of society, subsidizing onlending interest rates, and weak repayment enforcement should be phased out as soon as possible; they conflict with efforts to encourage private sector MFI sustainability.
- **Reduce government ownership and control of the RDBs.** Although the RDBs were given greater autonomy in 1998, the main shareholder remains the CBSL and shares are also held by other government agencies. To minimize adverse political interference in the RDBs and strengthen the market orientation of these banks, the CBSL and the other government shareholders should progressively reduce their ownership control. Promotion of private investment in the banks through privatization should be seriously considered in the near future. The RDBs appear ripe for privatization, because each of them has reported profits in serving their respective rural financial markets over the last couple of years.

*Strengthen the Legal Framework*

- **Resolve legal ambiguity regarding savings mobilization by microfinance NGOs.** Savings mobilization by microfinance NGOs without legal authority is placing clients' savings at risk, which in turn places the microfinance industry's reputation at risk. The Government should require and enforce all microfinance NGOs to deposit savings into a formal financial institution and not onlend them to microfinance clients, or require that all such deposits be covered under the national deposit insurance program.
- **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 international experiences in Africa (such as in Uganda) 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. The ability of these institutions to mobilize deposits legally and to obtain deposit insurance is crucial to enhance their financial self-sufficiency and the commercialization of the microfinance industry. Strengthening the 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.

*Improve Banking Regulation and Supervision*

- **Increase the capacity of the Central Bank of Sri Lanka.** The types of institutions regulated by the CBSL should be expanded in accordance with the growth in recent years of several types of nonbank financial institutions, especially those that mobilize savings. Since many of these institutions engage in significant microfinance operations, regulation is of particular concern in light of the need to protect poor savers. The 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 the CBSL does not currently have the capacity to regulate and supervise all MFIs, alternative forms of oversight should be considered. 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 thorough 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.

### 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. 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. This will help MFIs 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 avoid creating distortions in the market. If onlending funds are provided, they should be coupled with time-bound, quantitative performance indicators, the achievement of which determines the timing and amount of subsequent funding. An integral part of this second major role for the donor community is its assistance in the development of commonly accepted microfinance industry standards in organizing, operating, financing, and reporting.
- **Support innovation in enterprise development and microfinance.** 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 (such as business training, setting product standards, and marketing assistance) should be passed to purely socially-oriented NGOs. Microfinance NGOs reaching for sustainability will then be more able 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 to financial services by underserved groups.
  - **Promote formal-semiformal financial sector linkages.** The Hatton National Bank (HNB) currently partners with about 15 NGOs to find suitable clients, with NGOs providing the social mobilization and HNB lending directly to the clients. Donor efforts may assist in removing some of the obstacles between the microfinance NGOs and commercial banks so that more mutually beneficial business relationships can develop between them.

## Roles of MFIs

- **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. To expand outreach commensurate with demand in a sustainable manner, it is imperative that the MFIs move toward financial self-sufficiency through a combination of strategic and business planning, adoption of cost-recovery interest rates, and increasing efficiency. The success of the most financially self-sufficient and largest microfinance NGO in Sri Lanka, SEEDS, demonstrates that only through achievements in financial self-sufficiency can outreach be expanded in a substantial and sustainable manner.
- **Become more responsive to clients.** To become more client-responsive, MFIs will 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 clients' responses to survey or focus group questions. As clients express their interests, new product ideas will undoubtedly emerge. Microfinance providers should also work to understand the reasons behind client desertion. Exit interviews and surveys can help an MFI to understand and avoid client desertion, by developing successful client recovery strategies.
- **Improve institutional capacity.** Given that institutional capacity in the vast majority of MFIs is extremely weak, 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. Improving boards by including directors who have an understanding of business and finance is crucial. MFIs need to charge interest rates higher than those of commercial banks, yet lower than those of money lenders. Preparation and audit of standard income statements and balance sheets will increase the transparency of MFI operations and enable performance improvements, ultimately leading to access to commercial sources of capital. In addition to the above general suggestions, specific MFI recommendations are as follows:

- *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, such as the RDBs or a major commercial bank. This recommendation is likely to be viable only if the multipurpose cooperative society can see that it can have a greater profit potential from such a restructuring.
- *Strengthen the management and 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 SANASA Development Bank serving as an apex body—but also at the district level. For this, a first step should be to strengthen the technical skills of the 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. The auditing process must also be reorganized.

- *Improve the transparency of microfinance NGOs' operations and accounts.* Microfinance NGOs should separate their nonfinancial activities from their financial services and work toward defining a generally accepted chart of accounts in coordination with the CBSL. Once the chart of accounts is accepted, MFIs should have their annual financial accounts independently audited. The process of developing financial and reporting standards can then gain momentum with a view to establishing reliable ratings, which are a prerequisite to access increasingly commercial sources of funds.

### Roles of Support Institutions

- **Second-tier lenders (apex organizations).** The National Development Trust Fund (NDTF) is the main supplier of loan funds to microfinance NGOs, providing loans to 56 of them. Despite its efforts to have a capacity building focus, its main attention has been on loan recovery. Although the 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 restructured to create a second-tier funding and capacity-building agency for MFIs.
- **Credit information bureaus.** Credit information coverage and quality should be increased to allow MFIs to use this valuable tool. Thought should be given to expanding coverage to loan amounts less than SLRs100,000 (\$1,111), including other 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) relevant to microfinance providers. Such information should be accessible to a greater range of semiformal financial institutions, such as the CRBs and TCCSs.
- **Microfinance Network.** The Sri Lanka Microfinance Network needs to focus 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 such groups as practitioners and funding agencies. 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 based on widespread adoption of those standards. The Network should also organize a working group on appropriate legal and regulatory reforms, especially regarding MFIs mobilizing savings.
- **Microfinance training institutions.** Currently the capacity within Sri Lanka for training in microfinance is very limited. This is a major issue; there are very few institutions providing training or capacity building of microfinance. The main institutions are CBSL Centre for Banking Studies, International Center for Training of Rural Leaders, SEEDS Management Training Institute, Rural Development Training Institute, and SANASA Training Institute. Two of these five institutions were established by SEEDS and TCCSs, respectively, to train their own staff and they 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 the CBSL's Centre for Banking Studies and the International Center for Training of Rural Leaders as facilities that could offer microfinance capacity-building training. The latter is strong at training in

management and accounting for microfinance at the community-based organization level. But both have weak capacity to offer training on local and international microfinance best practices. 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 of the Consultative Group to Assist the Poorest may be helpful in this regard until sufficient domestic training capacity is developed.