Title : Commercial Microfinance: A Strategy to Reach the Poor?

Author : Ms. K.D.D. Perera

Affiliation : Department of Accountancy
Faculty of Commerce & Management Studies
University of Kelaniya
Sri Lanka

Presenter : Ms. K.D.D. Perera

Email : dinuja@kln.ac.lk
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ABSTRACT
The microfinance sector in Sri Lanka suffers from the core problem of poor quality of microfinance services offered, indicated by insufficient outreach, poor repayment rates, low cost efficiency, recurring losses, financial products which are not client driven and significant deficiencies in regulation and supervision. This seriously threatens the sustainability of the offered financial services and their outreach to poorer households, micro and small entrepreneurs. In early days, financial exclusion; the provision of financial services to those excluded from the formal financial system was a hint of potential breadth of micro financial services which was an expanding focus for microfinance institutions. However, “Commercial Microfinance”, where microfinance services are provided by commercial organizations that are part of the formal financial system has received increasing attention in today’s financial market. Therefore, this study explores “downscaling” by banks as a model of microfinance commercialization that has used as a strategy to reach the poor. In order to answer the main research question, an explorative case study methodology was chosen, based by a microfinance programme of a well established commercial bank in Sri Lanka, the “Hatton National Bank”. This study was based on commercialization debate areas; trade-off between sustainability and outreach, financial performances and impact on clients. The findings reveal that commercialization of microfinance gives rise to a trade-off between sustainability and outreach. However, protection against regulations, physical infrastructure, better know-how, greater access to funds, and enhanced capacity, make commercial banks the most qualified to meet the untapped demand of micro entrepreneurs.
**Introduction**

The microfinance industry has developed from a history of microcredit programmes, and today it had grown to cover a broader range of products and services, from credit and savings, to insurance and money transfers. Today many speak in more general terms of microfinance as the provision of financial services to those excluded from the formal financial system. The financial exclusion therefore a hint of potential breadth of micro financial services, which was an expanding focus for microfinance. Effective microfinance was therefore positioned to overcome a variety of access barriers to a wide range of financial services for the different customers who were excluded from the formal financial services. Thereafter, microfinance institutions (MFIs) began shoulder to cater this neglected niche market and have proven their clients are bankable and institutions are profitable.

Most of the bankers have not regarded microfinance as genuine option and they have believed it unprofitable. One major reason for this perception was bankers perceive small business and microenterprises as bad credit risks. The perception was that small clients do not have stable, viable business for which to borrow and from which to generate repayment and lack of traditional collateral to guarantee their loans. They further believed that since the microloans are small and have short terms, operations will be inefficient and costly. In many developing countries, social, cultural and language barriers too did not allow for an easy relationship with modern banking institutions.

However, surprisingly, many commercial banks in developing countries have begun to examine the microfinance market by relaxing their previously tough lending conditions and
have entered into the microfinance sector with more favorable approaches (Baydas, Graham & Valenzuela 1997).

**Commercial Microfinance**

Commercial microfinance therefore is broadly defined as microfinance services provided by commercial organizations that are part of the formal financial systems such as banks, and non-bank financial institutions. These organizations are financed by commercial capital and usually confined by regulatory framework (Clark 2005).

**Models of Commercial Microfinance**

Downscaling as a model of microfinance allows the programme to take advantage of the funding and infrastructure advantages of a commercial bank while providing the microfinance programme with the necessary space to operate successfully (Bharti, Bhargava, Bellur 2006). Therefore, the researcher focused on the model of downscaling to proceed this study.

**Debates in Commercial Microfinance**

The debates on commercial microfinance begins with the argument that whether commercial approach is concerned on the ultimate objective of microfinance; the poverty alleviation. Because, the poverty oriented microfinance institutions will prioritize the impact that the lending programme is having and the level of clients’ poverty. However, commercially oriented microfinance institutions believe that a permanent impact can only be had if services and products can be provided in a sustainable manner (Bharti, Bhargava, Bellur 2006). Therefore, sustainability and outreach would be a main debate area of commercial microfinance which often identifies a trade-off between these concepts. So that the researcher
would mainly focus on these debate areas; trade-off between sustainability and outreach, financial performances and impact on clients.

**Brief overview of Microfinance in Sri Lanka**

The microfinance sector in Sri Lanka suffers from the core problem of poor quality of microfinance services offered, indicated by insufficient outreach, poor repayment rates, low cost efficiency, recurring losses, financial products which are not client driven and significant deficiencies in regulation and supervision (CLEAR Review). This seriously threatens the sustainability of the offered financial services and their outreach to poorer households, micro and small entrepreneurs. Commercial banks have made some efforts to serve the poorer population; however, one suspects that these efforts are merely to boost their image.

Microfinance Interventions have typically been included in general poverty alleviation programmes, however, there is no national policy for Microfinance Sector in Sri Lanka or an institutionalized mechanism to coordinate microfinance interventions with other policies which have been formulated for rural development and poverty alleviation (Microfinance Industry Report 2009). Nevertheless, the microfinance in Sri Lanka is recently planning to apply best practices by transforming MFIs into regulated intermediaries which would therefore contribute to a streamlining of institutions and practices, and thereby, ensure the sustainability of the institutions.

**Microfinance Practitioners in Sri Lanka**

Microfinance in Sri Lanka is practiced by a diversified range of institutions. These can be broadly categorized into three sectors; the *formal microfinance sector* which comprises commercial banks, Regional Development Banks and SANASA Development Bank, the
semi-formal MFIs comprising Cooperative Rural Banks (CRBs) and NGO-MFIs, and the informal sector, or non-institutional service suppliers such as savings associations, rotating savings and credit associations, funeral or death-benefit societies, traders, moneylenders, input suppliers, friends and relatives.

At present, out of eleven (11) local commercial banks; two state owned commercial banks (Bank of Ceylon and People’s Bank) and two private banks (Hatton National Bank and Seylan Bank) in Sri Lanka have downscaled their banking operations into the microfinance sector with some efforts to serve the poorer population.

On the other hand, amongst the large number of Microfinance Institutions (MFIs), some promising institutions exist. A few non-governmental organizations (NGOs) are on the edge of becoming operationally self-sufficient and are beginning to seek commercial refinancing. Institutions like the thrift and credit cooperatives (organized in Sanasa), or the Cooperative Rural Banks have been reaching out to many poor and rural-based families. Some of them have the potential to become leading agencies in the cooperative movement (CLEAR Review).

**Research Problem**

From the regulated commercial banks’ perspective, entering into the microfinance sector would be a natural sign of growth. However, due to some structural deficiencies in the microfinance institutions (MFIs) and the unstable financial environment occurred due to the collapse of unregulated financial institutions in the recent past of Sri Lanka, it has created a dilemma in the microfinance sector. Therefore, this research would focus on the main problem of whether the commercial microfinance is playing a pivotal role in serving to the poor while maintaining the sustainability and objective of microfinance.
Objectives

The main objectives of this study are,

1. To identify the microfinance experience of commercial banks in Sri Lanka.

2. To identify the trade-off between sustainability and outreach of commercial microfinance programmes.

3. To identify the level of sustainability and outreach of Gami Pubuduwa (Village Awakening) Programme offered by the Hatton National Bank of Sri Lanka.

4. To recognize the extent to which the Gami Pubuduwa (Village Awakening) Programme has been able to achieve the objective of poverty alleviation.

Literature Review

Some relevant literature was reviewed by the research especially in the areas relating to the intervention of commercial banks into the field of microfinance. Accordingly, Baydas, Graham & Valenzuela, (1997) have concluded in their study; (1) microfinance within commercial banks is largely attributed to the efforts of a single person or to a small group of people to promote these activities. Some of these individuals have been close to and aware of the NGO operations in microfinance. With few exceptions, microfinance in commercial banks has seldom been based strictly on profit-seeking motives. (2) Prudential regulation, with few exceptions, does not seem to discourage microfinance activities in most of the banks. No additional requirements, other than what is typically reported by commercial banks to the supervisory authorities, are requested of commercial banks because of their microfinance activities. (3) Most commercial banks largely use their own deposit base for microloans. Donor funds and government rediscount lines still represent cheaper sources of funds for a number of organizations, but some conditions and limitations restrict use of these
resources. (4) The current outreach of commercial banks in microfinance is at best modest in scope.

Further, Bell, Harper and Mandivenga (2002), by a case study done on two different commercial banks in Zimbabwe and Kenya, has concluded that there are still very few cases of privately owned commercial banks downscaling to microfinance for purely business reasons. One of the most important reasons they have identified is the effect of liberalizing markets; as local banks face increasing competition from new, start-up local banks, and foreign banks entering the market, they are obliged to seek alternative markets to survive.

Isern and Porteous (2005) are in their view that commercial banks that wish to take advantage of the opportunities in microfinance should carefully evaluate the considerations, specifically their own goals, the potential market size and competition, the regulatory environment, and their current infrastructure and systems.

**Methodology**

**Figure 1: Conceptualization of the Problem**

![Diagram of Commercial Microfinance organizational structure, performances, products & services, operational self-sufficiency, financial self-sufficiency, methodology, microfinance products, business goals, regulatory environment, infrastructure & systems.]

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Based on the literature survey carried out for this study, the above conceptual framework was developed by the researcher. The ultimate objective of a microfinance practitioner would be the poverty alleviation. Thus, this research study focused on finding out the extent to which the commercial microfinance has contributed towards achieving this objective. Therefore, this study was based on commercialization debate areas; trade-off between sustainability and outreach, financial performances and impact on clients. Consequently, the researcher focused on organizational structure, products and services offered and performance of the bank in terms of identified different variables as depicted in the figure 1.

**Data Gathering**

As there are only a few commercial banks have downscaled their operations into the commercial microfinance in Sri Lanka, case study methodology was followed by selecting a big player in MF, Hatton National Bank (HNB) to assess their operations through a well know microfinance programme “Village Awakening” (Gami Pubuduwa-GP Programme).

**Findings & Discussion**

**Gami Pubuduwa (Village Awakening) Microfinance Programme – Hatton National Bank**

Hatton National Bank being an indigenous financial institution in Sri Lanka has been involved in rural development almost from the inception of the Bank in year 1972. Since then, HNB has involved in rural development providing financial services to rural community for variety of activities such as cultivation, animal husbandry, trading & other self employment projects.
During the period of 1988/89 Sri Lankan society experienced an island-wide youth unrest mainly due to unemployment & acceleration of poverty. HNB, having realized the importance of this social & economic upheaval, has initiated ‘Gami Pubuduwa’ (Village Awakening) programme in May 1989 with a view of extending bank’s assistance to the rural youth in exploring self employment activities.

Gami Pubuduwa Scheme has formulated not only with a view of extending credit facilities, but also to give a package of banking facilities. The main ingredients of the scheme constitute of rural savings mobilization and social development while extending credit. The Bank has appointed field officers known as 'Gami Pubudu Upadeshaka' (GPU) to closely associate with the rural community, identify their strengths & weaknesses and make suitable financial proposals to promote successful micro entrepreneurs.

**Organizational Structure**

**Business Goals**

The core objective of Gami Pubuduwa programme includes developing a sustainable programme which will provide a new orientation to the village folks, contributing to uplift their lifestyles. One of the main goals of Gami Pubuduwa programme is to contribute to the country’s social and economic development process while serving to the poor population.

**Regulatory Environment**

There is no separate microfinance regulation currently exist in Sri Lanka though the proposed Microfinance Act by the Central Bank is still at the draft level. Therefore, at present all MFIs are governed by existing regulations, which are applicable to financial intermediaries. Since there are different types of microfinance players currently operate in Sri Lanka, the regulations followed by each player are different to each other; some belongs to prudential
regulations whereas some belongs to non-prudential. The Gami Pubuduwa programme operated by the HNB is therefore governed by the *Banking Act No.30 of 1988* and the *Monetary Law Act No.58 of 1949* under the prudential regulations, which belongs to the category of Licensed Commercial Banks.

**Infrastructure & Systems**

The Gami Pubuduwa programme is integrated into HNB’s operations as an additional product line offered by the bank. Therefore, GP does not perform as a separate banking division, however, it is part of the Development Banking Unit, which is under the Personal Banking Division. The bank today has 110 micro financing units disbursing funds micro entrepreneurs. There are 37 agricultural professionals and 87 micro finance field officers. The banks has introduced the concept of micro finance team leaders in year 2008, promoting 5 who will support the field officers to drive the microfinance vision.

**Products and Services**

**Methodology and Microfinance Products**

The GP loan portfolio has an extensive exposure to a wide spectrum of micro enterprises consisting agriculture, cultivation & processing, fisheries & aquaculture, handicrafts, pottery, and food preparation etc., as depicted in Figure 2. Also with a view to enhancing local liquid milk production and promoting agricultural crops processing industries in the country has designed a novel scheme specially designed for small scale dairy farmers and large scale milk processors under the name ‘Agro Livestock Development Loan Scheme’.
The GP loans are ranged from a minimum of LKR 5,000 to a maximum of LKR 1,000,000 depending on the requirements of the customers. The qualified clients of the bank have however the advantages of obtaining a loan beyond this limit case by case. The loan is initially approved by the branch manager, of which GP is currently operated in 87 branches. However, the approval should obtain from the head office when the loan amount gets larger.

Performances

Sustainability

Operational Self Sufficiency and Financial Self-Sufficiency

In terms of microfinance, sustainability can be maintained by achieving Operational Self Sufficiency (OSS) and Financial Self Sufficiency (FSS), indicated by the percentage of all operational cash expenses covered by its operating income and adjusted (inflation adjustment etc.) operational expenses covered by its operating income respectively. However, the GP programme at HNB does not separately identify OSS and FSS for their decision making.
Because, the branch offices only maintain their financial information separately and the cumulative income and expenditure will be accounted at the head office including all HNB operations. Therefore, the researcher would see this as a major limitation of this study. A previous study which have been done by USAID in 2005 for the HNB Gami Pubuduwa programme identifies the OSS for the year 2003 as 121%, which indicates that HNB GP programme has been able to cover its operational expenses while achieving sustainability.

Table 2: Financial Indicators 2008

<table>
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<th>Financial Indicators 2008</th>
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<tr>
<td>Operational Self-Sufficiency</td>
<td>121%*</td>
</tr>
<tr>
<td>Client Repayment Rate</td>
<td>95%</td>
</tr>
<tr>
<td>NPA Rate</td>
<td>5%</td>
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</tbody>
</table>

*This figure was extracted from USAID Report 2005

Further, GP programme has been able to maintain a client repayment rate of 95% according to HNB GP programme officials and their NPA rate is therefore at a very low rate of 5% (HNB PLC Annual Report 2008).

Moreover, most of the GP projects are operated through HNB retained funds and refinancing funds. As such they do not have any difficulty in generating funds. One major advantage would be their deposit base. The GP programme currently maintains a deposit base of approximately 2Bn which is nearly to their loan portfolio. The GP programme has 124 field officers by the year end 2008. The borrowers to field officers ratio is therefore 113, which is considerably a lower target. Unlike most MFIs, the GP field officer however, do not visit their clients to collect their loan installments, instead the bank will directly charge the installment plus interest from their accounts maintained at the bank. The bank has therefore an advantage of reducing their operational cost.
The lending rate of GP projects vary depending on the type of financing. The interest rate has been varied between 21% to 25% over the year 2008 for projects maintained by the retained funds. For refinancing funds it has been varied between 9% to 14%.

The bank maintains due care to avoid adverse selection, where field officers are responsible for obtaining the background information of the client before they grant loans and clients too can access to all relevant information from the field officers before they are being qualified for a loan.

**Outreach**

Outreach refers to the ability of the Microfinance Institutions (MFIs) to reach large number of clients. The depth of outreach indicates whether the MFI provides microfinance services to clients belonging to the lower income segment of the country. The basic assumption is that smaller the loan size, the deeper the outreach, or the poorer the client. Thus, loan size has been consistently used as a “proxy” for the level of poverty. And also lower the percentage of depth, deeper the outreach of the institution.

**Table 1: Outreach of Gami Pubuduwa Programme**

<table>
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<th>Year</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
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<tbody>
<tr>
<td>Loan Portfolio (LKR)</td>
<td>1,700,000,000</td>
<td>2,049,787,160</td>
<td>2,230,692,000</td>
</tr>
<tr>
<td>No.of Borrowers</td>
<td>16,000</td>
<td>14,434</td>
<td>14,053</td>
</tr>
<tr>
<td>Average Loan Outstanding (LKR)</td>
<td>106,250</td>
<td>142,011</td>
<td>158,734</td>
</tr>
<tr>
<td>Per Capita GNP (LKR)</td>
<td>145,744</td>
<td>176,893</td>
<td>213,262</td>
</tr>
<tr>
<td>Depth</td>
<td>73%</td>
<td>80%</td>
<td>74%</td>
</tr>
</tbody>
</table>

The total outstanding loan portfolio as at the year end 2008 of the GP programme is amounted to LKR 2.2 Bn. A gradual decrease in the number of borrowers is encountered as it moves from year 2006 to 2008, though the total portfolio has been grown by around 9% in
year 2008. Thus, the average loan size is approximately placed between LKR 100,000 to LKR 150,000 over the past few years. As far as the depth of outreach is concerned, the figures remain 70% to 80% which is considerably high compared to the microfinance norms. The GP programme is however catering to the category of “entrepreneurial poor”, as rightly indicated by their depth of outreach.

When the scale of lending in terms of loan portfolio is increasing from small to large scale, the spread of depth of service reduces. In other words, the ability of the institution to reach large number of clients is reducing. Microfinance has evolved as an economic development approach intended to benefit low-income groups. Therefore, when the depth of service is reducing with large scale loan outstandings, it ignores the theme of microfinance “reaching down to the poor”.

The present population in Sri Lanka is approximately 20Mn, where 41.6% of them are at poverty, earning below USD 2 per day and 5.6% are earning below USD 1 per day (Central Bank Annual Report 2008). Further, based on household income and expenditure survey carried out in year 2006/2007, it has identified that 15.2% of people are belonging to the category of poor households. This situtaion is very depressing and therefore, institutions specially microfinance programmes like GP should be tamper with their outreach if their ultimate objective is to contribute to eradicate poverty in Sri Lanka.

**Trade-off between sustainability and outreach**

Trade-off means sacrificing one objective to achieve the other. There are two major objectives, namely the reaching out to poorer groups (depth of outreach) and the sustainability of the MFI by achieving OSS and FSS. In the outreach objective, extension of financial services to the poor and underserved populations can not be sacrificed because it is
a prime responsibility of any MFI. From this they should strive to ensure that these institutions and financial services last in the long-run with greater vigor.

However, as per depicted in this case study, the GP programme at HNB is little deviate from the concept of microfinance. Because, GP programme maintains its sustainability by concentrating on a few larger loans at the deprivation of services to the entrepreneurial poorer segments as happening in certain cases where commercial banks collect small savings from village areas and use these funds to grant loans to better off customers in urban areas. Therefore, there exists a trade-off between sustainability and outreach in microfinance services provided by GP programme. The microfinance institutions should sustain and increase the financial services to the poor, they should expand their market reach, while diversifying the risk and products and reducing costs. Consequently, sustainability and outreach will be two complementary objectives for successful microfinance institutions.

**Conclusion**

Microfinance was initially recognized as the provision of financial services to those excluded from the formal financial services. However, downscaling of commercial banks operations into microfinance has received increasing attention in today’s financial markets. This case study was therefore mainly focused on the argument that whether commercial microfinance is truly a strategy to reach the poor. In other words, this study was focused on a microfinance programme (Gami Pubuduwa) operated by a well established commercial bank (HNB) in Sri Lanka to identify whether the programme touches the hearts of poorer population while maintaining their sustainability. The findings revealed that the GP programme maintains its sustainability by concentrating on a few larger loans at the deprivation of services to the entrepreneurial poorer segments. The ‘reaching down the poor’ concept ignores in this regard, while giving rise to a trade-off between sustainability and outreach. However,
protection against prudential regulations, physical infrastructure, better know-how, greater access to funds, and enhanced capacity, make commercial banks the most qualified to meet the untapped demand of micro entrepreneurs.

Reference


11. USAID (2005), “Case Study on Profitability of Microfinance in Commercial banks”.

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