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Micro Finance Business Proposal

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Executive Summary

About Microfinance in Sri Lanka

Sri Lanka's financial system is comprised of a variety of institutions which include the Central Bank of Sri Lanka (CBSL), commercial banks, specialized banks, finance companies, specialized leasing companies, insurance companies, unit trusts, merchant banks, venture capital companies, authorized primary dealers, stock brokers and dealers, and contractual savings institutions such as the Employees' Provident Fund and the Employees' Trust Fund. These institutions operate within the formal financial markets such as the money market, bond market, foreign exchange market and the equity market and are supported by a financial infrastructure consisting of the payments and settlement systems and an applicable legal framework.⁵ There are also a number of rural banks, thrift and credit co-operative societies, pawnbrokers as well as microfinance institutions (both NGOs and companies, collectively referred to in this report as NGO-MFIs) in operation. In addition, there is a thriving informal financial system which includes a large number of moneylenders, ROSCAs, etc.

The microfinance movement in Sri Lanka dates as far back as 1906 with the establishment of Thrift and Credit Co-operative Societies (TCCSs) under the Co-operative Societies Ordinance introduced by the British colonial administration. These were the first credit co-operatives to be established in Sri Lanka. The societies fulfilled a wider role during the early decades of the 20th century, being involved also involved in procurement of inputs and distribution of products, a role eventually taken over by the Multipurpose Co-operative Societies (MPCSs) which were originally established during the 1940s as Consumer Co-operative Societies and renamed Multipurpose Co-operatives in the 1950s.

Commencing in 1985 the Government established 17 Regional Rural Development Banks (RRDBs) through an Act of Parliament. These institutions were given the task of reaching remote rural areas and smallholders who lacked access to financial services from commercial banks. The RRDBs covered all districts of Sri Lanka with the exception of the North and East. Their success, however, was limited by internal structural weaknesses and excessive geographical fragmentation, which prevented them from reaching a critical mass. In addition, the banks lacked sound lending and monitoring policies, and operations were difficult to improve and standardize. A significant restructuring and recapitalization took place in 1998/1999 and the RRDBs were consolidated into the six Regional Development Banks (RDBs) which exist today. This involved granting RDBs more autonomous management, allowing a broader ownership base, and having board members appointed by shareholders with the intention of creating more professionalism of operations and, thus, their viability and sustainability in the long-term.

A recently emerging trend is the entry of commercial banks and registered finance companies and other large corporate entities into the microfinance business. Hatton National Bank's "Gami Pubuduwa" ("Village Awakening") microfinance programme is probably the oldest microfinance program among the licensed commercial banks, having

been established in 1989 and disbursing over Rs. 3.5 Bn (approximately US\$ 35 Mn) to around 70,000 micro entrepreneurs over the years. Some recent entrants are aggressively moving into the sector and have the resources and infrastructure to scale up rapidly. However, for many commercial banks and finance companies, microfinance is more a Corporate Social Responsibility (CSR) or image building activity.

Microfinance providers in Sri Lanka

Sri Lanka's microfinance sector is served by a diverse range of institutions. These can be segregated into the following broad categories.

- Regional Development Banks and other licensed specialized banks
- Co-operative Rural Banks and other co-operatives
- Thrift and Credit Co-operative Societies (TCCSs/ Sanasa societies)
- Samurdhi Bank Societies (SBSs)
- NGO-MFIs
- Other financial institutions (this category includes commercial banks, registered finance companies, etc., which offer some microfinance services).

Network of microfinance outlets

The CGAP CLEAR Review of 2006 estimates that there are over 14,000 providers of microfinance in Sri Lanka. This includes the network of Sanasa societies of which there are officially 8,440. However, more than 50% of these are inactive, according to Sanasa. In reality, therefore, the number of active providers of microfinance is probably less than 14,000. An island wide survey of microfinance institutions (hereafter referred to as the MFI survey) commissioned by the GTZ - ProMiS (Promotion of the Microfinance Sector) program in 2006/2007 reveals a network of at least 10,000 outlets which are active across the country.

A breakdown of this is given below:

Type of Institution	No. of Outlets
RDBs	215 Branches
Other licensed specialized banks Sanasa Development Bank	36 Branches
Samurdhi Bank Societies	1,038 Societies
CRBs & Women's development co-operatives	1,684
Sanasa/TCCSS	3,794 Active Societies
Other MFIs (NGOs/Limited liability companies/companies limited by guarantee)	2,500
Total (excluding banks & other financial institutions)	9,267

Regional coverage

The regional and sectorial distribution of microfinance outlets is depicted in Figures 1 and 2 below, based on the MFI survey.¹² Although 3 of the country's 25 districts could not be covered, the MFIs which were covered by the survey include all the large providers of microfinance in the country, therefore the data given below is considered to be quite comprehensive. The regional distribution depicted in Figure 1 covers 7,141 microfinance outlets of the MFIs which participated in the survey. It includes all the RDBs, all the SBSs and the 3,794 active societies of Sanasa. It also covers over 85% of CRBs and 83 NGO-MFIs. Given our estimate of c. 10,000 microfinance outlets in the country, the regional distribution depicted below covers at least 70% of outlets. There is clearly a strong presence of MFIs in the Southern Province, with nearly a quarter of outlets located there. On the other hand, the predominantly agricultural North.

Figure 1 - MF Outlets by Province

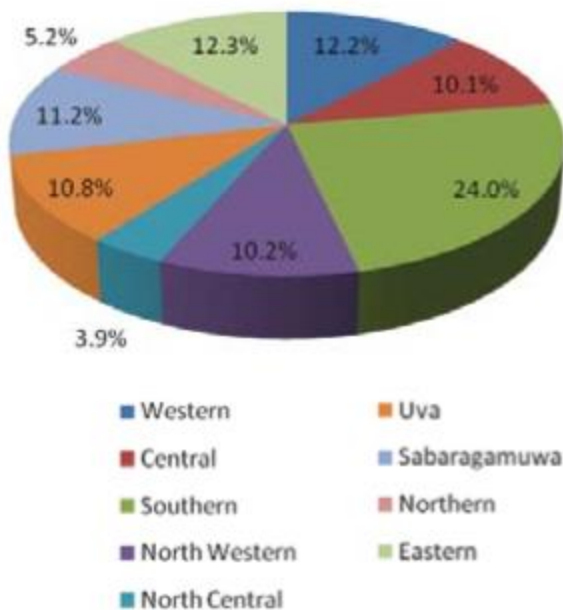
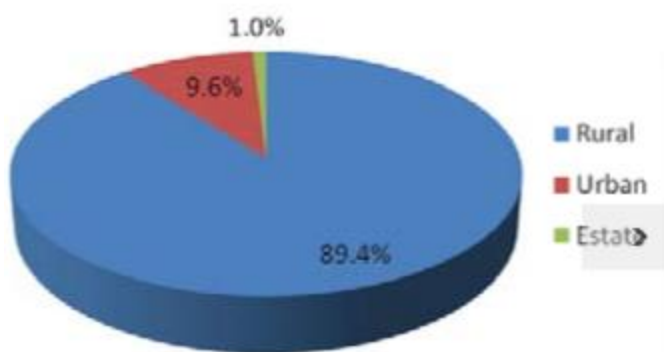


Figure 2 - MF Outlets by Sector



Household Income and Expenditure Survey 2006/07 –
Department of Census and Statistics Sri Lanka

Challenges And Opportunities In The Microfinance Sector

Despite the long history of microfinance in Sri Lanka and a proliferation of institutions engaged in microfinance activities, it is only in recent years that questions concerning sustainability, transformation and an inclusive financial system have been given serious consideration by practitioners, policymakers and other stakeholders. The challenges facing the sector are many and they exist at all levels, macro, meso and micro.

Macro Level

A key challenge is the lack of a long term vision and policy for the sector. This is addressed also in the Government's 10 year development plan, the Mahinda Chintana, which points out that the lack of a policy has resulted in there being no institutionalized mechanism to coordinate microfinance interventions with other policies which have been formulated for rural development.

- The CGAP CLEAR Review of Sri Lanka also highlights the following macro level challenges: inadequate supervision of savings in the SBSs and CRBs. This is related to the point above. Under the existing system, the CRBs are supervised by the Department of Co-operative Development through provincial level cooperative commissioners and district officers (therefore essentially self-regulated). Similarly, the SBSs are not externally supervised. The Central Bank has in the past highlighted the risks of SBSs mobilizing large volumes of savings without proper regulation and supervision.
- Politicization is a fundamental issue affecting government owned and/or controlled microfinance institutions. Microfinance is often used as a political tool through institutions such as the Samurdhi. Microfinance services are often confused with welfare and there is pressure to give "free" loans or place a ceiling on the interest rate. This has a "crowding out" effect on private microfinance providers who are unable to compete against subsidized interest rates. Prior to elections it is not unusual for politicians and political parties to influence particularly government owned/ controlled microfinance institutions to write off some outstanding loans in order to win votes.

Meson Level

- Funding issues. The 2006 CLEAR Review cites underutilized apex funds as a challenge facing the sector, stating that disbursement of the main apex funds is low, indicating limited interest or absorption capacity of MFIs. Lack of interest could also be due to the various conditions attached to the funds provided as well as single institution.
- Insufficient specialized microfinance training facilities have contributed to many microfinance providers failing to meet the standards required for them to transform into financial institutions and attract the funding they require from commercial investors in order to scale up their operations in an environment where cheap donor funds are fast drying up.

Micro Level

- Quality of human resources. The quality and skill levels of MFI staff seem to be issues that cut across the institutional types. In the GTZ survey of microfinance institutions, staff issues ranked among the top 5 challenges faced by most MFIs. The cause of the problem however, differs across institutional types. The SBSs face overstaffing as they are frequently used to achieve political objectives by providing employment for political supporters. The Sanasa societies work through a large number of voluntary staff, therefore suitably qualified individuals usually seek better paid jobs as permanent employees elsewhere, leaving less qualified individuals volunteering for positions in the Societies. Relatively poor remuneration and difficult working conditions for microfinance providers working in remote rural areas are also contributory factors in the issue of attracting and retaining quality staff. In the NGO-MFIs most of which originated as social service organizations, the staff still has a more “development and social welfare” approach and are unsuited to the task of managing a financial services business. Basic knowledge of accounting, IT and human resource management is, overall, very low. This has resulted in weak organizations, especially at middle management level. Other than in the case of the RDBs which are seen as “formal banks”, the rest of the sector suffers due to the general perception that microfinance is not an attractive career option with qualified individuals seeking employment in state banks or private sector companies. The introduction of academic programs in microfinance through universities and recognized institutions such as the Institute of Bankers would go a long way towards making microfinance a more accepted profession and providing more qualified staff for the sector.

- Involvement of government in retail credit provision is widespread as more than half of microfinance clients are with government owned or controlled institutions. This paves the way for political interference in these institutions and a mixing of social, political and financial objectives to the detriment of the sustainability of the institution.
- There is limited focus on sustainability as the sector has been protected by a large amount of subsidized funding, from government and foreign donors alike, although the latter source is now much reduced. MFIs have therefore been lulled into a state of complacency, paying little attention to questions of long-term sustainability. The large amount of subsidized funds hides the real sustainability picture of the MFIs as measured by financial self-sufficiency. Few institutions can be said to be financially self-sustainable. Loan portfolio quality is also poor in many instances – the common practice is to measure the loan recovery rate which provides a misleading perception of portfolio quality. Understanding of concepts such as Portfolio at Risk (PaR) is very limited. In the GTZ survey of microfinance institutions, although many respondents across all institutional types claimed to understand the concept of PaR, the definitions provided were varied and mostly incorrect or not in keeping with internationally accepted definitions.
- Organization culture in most NGO-MFIs still leans towards a social welfare mentality. Many such MFIs still adopt an integrated approach, combining microfinance business with community development activities. However, there is a change of mind-set taking place among a handful of MFIs which have separated their microfinance business from their other activities through the creation of independent microfinance institutions. These players have a much stronger focus on cost efficiency and sustainability. The government controlled MFIs are hampered by excessive bureaucracy and hierarchies as well as insufficient performance incentives. As a result, the growth of these institutions has remained sluggish despite their extensive branch networks spread across the country.
- Lack of transparency and standardization. There is an overall lack of transparency and reluctance to share even the most basic, non-financial operational information among MFIs, even those who are not direct competitors. This was a major issue during the GTZ survey of microfinance institutions as many MFIs were reluctant to provide basic information. The non-availability of information is due in part to manual systems being used, resulting in unreliable operational and financial information.
- Limited use of technology. Despite widespread use of technology in the formal financial sector, its use in the microfinance sector is still very limited. It is only during the past 5 years that computerized systems were introduced even in the RDBs with the installation of the Micro Banker. The use of ICT in improving delivery technologies and reducing transaction costs is being explored only by very few institutions. Very low IT knowledge among the staff of MFIs, particularly in the NGO

sector, has been a limiting factor in accessing the full potential of technology to improve information and monitoring systems

Opportunities

While many challenges exist for the sector there are also many strong points in its favor. The key points are summarized below based on the CLEAR Review of Sri Lanka.

- Diversity of institutions. There is a long tradition of informal savings and credit in Sri Lanka, especially through grass root initiatives.
- Significant savings culture. The CLEAR Review estimates 15 million savings accounts in Sri Lanka with a value of Rs.49 billion. If the entire banking system is considered, (exact figures are not available), indications are that the number is significantly in excess of this as the People's Bank and Bank of Ceylon alone have around 18 million savings accounts. Since this covers the 2 state owned commercial banks only, the total number for all banks would be even higher. According to the Central Bank, the volume of deposits in the financial system (including TCCSs, SBSs and CRBs) amounts to Rs. 1,700 billion as at June 2007. A significant savings culture is also indicated from the GTZ survey on outreach of financial services with 74% of households stating that they save with a financial institution.
- Large outreach. A high proportion of the population has access to financial services. In the GTZ outreach survey, 82.5% of households stated that they use the services of a financial institution.
- Specialized microfinance training emerging. The University of Colombo and Institute of Bankers have/plan to introduce microfinance diploma programs. These are encouraging steps towards formalizing the study of microfinance and introducing international standards and best practices through the involvement of internationally recognized institutions such as the Frankfurt School of Finance & Management. In addition, SEEDS, Sanasa and the co-operative system have specialized training facilities. While the standard and quality of training may differ, the recognition of the need to have such specialized training augurs well for the sector.

Key Competitive Advantage

From the challenges mentioned above it is evident that despite the widespread use of technology in the financial sector, the use of ICT in the Microfinance sector is very limited. The key reason for this is that very few institutes are exploring the ICT usage and the skill level of the human resource. The key competitive advantage is to introduce a multilingual, simple web based solution implemented to help all stakeholders.

The solution can be a web based system that can be accessed from many locations and information can be centralized. The high level functionalities of the system can be pointed as follows:

- **Providing information on available financial instruments.** Enabling a system to provide information to the rural community through a common web based solution in all three languages using simple easy to use navigations.
- **Eligibility inquiry via internet.** Enabling the potential client to check his/her eligibility for micro financing.
- **Application submissions via web based solution.** Enabling potential candidates to submit their own applications online in their preferred language.
- **Application tracking /Application status monitoring.** Enabling the candidates to check the status of the applications submitted. Can be integrated with a mobile solution and enable mobile alerts via SMS on applications status
- **Tracking payment history and payment dues.** Once financial services are obtained the clients have the options of tracking their activities online through a web based solution
- **Reporting complaints.** The clients have the ability of giving feedback on services provided and receive valuable real time information on areas for improvement. Thus, being proactive in client management.
- **Integrating with mobile easy pay system to increase penetration etc.** Since mobile penetration is high in Sri Lanka even in the rural areas, it will be very helpful for the client to enable settlement via mobile transactions. Thus, eliminating or minimizing the hassle of maintaining collections centers.

It must be noted with the emergence of the generation Y (millennial generation) into the work force, the usage of information and communication technology is rising. This trend provides a massive opportunity to address several key issues and thus, gain a competitive advantage. Another key feature of this generation is the rise in part time and freelance employment.

The system should be combined with a freelance workforce as opposed to a permanent work force, where a person with thorough microfinance knowledge can work on commission basis and reach out to the rural community and thus, guide the potential clients to become customers. This provides opportunities to create branches independent of the financial institute and act as a representative of the financial institute, which will significantly reduce the overhead cost of maintaining a branch outlet and resources. The cost incurred will be the cost of providing the ICT services, initial training of the ICT system and the sales commissions. However, depending on the requirement the level of authority outsourced, should be configurable depending on a situational basis. This method of Micro Financing is not yet being used in Sri Lanka in a large scale and thus, will provide a major first mover advantage if executed strategically.