SRI LANKA CONNECTING REGIONAL ECONOMIES (USAID/CORE)

MICROFINANCE SECTOR ASSESSMENT

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MICROFINANCE SECTOR ASSESSMENT

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Acronyms

ADB	- Asian Development Bank
BoC	- Bank of Ceylon
BRAC	- Building Resources Across Communities
CORE	- Connecting Regional Economies
CBOs	- Community Banking Organizations
CBSL	- Central Bank of Sri Lanka
CRIB	- Credit Rating Information Bureau
DQIR	- Delinquency Management and Interest rate setting
EPF	- Employees Provident Fund
GDP	- Gross Domestic Product
GTZ	- Gesellschaft fur Techhnische Zusammenarbeit
ICB	- Institutional Capacity Building
IFC	- International Finance Corporation
IFAD	- International Fund for Agriculture Development
KYC	- Knowing Your Client
LOLC	- Lanka Orix Leasing Company
HNB	- Hatton National Bank
MFIs	- Micro Finance Institutions
NCRCS	- New Comprehensive Rural Credit System
NDB	- National Development Bank
NDTF	- National Development Trust Fund
NGO	- Non Governmental Organization
ORM	- Operational Risk Management
PB	- People's Bank
PAR	- Portfolio at Risk
PAMP	- Poverty Alleviation Microfinance Project
RFSDP	- Rural Finance Sector Development Project
SEEDS	- Sarvodaya Economic Enterprise Development Services (Pvt) Ltd
SFLP	- Sustainable Fisheries Livelihood Program
LAMP	- Lanka Association of the Microfinance Practitioners
USAID	- U.S. Agency for International Development
VFL	- Vision Fund Lanka
VOs	- Village Organizations
VSs	- Village Societies
WDF	- Women's Development Fund
WB	- World Bank

Executive Summary

Sri Lanka is considered today as one of Asia's most open economies with trade accounts representing over 54% of the GDP. It has a relatively developed market infrastructure and a per capita income of USD 2,014 (2008). However, the country's development remains behind its potential and the armed conflict has exacted a heavy price on the overall performance.

Building on over 50 years of the U.S. Agency for International Development's (USAID) successful economic growth activities in Sri Lanka, the USAID funded Connecting Regional Economies (USAID/CORE) Project seeks to address the disparity in economic development between post conflict Eastern Province, the bordering North Central and Uva Provinces and the rest of Sri Lanka. This is to be accomplished through an integrated approach that (a) extends value chains broadly and deeply into the grassroots level; (b) gives individuals the skills and support services they need to participate in value chains; and (c) improves the business environment.

As part of the USAID/CORE activities, in April 2009, the Project contracted the services of a microfinance expert to carry out an overall assessment of the microfinance sector in Sri Lanka with emphasis on the above target districts; Eastern, North Central and Uva Provinces. The assessment identifies the current organizations providing funding to micro, small and medium enterprises in these regions, identify the most appropriate organizations to provide funding and make recommendations for the sector in general. This document presents the main findings, conclusions, and recommendations of the assessment.

The devastation caused by the tsunami of 2004 brought into the country a large influx of financial resources from bilateral and multilateral donors such as USAID, ADB, IFC, WB, and IFAD. A main impact of the large amount of funding available has been the proliferation of microfinance institutions of a widely diversified nature, size, mission, and scope. Statistics from different sources estimate the number of microfinance service providers to be in the range of 3,000 to as large as 22,000[1].

Formal financial services are provided by two government commercial banks (People's Bank and Bank of Ceylon), government licensed specialized banks (National Development Bank and SANASA Development Bank), six Regional Development Banks, and a private bank (Hatton National Bank). From the cooperative sector there are more than 300 cooperative rural banks (1,200 branch/outlets) and 8,500 thrift and credit cooperative societies. In addition, funds are available through over 970 Samurdhi Bank Societies[2], some of the nearly 200 international NGOs, pawnshops and over 4,000 savings collecting post-offices. Informal sources are also numerous. They include rotating savings associations,

[1] Department of Census & Statistics place the number of microfinance service providers near 22,000. However, this figure includes thousands of Community Based Organizations, cooperatives, and Samurdhi societies though formally registered, are inactive and/or just very small with limited scope and activities. Most practitioners interviewed actually place the number closer to 2,000.

[2] Samurdhi Bank Societies operate a credit scheme to improve income levels of the poor. This is a government run program under the Samurdhi Authority of Sri Lanka.

funeral societies, traders, moneylenders, and suppliers. Although many issues with service quality, financial performance, outreach, and sustainability remain to be addressed, it is certain that the large number of players have contributed significantly to improve the rural population's access to financial services.

The large number of practitioners has also led to a wide variety of practices and methodologies. Yet, the vast majority of microfinance institutions use group lending and savings methodologies in different forms and are labeled under Community Based Organizations (CBOs), Village Societies (VSs), etc. Poverty alleviation is the underlined objective behind it all.

Another important impact has been the large geographic coverage. At present, the outreach of financial services is large countrywide. A 2008 GTZ study[3] reports that 82.5% of all households in the country have used financial services from financial institutions. This figure states almost the same for rural (82%) and urban households (84%). An outstanding issue is that microfinance services have not uniformly reached all regions. For example, the percentage of households using financial services varies from 60.7% in Trincomalee to 98% in Polonnaruwa. In other target districts[4] the percentages are 86% in Ampara, 85.6% in Anuradhapura, 75.6% in Batticaloa, and 73.8% in Monaragala.

Disparities in outreach are, however, more apparent across services. According to the survey, 75% of total households have saved as compared to only 47% that have borrowed from MFIs. In the target districts, the percentage on household borrowings range from as low as 18% for Trincomalee, to 36% in Monaragala to 45%, 55%, and 64% in Batticaloa, Ampara, and Anuradhapura Districts, respectively. Overall, Trincomalee District records the lowest utilization of credit.

Programs initiated by Government agencies have traditionally dominated the sector and played key roles as both funders and implementers. The National Development Trust Fund (NDTF) and the Central Bank of Sri Lanka (CBSL) refinance lines currently constitute the main sources of funding for the vast majority of microfinance institutions countrywide. In general, funds from government agencies for lending purposes are available on soft terms (4% annual interest) and are accessible to even the smallest programs. In exchange, however, institutions must do onward lending to clients at predefined subsidized rates, with results that have proven to be highly detrimental to both clients and programs. Repayment rates, which indicate the program's capacity to manage lending and client satisfaction with the service rendered, are, by and large, significantly low (60% to 85%).

Today, some commercial banks are involved in microfinance through their own in-house interventions or as vehicles of the state wholesale financing to microfinance service providers. The government owned People's Bank (PB) and Bank of Ceylon (BoC), as well as the privately owned Hatton National Bank (HNB) have the largest track record in providing first and/or second tier financing to the microenterprise sector in the country.

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[3] GTZ, Outreach of Financial Services in Sri Lanka: A look at the Demand-side from a Microfinance Perspective, 2008.

[4] The target districts are Ampara, Batticaloa, Trincomalee, Anuradhapura, and Monaragala.

While the number of non-regulated microfinance service providers is significantly large, the vast majority are very small in outreach, administratively weak and financially dependent on donors for sustainability. Institutions like Sarvodaya Economic Enterprise Development Services (Pvt) Ltd. (SEEDS) with 1.8 million active clients, Arthacharya with 125,600, Women's Development Fund (WDF) with 65,537, BRAC with 48,000, Lak Jaya with 45,000, government licensed SANASA with 300,000 and the government operated Samurdhi with 2.95 million are the exceptions among thousands of microfinance programs in the country. Only a few work at a national level and the remaining MFIs work at provincial or district levels.

Statistics of the Lanka Association of the Microfinance Practitioners (LAMP), a network that groups the 75 largest MFIs in the country shows that, as of December 2008, only 5 institutions had more than 10,000, and only 3 more than 50,000 active clients. These figures worsen for those MFIs located in the target districts where client outreach is lower than 1,000. For example, the Lower Uva Development Centre in Monaragala has 752 active clients. Similarly, the Surekuma Organization in Matale has 922 active clients and the Dhiriya Women's Organization in Anuradhapura has only 213. Exceptions are found in Batticaloa with, YMCA and the Sareeram Sri Lanka National Foundation with 3,310 and 7,516 active clients, respectively, as of December 2008.

In terms of depth of outreach, non-regulated MFIs in Sri Lanka do serve poor people. First, government funding promotes, and usually mandates, the use of group lending methodologies typically effective in reaching poor populations. Over 90% of all MFIs use group lending to reach their clients. Moreover, average loan sizes, an indicator typically used to measure depth of outreach, are fairly low. For example, LAMP statistics show that an average loan size per client is below USD 200 for 94% of the MFIs, below USD 100 for 77% and below USD 50 for 51% of them. Only three institutions have average loan sizes above USD 200: SEEDS (USD 202), Vision Fund Lanka (USD 204) and Agro Finance (USD 261). Women's participation, another depth of outreach indicator, is significantly high. For example, women's participation is above 50% for 83% of the current MFIs members, and 90% for 51% of them. Among the large MFIs those with the highest female participation are WDF (100%), BRAC (97%), Arthacharya (94%), Vision Fund (77%), and SEEDS (62%).

Notwithstanding, a multiplicity of non-financial services dilutes institutional priorities, decreases service quality, reduces sustainability, increases administrative costs for the lenders and transaction costs for the client. Typically lending programs are offered in combination with health programs (e.g., BRAC), mandatory training (e.g., SEWA), environment protection (HELP-O), religion (CCF-SL, YMCA), community development (CARE), children (Save the Children), etc. The main consequence has been that despite being in operation for many years, most MFIs are not self-sufficient financially or even operationally. After more than ten years in operation self-sufficiency rates are 92% for SEEDs, 90% for SEWA, 68% for BRAC and 81% for Arthacharya. The problem is exacerbated by a staff largely comprised of volunteers and or underpaid professionals. Sound financial management, profitability and self-sufficiency are concepts not fully accepted or even understood. Audit departments are lacking and internal controls are poor in some of the MFIs.

NGOs do not have owners who are accountable and because of the non-profit nature of these types of institutions, their board members might lack the necessary motivation to push the institution into implementing sound financial practices. Governance structures are weak as well. Readily available grants and soft loans further reduce the need for, and act as a deterrent to, the implementation of sound financial practices. The situation does not improve in the case of cooperatives where ownership is diluted in a large number of members/associates whose dual role as owners and clients prevents them from making sound financial decisions. High levels of politicizing in the cooperative sector, adds vulnerability to an already weak governance structure. In addition, Management information systems (MIS) are poor or lacking. Inability to generate timely, reliable and accurate information of portfolio performance combined with ill-defined policies and procedures on loan follow-up and recovery negatively affects portfolio quality. The problem is worse in rural areas. Prevalent misconceptions on the poor's capacity to pay market interest rates and government practices of debt pardoning, have created the perception among small farmers that loan repayment is, at best optional.

Despite general claims of high repayment rates, portfolio quality measured by the portfolio at risk (PAR) rate over thirty days past due (PAR_{30}) is poor even for the largest MFIs. As of December 2008, SEEDS reports a PAR_{30} of 11%, SEWA 8%, and Arthacharya 15%. Performance among government direct lending programs and cooperatives does not show any improvement. Samurdhi reports a PAR_{30} rate of 12% while SANASA reports a rate of 14.5%. Furthermore, the lack of transparency prevalent among microfinance operators makes it difficult to assess portfolio performance for the sector at large. Most MFIs are unable, (due to poor MIS), or unwilling (due to poor performance) to provide portfolio statistics. In fact only 47% of LAMP member MFIs provides regular statistics.

Informal lending is widespread despite the large outreach and geographical coverage of formal sources. Moneylenders, middlemen, relatives and friends provide small, short-term loans for emergencies, business and other purposes to those unable to access formal sources. The GTZ 2008 study reports that 18.3% of 970 surveyed households still use informal sources to meet their credit needs. This percentage increases to near 26% for the North Central province and becomes the lowest for the Eastern province (13%). Relatives and friends (62%) and moneylenders (26%) constitute the main sources of informal lending. Contrary to formal ones, informal lenders require no collateral, little documentation and disbursement is immediate. While interest rates charged to the client are typically very high (5% to 20% per day), transactions costs (e.g., costs of documentation, registrations, mandatory training, mandatory savings, travel, processing time and the like) are instead very low. The widespread use of informal lending demonstrates that micro entrepreneurs and small farmers are willing to, and actually do pay high interest rates if other terms and conditions are suitable to their needs (no collateral, little documentation, rapid disbursement).

Over the past few years, the country has gone through a process of deregulation with a significant impact on the modernization, expansion and diversification of the financial sector and the services provided. However, the current regulatory environment remains poorly conducive to the provision of microfinance services. On the lending side, micro lending methodologies are largely based on non-collateral, minimum documentation and

none or basic financial analysis. Current regulations ruling for hard collateral, heavy documentation and deep financial analysis to support the usually large loans of a regulated entity could hardly apply to micro lending without generating costly loan loss provisions. As the vast majority of microfinance service providers are non-regulated, the lack of an appropriate environment does not affect them substantially in as long as they do not seek to "transform" into commercial banks or regulated financial companies. Once they do, the costs of compliance with regulations that are hardly suitable to micro lending operations will force them into serving larger, less costing clients. These same issues might prevent current private commercial banks from servicing very small clients.

On the deposit side the situation is more difficult for non-regulated MFIs. Despite the fact that only regulated institutions are allowed to take deposits from the public, deposit taking is widespread among MFIs. According to the statistics of the Lanka Microfinance Association for the 35 largest programs in the network, savings represent 84% of the loan portfolios. The combined value of deposits amounts to LKR 4,129 million, for a total of 1,417,594 clients.

In 2005, a Microfinance Act was submitted to the CBSL with the support of the ADB and the LAMP. The Act, unsuccessfully sought to convince the CBSL into licensing MFIs to mobilize deposits. In summary, the Act, conceptually flawed, proposed licensing those MFIs able and willing to meet one of three decreasing levels of capital requirements and geographical scope of operations. The CBSL rejected the proposal as the relatively low levels of capital requirement proposed would bring into the CBSL supervision an unmanageable large number of small, very weak MFIs. Recently, the Government has brought up again the need to have a regulatory framework for microfinance operations. The government has requested the CBSL to draft a new Act to be submitted in six months to Parliament.

This document presents the assessment main findings, conclusions and recommendations. It also presents an implementation plan in phases to support development of the sector. The first chapter presents an overview of the current situation of the microfinance sector in Sri Lanka. It analyzes the composition of the sector, main players, and type and performance of microfinance service providers. Extent and depth of outreach, products and services offered and issues with sustainability and quality of services are discussed at length in this chapter. Outreach in target provinces and districts are an integral part of the analysis.

The second chapter presents a brief description of donor and funding agencies and the main microfinance service providers, regulated (commercial banks) and non-regulated (e.g., NGOs, companies). The outreach and financial performance by type of microfinance institution (e.g., NGOs vs. commercial banks) and individually (e.g., SEEDS, SEWA, BoC) is revisited here. Potential key players for the development of the microfinance sector, such as Dialog Telekom and the eZ Pay service, the Credit Information Bureau of Sri Lanka (CRIB), as well as USAID 's guarantee fund with LOLC and a possible Diaspora Bonds program are also analyzed in some detail. The chapter concludes with a section on informal sources of lending and target district-specific statistics.

Current issues with the supervisory and regulatory framework for microfinance activities are discussed in chapter three. The analysis focuses on outstanding issues with the Microfinance Act submitted to the CBSL in 2007 by the LAMP and still pending for approval. In view of a renewed interest from the Government in finding a solution to non-regulated MFIs increasingly large deposit taking activities, this chapter provides some insights on a prudentially sound approach to microfinance regulation.

Chapters four and five summarize the assessment's main findings, recommendations and implications for possible interventions in the microfinance sector. Proposed areas for intervention include assisting the Government and the CBSL in drafting a prudentially sound microfinance regulatory framework, and a capacity building program for financial and non-financial institutions. Other proposed areas of intervention are supporting eZ Pay Dialog mobile banking system as a key tool in the expansion of financial and information services to target regions.

The main findings and recommendations are summarized as follows:

Need for development of a regulatory framework conducive to the provision of microfinance services

Notwithstanding the issues with the proposed Microfinance Act, there is clearly a need for modifications to the regulatory environment surrounding microfinance services. As per Government instructions, the CBSL must prepare within the next six months a new draft of the Microfinance Act. Ensuring that this new Act contains the appropriate set of regulations is key, to developing the sector and is a recommended area of intervention.

An appropriate regulatory environment will benefit the microfinance sector at large in a sustainable way. It will foster expansion and diversification of microfinance services to poor, displaced, rural and/or isolated populations. It will also facilitate transformation of large MFIs into regulated deposit-taking institutions and attract more commercial banks into providing services to the sector. Regulations on electronic and cell phone banking furthermore will have a major impact on the provision of financial services to the isolated and rural. Moreover, due to strong competition in urban areas, and in view of the end of the armed conflict, MFIs are now expanding their outreach in the Eastern, North Central and Uva Provinces. Large MFIs like SEEDS, BRAC, and Arthacharya, HNB (private bank), and licensed specialized banks such as NDB and SANASA identified the expansion to these provinces as their next steps to be taken towards the expansion of their programs.

Large number of donor and financing Agencies: No need for direct funding to MFIs

While cumbersome and highly conditioned, funding from government and private agencies, notwithstanding, is available even to very small MFIs. NTDF, PB and CBSL refinance lines, are today the major sources of financing. In addition, a large number of microfinance institutions are intensively involved in deposit mobilization. The deposits to loans ratio is 72.5% for WDF, 92% for SEEDs, and 70% for Arthacharya Foundation. In fact, deposit mobilization represents an average of 81% of the portfolios of 28 of the largest non-regulated MFIs in the country. The excess of liquidity resulting from deposit

mobilization and/or external funding is usually placed in investments and treasury bonds. For example the 2008 financial statements of SEEDS and Arthacharya show investments (e.g., treasury bonds and similar instruments) representing 21%, and 26% of total assets, respectively. Not surprisingly, all MFIs interviewed, identified lack of managerial capacity as the main barrier to growth. None except one MFI (BRAC), identified lack of funding as the main barrier.

Need for Strengthening MFIs' managerial and financial capacity to provide services efficiently, profitably on a large scale.

In interviews with funding agencies (GTZ, IFC, NTDF and CBSL) and microfinance service providers, they all identified institution capacity building as the most pressing need for the development of the microfinance sector in Sri Lanka. With the exception of SEEDS, WDF, SEWA, Arthacharya, Samurdhi, Lak Jaya, BRAC and SANASA, most MFIs are small in scope, and administratively and financially weak. There is a clear need for capacity building even among regulated institutions. Commercial banks, for instance, have the managerial, financial and legal capacity to manage and offer microfinance services in a sustainable manner. They lack however, the technology (methodology) that will allow them to do it massively, profitably and cost-effectively.

Need to reduce transaction costs for the client

While interest rates charged are low, transaction costs for the client are high. Prior to accessing a loan, group applicants must go through a six to twelve week group formation process. This process is time and resource consuming for the client (time and travel costs, costs of time away from work, documentation costs). Compulsory savings pre and post credit and mandatory weekly meetings, also increase the transaction costs for the client. Group loans are heavily collateralized by savings and as such clients are at a higher risk and the cost of losing their savings in case of a member's default. Compulsory training programs, usually of very low quality, just contribute to further increase the already high transaction costs.

Need to facilitate the implementation and further development of Dialog eZ Pay and other electronic wallet systems

Capacity to make payments, transfer money and manage deposits for small farmers and entrepreneurs will accelerate the expansion of financial services by reducing transaction costs to the client and administration costs to the MFIs. Dialog eZ Pay or other electronic wallet systems will enable even the most isolated client, to open savings accounts, deposit and withdraw money, receive loan disbursements, send and receive remittances, pay utility bills, make loan payments, receive salaries and buy goods and services from the convenience of their homes, by just having a cell phone. With potential gains for both banks and borrowers seen to be substantial, support should be continued for these initiatives. Currently, the main barriers to expansion are regulatory. The money held in an electronic wallet is de facto a deposit and Dialog Telekom is not a regulated financial institution. Dialog Telekom has petitioned the CBSL for a special license that would allow them to operate electronic wallets. The CBSL is keen to find a solution through a special

license and seeks to draft regulations on electronic banking and electronic accounts. The timing for these actions still remains uncertain. Regulatory issues surrounding cell phone banking should be included the efforts towards drafting a new microfinance Act.

For long term sustainable development of the microfinance sector, three specific areas of intervention are recommended:

(1) Provide technical assistance to the Central Bank in the drafting of a prudentially and financially sound Microfinance Act, by proposing needed regulation on electronic accounts and cell phone banking, simplified requirements for provision of small loans, improvements in the credit bureau management and services for regulated and non-regulated microfinance providers;

(2) Capacity building of microfinance service providers, including commercial banks through MFI training initiatives that include management and staff training for selected MFIs tailor-made to suit individual institution requirements and training of trainers; and

(3) Facilitating accessibility to useful credit information services at the Credit Information Bureau and promoting the use and provision of credit information as part of the decision making process on loan applications. Credit information is crucial to the development of the microfinance sector. Sound accounting procedures and useful credit information could potentially lead to improved performance of MFIs.

1. Introduction

The Central Bank of Sri Lanka (CBSL) statistics of 2008 estimates a population of 20.2 million. Over the past years the country has been going through a process of economic and financial liberalization with positive results on economic growth and modernization of the financial sector. Sri Lanka is considered today one of Asia's most open economies with trade accounts representing over 54% of the GDP in 2008. It has a relatively developed market infrastructure and a per capita income of USD 2,014[5]. However, the country's development remains behind its potential and the armed conflict has exacted a heavy price on the overall performance further.

At present, the budget deficit is high, the public sector is extremely large and the economy supports unsustainable levels of military spending. Poverty largely persists in the North and East regions, tea plantations, and urban slums. Anywhere between 25% and 35% of the population live near or below poverty lines. The newly restored peace is not expected to bring a significant change to the current situation in the short run, as demobilization of armed forces from both sides of the conflict can potentially create large economic problems.

Microfinance and rural lending had a Government focus with the establishment of the Cooperative Rural Banks in 1964, the Regional Development Banks by the CBSL in 1986, the Janasaviya Trust in 1990 and the Small Farmers and Landless Credit Project in 1991. The period can also be considered as the beginning of major Non Governmental Organization (NGO) involvement in the field with the creation of Sarvodaya Economic Enterprise Development Services Pvt Ltd (SEEDs) in 1986. The next most significant step was the establishment of the Samurdhi Authority and its microfinance program in 1997. The Government also restructured the Regional Banks into six banks in 1997, thereby reducing the control of and ownership of the CBSL, and transferring it to the Bank of Ceylon (BoC), the People's Bank (PB) and the Employees Provident Fund (EPF) with workers being main owners.

In terms of current involvement, the Central Bank Rural Credit Department remains the main government agency responsible for rural credit and microfinance, outside of the Samurdhi Authority. It supervises over 20 projects many of which have microfinance components. Two projects, the Poverty Alleviation Microfinance Project (PAMP) and Sustainable Fisheries Livelihood Program (SFLP) are microfinance-specific. The Department however, acted mainly as a financial channel for donor funded projects.

At the center of sustainable development is the challenge of expanding and improving value chains in Sri Lanka within post conflict (Ampara, Batticaloa, and Trincomalee Districts in the Eastern Province) and bordering regions (Anuradhapura District of the North Central Province and Monaragala District of the Uva Province) so that grassroots producers can

[5] Annual Report, CBSL, 2008.

participate with mainstream businesses and some, as a consequence, become entrepreneurs.

This is an assessment of the microfinance sector in Sri Lanka with a particular emphasis on the Eastern, North Central and Uva Provinces. This assessment identifies the current organizations providing funding to micro, small, and medium size enterprises in the above regions, and also identifies the most appropriate organizations to provide funding. In addition, it makes recommendations for the sector in general. Based on the assessment an implementation plan is developed to support the sector. This plan includes the identification of important partners to carry out the work, recommendations for direct support for capacity building for financial and non-financial institutions, recommendations for use of technology and policy changes, opportunities to train bank officers in developing new products and services, identification of innovative tools to increase lending based on global best practices and the use of technology, suggestions to decrease transaction costs and capacity constraints of MFIs operating particularly in the Eastern Province. In order to undertake the assessment the following methodology and resources were utilized:

- Review background information on the financial sector situation in Sri Lanka in general and in the Eastern, North Central and Uva Provinces, in particular and differences across target sectors;
- Conduct interviews with relevant financial and non-financial institutions to understand their operational strengths and weaknesses (Appendix);
- Conduct interviews with commercial banks, financial companies and other regulated microfinance service providers;
- Conduct interviews with relevant donors and cooperating agencies, national and international including International Finance Corporation (IFC), Gesellschaft fur Techhnische Zusammenarbeit (GTZ), Asian Development Bank (ADB), National Development Trust Fund (NDTF), among others;
- Conduct interviews with relevant Sri Lankan government organizations including CBSL; and
- Conduct Interviews with relevant USAID officials.

2. The Microfinance Industry in Sri Lanka

2.1 Overview

The Sri Lanka microfinance sector is comprised of a vast number of national and international funding agencies, and a wide variety of implementing institutions including directed government programs, non-government organizations (NGOs), commercial banks, financial companies, and cooperatives, among others.

The devastation caused by the tsunami of 2004 brought into the country a large influx of financial resources in the form of grants and, to a lesser extent, soft loans from bilateral and multilateral donors such as USAID, ADB, IFC, WB, and IFAD. International non-governmental organizations (international NGOs) like GTZ, CARE, Save the Children, World Vision and Forut, have also brought millions of dollars to implement relief and other programs directly or in partnership with local institutions.

A main impact of the large amount of funding available has been the proliferation of microfinance institutions of a widely diversified nature, size, mission, and scope. Today, a large number of NGOs, cooperatives, government programs, limited liability companies, commercial banks, and financial companies, provide microfinance services locally, regionally or nationwide. Statistics from different sources estimate the number of microfinance service providers to be in the range of 2,000 to as large as 22,000[6].

Another important impact has been the large geographic coverage. Microfinance programs, public and private are found spread out throughout the country. Rural microfinance has also benefitted from the influx of post-tsunami funding. It has grown from a government-based highly directed intervention to diversifying into a myriad of national, international, private and public players, funders and practitioners.

Today formal financial services are mainly provided by government commercial banks (PB and BoC), government licensed specialized banks (SANASA Development Bank), six Regional Development Banks, and a private bank (HNB) with a combined network of over 1,000 branches. From the cooperative sector there are also more than 300 cooperative rural banks (1,200 branches/outlets) and 8,500 thrift and credit cooperative societies. In addition, there are over 970 Samurdhi Banking Societies, a portion of nearly 200 international NGOs, pawnshops and over 4,000 savings collecting post-offices. Informal sources are also numerous. They include rotating savings associations, funeral societies, traders, moneylenders, and suppliers. Although issues with service quality, financial performance, outreach and sustainability still remain as issues to be addressed, it is certain that the large number of players have contributed significantly to improve the rural population's access to financial services.

[6] The Department of Census & Statistics places the number of microfinance service providers at nearly 22,000. However, this figure includes thousands of CBOs and Samurdhi societies that though formally registered are just very small community based organizations of limited scope and activities. Most practitioners interviewed actually place the number closer to 2,000.

Text Box 1: Brief Description of CBOs and VSs

Typically, CBOs/VBs are self-managed credit and savings groups of 15 to 35 members, mostly women, established to improve members' access to credit, build a community self-help group and guarantee each other's loans. In order to facilitate group organization and management, members are usually integrated into groups of 4-7 members. Members are self-selected. Each group appoints a Group Leader. A Committee of three freely elected officials manages the CBO operations (Chief, Treasurer, and Secretary).

The loans require no hard collateral. Instead all members agree to offer collective guarantee and attend weekly meetings. First loans for individual members range from LKR 2,000 to LKR 10,000. The sum of all individual member loans comprises the CBO loan. Subsequent loans are determined by the member's repayment behavior, savings accumulation, attendance to meetings and the repayment capacity. In order to qualify for a loan the CBO must repay the previous loan in full. Loan maturity is typically four months (16 weeks) with payments made in weekly installments (1/16 of the obligation) of interest and capital. The weekly installments are accompanied by mandatory savings equal to 5% to 20% of the loan amount.

Loan destination, depending on the funding institution and geographic location, include agriculture, manufacture, service, trade and home improvement. A field officer directly monitors the CBO. He or she is responsible for group formation and training, attends the weekly meetings and provides guidance to the committee officers on loan management.

The large number of practitioners has also led to a wide variety of practices and methodologies. Yet, the provision of microfinance services, rural and urban, is mostly limited to lending and deposit taking. The vast majority of microfinance institutions use group lending and savings methodologies in different shapes and are labeled as community banking organizations (CBOs), village societies (VSs), amongst others. A mandatory savings component is usually present in these different versions. Poverty alleviation is the underlined objective behind all. In general, group lending methodologies have proven successful worldwide in reaching poor people, especially women, in large numbers, and in building social capital. Currently, women represent 65% to 100% of all MFI clients.

Today the outreach of financial services is high countrywide. The 2008 GTZ study on microfinance outreach[7] reports that 82.5% of all households in the country have used financial services from financial institutions. This figure states almost the same for rural (82%) and urban households (84%). An outstanding issue is that microfinance services have not uniformly reached all regions. For example, the percentage of households using financial services varies from 60.7% in Trincomalee to 98% Polonnaruwa. In other target

[7] GTZ, Outreach of Financial Services in Sri Lanka: A Look at the Demand –side from a Microfinance Perspective, 2008.

districts[8] the percentages are 86% in Ampara, 85.6% for Anuradhapura, 75.6% in Batticaloa, and 73.8% in Monaragala.

Disparities in outreach are, however, more apparent across services. According to the survey, 75% of total households have saved as compared to only 47% that have borrowed from MFIs. In the target districts, the percentages on borrowings range from as low as 18% for Trincomalee, to 36% in Monaragala, to 45%, 55% and 64% in the Batticaloa, Ampara, and Monaragala Districts, respectively. Overall, Trincomalee records the lowest utilization of credit (17%) whereas Vavuniya has the lowest for savings (22%). Polonnaruwa records the highest in savings (98%).

Table 1: Utilization of Financial Services

Sector	Loans and/ or Savings %	Loans %	Savings %	Total # of Households
Rural	82.5	49.5	74.2	2,302
Urban	84.6	40.2	78.2	513
Estate	74.6	30.0	68.5	130
Total	**82.5**	**47.0**	**74.6**	**2,945**
District				
Colombo	86.3	37.3	81.5	357
Anuradhapura	85.6	64.4	79.7	118
Monaragala	73.8	36.1	70.5	61
Ampara	86.0	54.8	72.0	93
Trincomalee	60.7	17.9	55.4	56
Batticaloa	75.6	44.9	57.7	78

Source: GTZ 2008 Outreach of Financial Services.

[8] The target districts are Ampara, Batticaloa, Trincomalee, Anuradhapura, and Monaragala.

3. Main Players in the Microfinance Sector

3.1 Sources of Funding

During the post-tsunami era, the number of international donor and financial agencies had proliferated. Initially, bilateral and multilateral agencies funding was mainly addressing relief type of activities. Over time, funds were increasingly available for micro lending activities, in both urban and rural areas. Funding from IFAD, ADB, USAID, IFC and other bilateral and multilateral agencies was largely channeled through government agencies for wholesaling and direct lending activities. Consequently, and despite the large number of donors and NGOs providing microfinance services in the country, government agencies and programs have traditionally dominated the sector and played key roles as both funders and implementers. The NDTF and the Central Bank Regional Development Department currently constitute the main sources of funding for the vast majority of microfinance institutions, rural and urban, countrywide.

In general, funds from government agencies for lending purposes are available at soft terms (e.g., low interest rates, little collateral requirements), and accessible to even very small programs. In exchange, however, institutions must on-lend to clients at predefined subsidized rates, terms, amounts and destinations. NGOs and all government direct lending programs operate under this framework with results that have proven to be highly detrimental to both clients and programs. Repayment rates, which indicate the program's capacity to manage lending and client satisfaction with the service rendered, are, by in large, significantly low (60% to 85%).

NDTF is the largest funding agency for MFIs in Sri Lanka. It started operations in 1991 as the Janasaviya Trust Fund with World Bank funding for USD 50 million. In 2004 it became NDTF, a government second tier agency, established to provide funding to NGOs, companies, cooperatives, and even commercial institutions for onward-lending to low income populations. Poverty alleviation through group lending is the main activity. Other activities include capacity building, mainly in the form of training, to participating institutions.

In order to be eligible for funding, applicant institutions must have (a) at least one year of experience in lending activities and in serving the very poor, (b) a repayment rate above 70%, and (c) social mobilization and group formation. NDTF's eligibility criteria define "poor clients" as those making less than USD 2 per day. Funding is provided at an annual interest rate of 9%; no collateral is required.

At present, NTDF provides refinancing to over 200 participating MFIs. In December 2008, the institution had a cumulative disbursement of LKR 1,403,030,080 to 45,207 borrowers in 200 active partner institutions. NDTF operates in 24 districts. Target districts represent over 30% of total disbursements: Anuradhapura (13%), Batticaloa (3%), Trincomalee (1%), Ampara (4%), and Monaragala (1%). The institution is funded entirely from the remaining funds of the World Bank Janasaviya Trust Fund. Currently, NTDF has a credit fund of LKR 800 million and a risk and investment fund of LKR 600 million.

3.2 Regulated Microfinance Institutions

The formal financial sector of Sri Lanka is comprised of twenty-four commercial banks, fourteen specialized banks, twenty-four finance companies and twenty-two finance leasing companies[9]. The CBSL is the supervisory and regulatory body governing their operations.

In 2004, soon after the tsunami, the CBSL mandated commercial banks to devote 5% of their portfolio to micro lending. In parallel, as a complementary measure, the CBSL implemented several rediscount lines to foster lending to small farmers, micro entrepreneurs, displaced and poor populations. Today, some commercial banks have become involved in microfinance through their own in-house interventions or as vehicles of the state wholesaling finance to microfinance service providers. The government-owned PB and BoC as well as private banks such as HNB have the largest track record in providing first and or second tier financing to the microenterprise sector in the country. The PB, together with BoC, account for 52% of the total assets of the Sri Lankan banking sector.

3.2.1 Bank of Ceylon

Established in 1939, the government owned BoC is one of the oldest and largest commercial banks in Sri Lanka. At present the Bank has a total asset portfolio of LKR 484.4 billion, and a network of 303 branches (260 rural), 117 extension offices, and 253 ATM facilities. Operations are managed by a staff of 8,500 professionals.

Since inception, BoC has provided financial services to rural producers and, as government owned, it has been instrumental in implementing the government of Sri Lanka (GoSL) development programs. In addition to rural finance, BoC became increasingly involved in microfinance as a key implementer of the microfinance refinance lines of CBSL.

The microfinance program serves micro enterprises, small farmers, cottage industries, craftsmen and small fishermen. The range of products offered involves assistance related to housing, poverty alleviation, employment generation, transportation, educational assistance and sustainable livelihood development. Lending is provided to individual entrepreneurs or self-help groups. In recent years, second tier financing to MFIs has become increasingly important.

In 2006, BoC implemented a CBSL refinanced line for medium-term lending (up to three years) to small farmers. Loan amounts ranged from LKR 10,000 to LKR 100,000 maximum. As of December 2008, the number of active clients was 9,240 in a loan portfolio of LKR 495 million with a PAR_{30} of 7%. This line complemented the already implemented New Comprehensive Rural Credit Schemes (NCRCS) which provided short-term financing for microfinance and livestock agriculture activities. Additionally, in early 2008, the Bank

[9] Annual Report, CBSL, 2008.

commenced the Poverty Alleviation Microfinance Project (PAMP) refinanced line specially designed to foster group lending. Under this line, loan amounts ranged between LKR 5,000 to LKR 50,000 maximum per member with weekly repayments of capital and interest. Loan charges include a 12% annual interest rate (refinanced by CBSL at 4%) plus an 8% administration fees. The Bank directly promotes groups of 4 to 10 members each, through a twelve-week formation process. Savings of LKR 25 per member are compulsory throughout the group formation. By the end of 2008, there were over 2,000 active groups and nearly 6000 clients with an outstanding portfolio of LKR 145 million and a PAR_{90} of 5%.

Today, the BoC's combined loan portfolio totals LKR 249.4 billion with a PAR_{30} of 17%. Deposits amount to LKR 316 billion of which around 90% comes from rural areas. The loan deposits ratio stands at 127%. BoC serves 7.5 million customer accounts across all 9 provinces. They include 4,718 active self-help groups comprised of nearly 27,000 members; 65% or more are women. Next steps into the expansion of microfinance services include the following:

- Expanding into the Northern and Eastern Provinces, including the Batticaloa, Ampara, Trincomalee, and Monaragala Districts;
- Implementing the new refinance line established by CBSL to reactivate the districts affected by the armed conflict; and
- Continuing targeting group loans.

The Bank identifies the expansion of rural lending as the most pressing need of the microfinance sector.

3.2.2 People's Bank

The PB is a government owned commercial bank established in 1961 to provide rural and agriculture finance. As the successor of the Cooperative Federal Bank, its mandate also includes the development of the cooperative movement. Current objectives include becoming a leader in the provision of microfinance services, the development of the agriculture sector, and the advancement of the cooperative movement. To this end, the Bank has become a major conduit for the microfinance and agriculture CBSL refinance lines. These lines are used for direct lending to micro entrepreneurs and rural producers, as well as for wholesale lending to MFIs, cooperative banks and development banks.

Loan products are heavily oriented to farmers and agriculture production. Refinance lines from the CBSL, such as the NCRCS and the Pledge Loan Scheme, finance a variety of crops that ranges from paddy, maize, and fruits to honey production and floriculture. Loan conditions include an interest rate of 12% annually and a term of 12 months. Depending on the destination, some financing include a 0.4% commission. There is also long-term financing from refinance lines such as the Second Perennial Crop Development Project and the Tea Development Loan scheme. Loan amounts run as high as LKR 20 million for maximum terms of up to 13 years including grace periods, at a heavily subsidized rate of 0.9% per year. Guarantees include movable and immovable property.

The Bank also provides financing to the cooperative sector (cooperative rural banks, cooperative societies, and cooperative federations). Pawn brokering, consumer lending and fuel sector lending are among the main activities financed. Non-financial services include funds for staff training. Microfinance services are primarily oriented to those with daily income below USD 2 through individual and group lending initiatives. Products to the sector include microcredit, micro savings, micro insurance, micro leasing, micropayments and non-financial services.

The CBSL's PAMP and the NDTF's Poverty alleviation Small Enterprise Development, address group and individual lending. Maximum loan amounts are LKR 50,000 and LKR 75,000, at 12% and 18% interest rates, respectively. Loan terms extend to a maximum of 36 months. Loans could be used to finance a wide range of income generating activities including agriculture, animal husbandry, manufacture, trade and services. Guarantees include personal and group guarantees.

Over the past few years PB has also been involved in second tier lending to microfinance institutions such as Lak Jaya Microfinance, BRAC Lanka, and SEEDS. In addition to the provision of financial services, PB also offers Credit Plus, a group lending initiative that involves training on management and marketing, among other topics.

As of December 2008, total assets amounted to LKR 397 billion with a combined loan portfolio of LKR 263.5 billion, deposits for LKR 324.5 billion, and 11.9 million customers. The portfolio at risk (PAR) rate for loans over 90 days past due is 7%. The Loan to Deposits rate stands at 123%. The Bank has a network of 143 branches including 42 in the target districts of Trincomalee (6 branches), Batticaloa (8), Ampara (12), and Anuradhapura (16). Next steps for the Bank include the following:

- Disbursing 50,000 loans by December 2009;
- Introducing new loan schemes;
- Establishing microfinance centers;
- Expanding the credit plus approach; and
- Second tier loans for a total of LKR 2,000 million to MFIs in 15 districts among them the target Districts of Batticaloa, Ampara, Monaragala, Trincomalee, and Anuradhapura.

3.2.3 Hatton National Bank

Hatton National Bank was established in 1972 and it is today one of the largest private commercial banks in the country. As of December 31st 2008, total assets amounted to LKR 255.3 billion with a loan portfolio of LKR 161.3 million. Deposits from the public are LKR 186.8 billion. The Loans to deposits rate is 116%.

Since inception, HNB has been involved in rural agriculture lending for a variety of activities including cultivation, animal husbandry commercialization and other self employment activities. The Rural Finance portfolio totals LKR 3.7 billion and over 14,000 clients. Medium and long term investment agriculture represents nearly 18% of the total portfolio.

In 1989, the Bank started a Microfinance program better known as *Gami Pubuduwa* (Village Awakening). The Program's initial objective was to extend the Bank's assistance to the rural youth in exploring self-employment activities. Over the years the program expanded to the provision of financial services (loans, deposits and insurance) to individual micro-entrepreneurs and self-help groups as well as to second tier organizations lending to MFIs.

Individual loan amounts run as high as LKR 1 million. Group loans are provided for amounts ranging between LKR 10,000 to 15,000. The interest rates vary from 22% to 12% depending on the source of funding (own resources or refinanced lines). Under the Rural Finance lines the Bank offers loans to small and medium size producers and rural micro-entrepreneurs.

At present, the program is considered one of the most successful microfinance programs in the country. As of December 2008, the loan portfolio totaled LKR 2.2 billion with nearly 15,000 active clients out of which 90% was from individual lending. A network of 110 microfinance centers, a staff of 87 microfinance officers and 37 agriculture offices support the program operations. Target districts are covered by branches in Trincomalee, Batticaloa, Ampara, Anuradhapura, and Monaragala.

HNB is an active recipient of credit lines funded by the ADB, IFAD, the Japan Bank for International Cooperation and the concessionary refinanced lines of CBSL. As next steps in microfinance expansion the Bank identifies three main areas:

- Expanding dedicated micro finance centers from a current number of 110 to 120 in 2009;
- Expanding of micro insurance services; and
- Expanding to the North and East regions.

3.2.4 SANASA Development Bank

SANASA Development Bank (SDB) was created in 1997 and is registered as a Licensed Specialized Bank. Formed by 3,500 SANASA Primary Societies and the SANASA Federation SDB is a cooperative bank that acts as the apex body of the SANASA movement. The Bank offers a wide array of financial services such as lending, leasing, pawning, solar power lending, home improvement, insurance and education to individual borrowers, CBOs, NGOs and cooperative societies. SANASA has its own training facilities for clients and staff. Client training, reportedly, is not mandatory. The Bank acts as an apex, wholesaler to the cooperative societies. Direct lending is limited to commercial loans.

As of December 2008 the institution had a total asset portfolio of LKR 11.3 billion with 317,000 active clients. The loan portfolio amounts to LKR 8.5 billion with a PAR_{30} rate of 11%. Deposits amount to LKR 8.2 billion. A network of 48 branches and a staff of 504

persons support the operations. Five branches serve the target districts of Trincomalee, Ampara, Batticaloa, Monaragala, and Anuradhapura. Next steps include the following:

- Seeking long-term funding due to mismatch in savings and loan terms;
- Increasing capital to become a commercial (as opposed to a specialized) bank; and
- Upgrading the Management Information Systems (MIS).

SDB identifies five main constraints to the development of the Microfinance Sector:

- MFIs meeting current capital requirements for becoming regulated financial institutions;
- Politicization and vulnerability of the cooperative movement;
- Lack of an enabling regulatory environment for microfinance;
- Poor managerial capacity particularly among small MFIs and coops; and
- Funding available from NDTF and CBSL is bureaucratic and unreliable.

3.3 Non-regulated Microfinance Institutions

3.3.1 Outreach

In general, microfinance in Sri Lanka is provided by non-regulated institutions among them being government and NGOs (domestic and international), limited liability companies, societies, and cooperatives. While the number of non-regulated microfinance service providers is significantly large, the vast majority are very small in outreach, administratively weak and financially dependable on donors for sustainability. Institutions like SEEDS (1.8 million active clients), Arthacharya (125,600), WDF (65,537), BRAC (48,000), Lak Jaya (45,000) and the government licensed specialized bank SANASA (300,000), and Samurdhi (2.95 million) are the exception among thousands of microfinance programs in the country of limited client outreach. Only this group works at a national level. The remaining MFIs, work at regional or district levels.

Statistics of the LAMP, a network that groups the 75 largest MFIs in the country, shows that, as of December 2008, only 5 institutions had more than 10,000 and only 3 more than 50,000 active clients (Table 2). These figures are worse for those MFIs located in the target districts where client outreach is lower than 1,000. For example, the Lower Uva Development Centre in Monaragala has 752 active clients. Similarly, the Surekuma Organization in Matale has 922 active clients and the Dhiriya Women Organization in Anuradhapura has only 213. Exceptions are found in Batticaloa with, YMCA and the Sareeram Sri Lanka National Foundation with 3,310 and 7,516 active clients, respectively, as of December 2008.

In terms of depth of outreach, by large, non-regulated MFIs in Sri Lanka do serve poor people. First, government funding promotes, and usually mandates, the use of group lending methodologies typically effective in reaching poor populations. Over 90% of all

MFIs use group lending to reach their clients. Moreover, average loan sizes, an indicator typically used to measure depth of outreach, are fairly low. Statistics provided by LAMP show an average loan size per client to be below USD 200 for 94% of the MFIs, below USD 100 for 77% and below USD 50 for 51% of them. Only four institutions have average loan sizes above USD 200: SEEDS (USD 202), Vision Fund Lanka (USD 204) and Agro Finance (USD 261) (Table 3). Women's participation, another depth of outreach indicator, is significantly high. For example, women's participation is above 50% for 83% of the current MFIs members, and 90% for 51% of them. Among the large MFIs those with the highest female participation are WDF (100%), BRAC (97%), Arthacharya (94%), Vision Fund (77%) and SEEDS (62%).

The geographic outreach for the largest MFIs is summarized as follows:

- SEWA Finance: four districts including Trincomalee, Ampara, Anuradhapura and Monaragala.
- BRAC: 55 branches in four provinces and 8 districts including Ampara, Batticaloa and Trincomalee.
- Arthacharya: seventeen branches in 17 districts including Monaragala.
- Samurdhi: 1,042 branches countrywide including Trincomalee, Ampara, Batticaloa, and Anuradhapura.
- SEEDS: 42 branches in 26 districts including Trincomalee, Batticaloa, Ampara, Monaragala, and Anuradhapura.
- SANASA Bank: 48 branches nationwide including the target districts of Trincomalee, Ampara, Batticaloa, Monaragala, and Anuradhapura.

Table 2: Data Summary of selected MFI portfolio as of December 31st 2008

INSTITUTION NAME	DISTRICT	TOTAL # ACTIVE CLIENTS	NUMBER OF FEMALE CLIENTS	OUTSTANDING LOANS	OUSTSANDING PORTFOLIO (LKR)	NUMBER OF SAVERS	SAVINGS BALANCE (LKR)
VISION FUND LANKA (Pvt) LTD	Colombo	13.103	10.943	13.103	322.314.217	17.138	
Lower Uva Development Centre	Moneragala	752	525	141	1.358.000	7.952	14.986
Praja Shakthi Padanama	Kandy	1.449	947	585	9.793.808	1.434	5.301.384
Janatha Sanwardana Padanama		7.397	4.459	1.075	8.043.629	7.397	2.558.056
Human & Environment Links Progressive Organization (Help-O)	Galie	10.000	9.568	567	123.564.787	9.880	3.157.050
Sustainable Appropriate Project Company Ltd. (SAPCO)	Kegalle	95	95	72	221.468	95	133.660
Community Reawaking Foundation	Colombo	665	433	416	6.475.430		
Pragathi Sewa Padanama		5.207	3.350	1.508	45.401.100	9.695	36.113.080
Agro Micro Finance	Colombo	5.615	2.988	5.615	176.036.592	9.472	40.156.644
Surekuma Organization For Community Resources Development	Matale	922	922	608	6.119.657	922	3.291.696
Ecumenical Loan Fund Sri Lanka (ECLOR)	Colombo	17.100		684	123.000.000		
Arthacharya Foundation	Colombo	33.200	31.050	14.100	193.473.199	125.600	130.611.102
Desiya Sampath Sanwardardana	Anuradhapura	854	301	127	4.812.000	854	
Institute for Dev. of Community Strengths (INDECOS)	Matara	2.057	2.057	942	8.056.887	2.057	2.994.364
Praja Sanwardana Sanwidanaya		459	442	2.823.850	197.789	391	1.032.175
Dhiriya Women Organization	Anuradhapura	213	69	30	15.179	55	16.500
Uva Govijana Kendraya	Badulia	3.270	2.922	673	3.506.708	3.270	17.099.597
Nation Builders Association (NBA)	Kandy	1.515	1.368	1.283	12.152.310	1.340	4.742.805
The Gami Seva Sevana Ltd		395	15	16	496.686	42	61.200
Christian Children's Fund Sri Lanka	Colombo	9.005	8.000	9.505	180.000.000		
Arthacharya Foundation	Batticaloa	3.310	3.278	2.203	19.057.474	3.310	7.948.305
YES Foundation	Hambantota	2.011	1.983	956	9.741.191	2.011	3.246.385
Ekabadda Praja Sanwardana Kantha Maha Sangamaya	Ratnapura	2.549	2.549	621	13.249.294	2.549	9.536.081
Sewa Finance	Colombo	10.377	7.161	771	158.467.700	771	22.050.225
Centre for Human Development (CHO)	Kegalle	3.199	2.399	1.663	25.564.406	3.199	5.537.511
Temperance Youth Club Of Sri Lanka		2.704	128	189	3.662.177	2.515	571.539
Habaraduwa Participatory Dev. Found.	Galle	6.909	601	379	72.914.775	24.434	54.571.042
Ruhunu Rural Women's Organization	Hambantota	272	272		2.506.393		
Swashakthi Grama Sanwardana Kantha Maha Sangamaya	Hambantota	1.745		900	420.000	1.745	597.400
Sarvodaya Economic Enterprise Development Services (SEEDS)	Colombo	179.332	110.660	179.332	3.870.040.626	1.088.237	3.555.959.103
Hambantota Women's Development Federation (WDF)	Colombo	34.833	34.833	16.038	28.249.990	65.537	203.696.173
Saviya Development Foundation	Galie	459	413	424	2.169.339	185	477.977
Sareeram Sri Lanka National	Batticaloa	7.516	7.112	3.521	117.490.156	7.516	9.447.722
Sahurda Sampath Sahasuruwan	Kurunegala	1.777	937	1.114	9.028.259		
All Ceylon Community Dev. Council	Colombo	18.005	13.188	8.896	4.254.230	17.990	8.650.409
TOTAL		**388.271**	**265.968**	**3.091.907**	**5.561.855.456**	**1.417.593**	**4.129.574.171**
TOTAL (US$)					46.348.795		34.413.118

Source: LAMP, 2009.

Table 3: Data Summary of selected MFI Loan portfolios as of December 31st 2008

NAME OF INSTITUTION	DISTRICT	AVERAGE LOAN SIZE (LKR)	AVERAGE LOAN SIZE (USD)	PERCENTAGE OF WOMEN	SAVINGS TO LOANS RATE	SAVERS TO BORROWERS RATE
VISION FUND LANKA (Pvt) LTD	Colombo	24.599	USD 205	84%	0%	131%
Lower Uva Development Centre	Moneragala	1.806	USD 15	70%	1%	1057%
Praja Shakthi Padanama	Kandy	6.759	USD 56	65%	54%	99%
Janatha Sanwardana Padanama		1.087	USD 9	60%	32%	100%
Human & Environment Links Progressive Organization (Help-O)	Galie	12.356	USD 103	96%	3%	99%
Sustainable Appropriate Project Company Ltd. (SAPCO)	Kegalle	2.331	USD 19	100%	60%	100%
Community Reawaking Foundation	Colombo	9.737	USD 81	65%	0%	0%
Pragathi Sewa Padanama		8.719	USD 73	64%	80%	186%
Agro Micro Finance	Colombo	31.351	USD 261	53%	23%	169%
Surekuma Organization For Community Resources Development	Matale	6.637	USD 55	100%	54%	100%
Ecumenical Loan Fund Sri Lanka (ECLOR)	Colombo	7.193	USD 60	0%	0%	0%
Arthacharya Foundation	Colombo	5.828	USD 49	94%	68%	378%
Desiya Sampath Sanwardardana	Anuradhapura	5.635	USD 47	35%	0%	100%
Institute for Dev. of Community Strengths (INDECOS)	Matara	3.917	USD 33	100%	37%	100%
Praja Sanwardana Sanwidanaya		431	USD 4	96%	522%	85%
Dhiriya Women Organization	Anuradhapura	71	USD 1	32%	109%	26%
Uva Govijana Kendraya	Badulia	1.072	USD 9	89%	488%	100%
Nation Builders Association (NBA)	Kandy	8.021	USD 67	90%	39%	88%
The Gami Seva Sevana Ltd		1.257	USD 10	4%	12%	11%
Christian Children's Fund Sri Lanka	Colombo	19.989	USD 167	89%	0%	0%
Arthacharya Foundation	Batticaloa	5.758	USD 48	99%	42%	100%
YES Foundation	Hambantota	4.844	USD 40	99%	33%	100%
Ekabadda Praja Sanwardana Kantha Maha Sangamaya	Ratnapura	5.198	USD 43	100%	72%	100%
Sewa Finance	Colombo	15.271	USD 127	69%	14%	7%
Centre for Human Development (CHO)	Kegalle	7.991	USD 67	75%	22%	100%
Temperance Youth Club Of Sri Lanka		1.354	USD 11	5%	16%	93%
Habaraduwa Participatory Dev. Found.	Galle	10.554	USD 88	9%	75%	354%
Ruhunu Rural Women's Organization	Hambantota	9.215	USD 77	100%	0%	0%
Swashakthi Grama Sanwardana Kantha Maha Sangamaya	Hambantota	241	USD 2	0%	142%	100%
Sarvodaya Economic Enterprise Development Services (SEEDS)	Colombo	21.580	USD 180	62%	92%	607%
Hambantota Women's Development Federation (WDF)	Colombo	811	USD 7	100%	721%	188%
Saviya Development Foundation	Galie	4.726	USD 39	90%	22%	40%
Sareeram Sri Lanka National	Batticaloa	15.632	USD 130	95%	8%	100%
Sahurda Sampath Sahasuruwan	Kurunegala	5.081	USD 42	53%	0%	0%
All Ceylon Community Dev. Council	Colombo	236	USD 2	73%	203%	100%
TOTAL		**14.325**	**USD 119**	**69%**	**74%**	**365%**

Source: LAMP, 2009.

3.3.2 Financial Performance

Despite achievements in outreach and a multiplicity of fund-driven services (mostly non-financial), diluted institutional priorities decreases service quality, reduces sustainability

and increases administrative costs for the institutions and transaction costs for the client. Typically lending programs are offered in combination with health programs (e.g., BRAC), mandatory training (e.g., SEWA), environment protection (HELP-O), youth (CCF-SL, YMCA), and community development. The main consequence has been that despite being in operation for many years, most MFIs are not self-sufficient financially or even operationally. After more than ten years in operation self-sufficiency rates are 92% for SEEDs, 90% for SEWA, 68% for BRAC and 81% for Arthacharya. The problem is exacerbated by a staff largely comprised of volunteers and/or low paid professionals. Sound financial management, profitability and self-sufficiency are concepts not fully accepted or even understood. Audit departments are lacking and internal controls very weak.

Governance structures are weak as well. NGOs have no owners and because of the non-profit nature of this type of institution, their board members might lack the necessary motivation to push the institution into implementing sound financial practices. Readily available grants and soft loans further reduce the need for, and act as a deterrent to, the implementation of sound financial practices. The situation does not improve in the case of cooperatives where ownership is diluted amongst a large number of members/associates whose dual role as owners and clients prevents them from making sound financial decisions. High levels of politicization in the cooperative sector add vulnerability to an already weak governance structure.

Management information systems are poor or lacking. Inability to generate timely, reliable and accurate information of portfolio performance combined with ill-defined policies and procedures on loan follow up and recovery, negatively affects portfolio quality. The problem is worse in rural areas. Prevalent misconceptions on the poor's capacity to pay market interest rates and government practices of debt pardoning, have created the perception among small farmers that loan repayment is at best optional.

Despite general claims of high repayment rates, portfolio quality measured by the portfolio at risk rate over thirty days past due (PAR_{30}), is poor even for the largest MFIs. As of December 2008, SEEDS reports a PAR_{30} of 11%, SEWA 8%, and Arthacharya 15%. Performance among government direct lending programs and cooperatives does not show any improvement. Samurdhi reports a PAR_{30} rate of 12% while SANASA reports a rate of 14.5%. Furthermore, the lack of transparency prevalent among microfinance operators makes it difficult to assess portfolio performance for the sector at large. Most MFIs are unable to (due to poor MIS), or are unwilling to (due to poor performance) provide portfolio statistics. In fact only 47% of LAMP member MFIs provides regular statistics.

3.4 Brief Description of Main Non-Regulated Microfinance Service Providers

3.4.1 SEEDS

SEEDS started operations in 1998 as Sarvodaya Economic Enterprise Development Services (Pvt.) Ltd., a limited liability company. The Company offers credit, savings and insurance

services. Credit is provided in combination with training and business development through forty-one branches in twenty six districts. The geographic coverage includes the target districts of Trincomalee, Batticaloa, Ampara, Monaragala, and Anuradhapura.

SEEDS is probably the most professional and transparent MFI in Sri Lanka. It is the only MFI in Sri Lanka that has been awarded a BB credit rating. Nearly 90% of the operations relate to microfinance. The institution follows the group lending CBO methodology where the CBOs work as self-managed associations that provide credit to, and mobilize savings from their members.

The institution is also the largest non-government microfinance program in the country. As of December 31, 2008, the program had 179,322 active borrowers, a loan portfolio of LKR 3.8 billion and a PAR_{30} of 11%. While the PAR is still high, in comparison to a best microfinance practice standard of 4% or less, the rate has declined steadily over the past few years, from 20% in 2007 to 15% in 2008 to 11% in April 2009. Women represent 62% of all borrowers. The average loan stands at LKR 24,599. In terms of outreach, SEEDS is only second to the government-owned Samurdhi Authority. The operational self-sufficiency is 110%; yet the financial self sufficiency is only 90%.

Deposit mobilization is impressive. The institution has 1.1 million depositors and LKR 3.6 billion in deposits; the average deposit is LKR 3,292. The loans to deposits rate being 98% translates to SEEDS being almost entirely financed by deposits. In addition to deposits, other sources of funding include Oxfam NOVIB, the largest donor, USAID, ETIMOS, NDTF, and Plan International.

Future steps towards the expansion of microfinance services include the transformation into a regulated financial institution, likely a commercial bank, and further expansion into ex-conflict regions. The institution identifies 3 main constraints to the development of the Microfinance Sector:

- Lack of an appropriate regulatory environment for microfinance;
- Lack of license to mobilize savings;
- Lack of institutional capacity building initiatives - need for staff training on portfolio delinquency management and on microfinance international best practice standards; and
- Lack of transparency.

3.4.2 SEWA Finance

Sewalanka Community Financial Services Ltd. known as SEWA Finance was established in 2005 as a limited liability company. The underlined objective was to become the financial arm of the Sewalanka Foundation, one of the largest development institutions in the country. The foundation specializes, among other activities, in community development through mobilization and strengthening of legally-registered CBOs. Once established, these CBOs self-manage a revolving fund made of the members' savings. Initially, the Foundation sought to link the CBOs to commercial lenders but later on, after facing some difficulties in following this approach, abandoned the idea and created its own lending company, SEWA

Finance. At present, loans to CBOs constitute 90% of the SEWA Finance's loan portfolio of LKR 161.4 million. The remaining 10% represents individual loans in the Ampara district. The average loan size is LKR 15,271.

Loan amounts in group lending range from LKR 10,000 to LKR 40,000 per individual member to a maximum of LKR 500,000 per CBO. Loan amounts in individual lending range from LKR 50,000 to LKR 200,000 maximum. Interest rates are set at 24% flat per year with a maximum term of 24 months. The average term for CBOs however is 12 months. No hard collateral is required from CBOs; instead, members must agree to guarantee each other. In the case of individual borrowers, two guarantors are required.

As of March 31st 2009, SEWA Finance had nearly 10,000 active clients, a portfolio of LKR 161.4 million and a PAR_{30} of 8%. A network of 17 branches and a staff of 60 people support the operations. SEWA Finance operates in four districts including, target districts of Trincomalee, Ampara, Anuradhapura, and Monaragala.

Current sources of funding include ETIMOS (international financial consortium), Stromme Foundation, Dutch Bank, and Rabobank among others. The Company, reportedly, does not mobilize savings. Operational self-sufficiency is still at 87%. Next steps include the following:

- Creation of a regulated institution, likely a commercial bank;
- Geographic expansion to the Northern and Eastern Districts;
- Decrease PAR_{30} rates to 7% or less;
- Target of 50,000 active clients by 2010; and
- Reach a level of 100% program financial sustainability.

The institution identifies five main constraints to the development of the Microfinance Sector:

- Lack of an appropriate regulatory environment for microfinance– lack of license to mobilize savings. Need for donors and practitioners to press for legislation;
- Lack of institutional capacity building initiatives- need for staff training on portfolio delinquency management and on microfinance international best practice standards;
- Lack of capacity building initiatives;
- Lack of accounting standards: need for a standard chart of accounts; and
- Lack of training material in Tamil and Sinhalese that will facilitate the expansion into the North and East.

3.4.3 BRAC Sri Lanka

An offspring of the widely successful BRAC Bangladesh, BRAC Sri Lanka started operations in the aftermath of the tsunami and registered as a non-government organization in 2005 with several relief and rehabilitation programs. In 2006, the institution started a

microfinance group lending program with Village Organizations (VOs) in partnership with four local NGOs. The main objective is poverty alleviation. The program provides small loans to VOs directly promoted or formed by BRAC and operates similarly to other group lending initiatives in the country.

Group formation takes a period of six weeks. First loans range from between LKR 10,000 to 20,000 with a one-year term at an annual rate of 12% flat. All borrowers are savers. The institution, however, follows a holistic approach and the microfinance program is accompanied by non-financial services such as education (distribution of school materials, stipends for orphans), health (disinfection of contaminated wells, construction of latrines, medical aid), among others. Initially the lending program focused on tsunami affected districts but today BRAC has 55 branches in four provinces and eight districts including the target districts of Trincomalee, Batticaloa and Ampara.

As of April 2009 BRAC had 58,447 active clients in an outstanding portfolio of LKR 786 million and a PAR rate of 3%. All borrowers are savers; however, savings are not mandatory. The savings balance amounts to nearly LKR 100 million, and results in a rate of deposits to loans of 12%. The operational self-sufficiency rate is reported at 137%. Sources of funding include CBSL rediscount lines, OXFAM, GTZ, SIDA, and STROMME Foundation.

The institution identifies three main constraints to the development of the Microfinance Sector:

- Lack of an enabling regulatory environment for microfinance and lack of license to mobilize savings;
- Lack of institutional capacity building initiatives; and
- Lack of long-term funding to MFIs[10].

3.4.4 Arthacharya Foundation

Arthacharya Foundation started operations in 1992 and is registered under the country's Companies Act. During the first year of operation the institution focused on lending to small farmers. In 2006, it started a group lending program through CBOs with the objective of targeting the poor. Contrary to other MFIs, Arthacharya does not get involved in group formation. Communities and potential clients are encouraged to create their own groups/CBOs. Groups must save for a period of six months before they could qualify for a loan.

Loan amounts range from LKR 5,000 to LKR 7,000 per member for a maximum term of one year. An interest rate of 22% on the declining balance and a 2% service fee is charged on all

[10] Funding from NDTF and the CBSL for microenterprise lending, though widely available, is mostly short-tem in nature (one to three year terms). From the standpoint of MFIs, longer terms allow for higher funding turnover, lower administration costs, and larger capacity to provide longer-term funding to clients.

group loans. As in the case of most group lending programs, members are required to guarantee each other. Loan amounts for individual borrowers range from between LKR 75,000 to a maximum of LKR 100,000.

As of March 2009, the institution had 34,000 active clients; 16,000 are borrowers and 18,000 are depositors only. The loan portfolio amounts to near LKR 200 million with a PAR_{30} rate of 15%. Deposits amount to LKR 130 million. About LKR 55 million in deposits comes from clients that have not yet received their first loan. A network of 17 branches and a staff of 140 persons support the operation. One branch serves the target district of Monaragala. Current sources of funding include ETIMOS and Rabobank. The Company, reportedly, does not mobilize savings. Operational self-sufficiency is still at 87%. Next steps include the following:

- Geographic expansion to the Eastern districts;
- Target of 50,000 active clients by 2010;
- Reaching operational and financial sustainability; and
- Creation of a regulated financial company.

The Foundation identifies four main constraints to the development of the MF sector:

- Lack of an enabling regulatory environment for microfinance, lack of license to mobilize savings;
- Lack of institutional capacity building initiatives;
- Barriers to foreign investment and finance due to currency exchange regulations. The political environment sees NGO activity with suspicion; and
- Funding available from NDTF and CBSL is very bureaucratic and time consuming.

3.4.5 Samurdhi Authority

The government-owned Samurdhi Authority has the largest social mobilization program in the country with over 34,000 Samurdhi village societies and 2.5 million members. Target clients are those living under poverty levels. As such, women represent 64% of the total membership.

The Program has 1,042 branch offices and 14,000 administrative units countrywide. These units count on 14,000 field officers for the provision of four main types of services: loans, savings, insurance, and investments. Samurdhi also provides financing for rural infrastructure development through the Samurdhi societies, Credit Plus facility that includes training and marketing services, as well as loans for livestock, agriculture, consumption and emergencies.

As of December 2008 deposits amounted to LKR 35 billion from 2.5 million depositors. The outstanding loan portfolio is LKR 32 billion for a rate of deposits to loans of 109%. The number of active borrowers is 2.95 million. Most lending activity is carried out through group lending through the 34,000 currently active village societies. Group loans are accompanied by a compulsory savings component.

Despite the impressive outreach, and after so many years of operation, portfolio quality and sustainability are still outstanding issues. PAR_{30} is reported at 10.5% while operational sustainability is reported at 80%. Lack of management capabilities, financial sustainability and transparency remains as key problem areas. Another fact remains that being government-owned the institution is fairly open to Politicization.

3.5 Other Players

3.5.1 eZ Pay Dialog

Dialog Telekom is a major cell phone service provider in the country with over 6 million subscribers. In 2008, the company implemented eZ Pay Dialog, an innovative service that transforms the cell phone into an electronic wallet. The system works similar to a process of reloading minutes into a prepaid cell phone. Instead of buying a reload/phone card for example LKR 1,000, the subscriber buys cash reloads of LKR 1,000 that will be added to the cash balance in his/her electronic wallet. This balance enables the subscriber to send remittances, make loan and utility payments, make deposits and withdrawals, receive loan disbursements and buy goods and services at anytime, from anywhere.

The potential of eZ Pay for the expansion of rural financial services, to the poor and isolated, is enormous. The system will enhance the availability of loans to micro-borrowers, many of whom live in relatively isolated rural areas. Given the high frequency of loan repayments as a major feature of “best practice” micro lending, the costs imposed on borrowers to bring their payments to rural bank branches, or on loan officers to visit

borrowers to collect, can disappear or become substantially reduced. Similar cost-saving benefits apply to payment of utilities and services.

3.5.2 LOLC Micro Credit Ltd.

LOLC started operations in 2008 as a regulated financial leasing company. The company is owned by LOLC Public Limited Company (80%) and FMO Netherlands (20%). It provides lending and leasing services to micro, small and medium enterprises and operates individual and group lending programs. As of April 2009, the Company had a loan portfolio of USD 22 million with 18,000 clients, 95% of them categorized under individual, asset-backed lending. A network of 23 branches, including in the Batticaloa, Ampara and Trincomalee Districts, and 15 postal offices support the operations.

In 2008, USAID established a USD 2.5 million guarantee fund to support LOLC in its efforts towards obtaining financing from international lenders, to expand their lending activities to the East. The agreement called for 100% in matching funds raised by the company during a one year period. It was expected that the guarantee fund would enable LOLC to attract financing at lower interest rates and longer terms. Ten months into the year, LOLC has not been able to obtain enough financing to meet the agreed upon matching levels, at least not within the softer loan conditions originally envisioned.

Reportedly, LOLC has raised over USD 17 million from European sources over the past ten months. Yet, none of these sources were interested in lowering their interest rates and/or in softening loan conditions. According to LOLC managers, the low response to the guarantee fund from international financing agencies lies in the perception of risks. European agencies, for example, are fairly knowledgeable on microfinance and perceive that risks are not associated with the sector, but rather with the quality of the lender. Moreover, they have developed a wide range of financial instruments to assess microfinance institutions and their risk potential. With the information available on the financial performance of the MFI by international rating agencies, some financing agencies do not see the need for a USAID guarantee, if provided at the expense of lowering their interest rates.

A new strategy being followed has been to target American financing agencies. So far ten sources have been approached among them being Mainland USA and Oiko Credit. Results are yet to be seen. In the absence of raised capital within the terms and conditions originally envisioned, the company plans to meet its counterpart with internal funds that can be freed from the newly raised USD 17 million.

3.5.3 Diaspora Bonds

USAID has been looking at Diasporas as a potential source of capital funding, specifically through Diaspora bonds, in many other countries. Diaspora bonds are debt instruments issued by a country or private sector institution to its Diaspora to raise capital for economic development. The main strategy has been to combine local banks and MFIs, with the Diaspora's desire to invest in their home country and USAID's own development assistance tools. The bonds are expected to provide long-term project financing to underserved sectors and borrowers particularly in the target and conflict ridden areas.

Such Diaspora bonds will enable local banks to issue bonds or offer certificate of deposits on behalf of themselves, MFIs and enterprises (borrowing companies) interested in raising debt capital from Diaspora investors (bond purchasers). The banks, directly or through a third party (conduit), will organize the issuance, rating, marketing, hedging and management of the bonds. The banks or their conduit will handle payments to the investors and report to proper authorities. With the capital raised, the banks will finance MFIs or enterprises.

Diaspora bonds have been used successfully by countries like Israel and India where they have mobilized nearly USD 40 billion. The potential success of this kind of initiative for Sri Lanka is still questionable. The bonds are expected to provide credit access to underserved populations. Two underlying assumptions/misconceptions are that (a) financial institutions need a "stimulus" to reach "underserved" populations, and that (b) there is a lack of funding. In Sri Lanka neither seems to be the case based on the following:

(a) There is a very large number of government, private and international institutions (estimates at 22,000) providing financial services countrywide. According to a GTZ 2008 Study, these institutions are reaching over 80% of the population, rural and urban, including in target districts (Table 1). Moreover, they do reach poor people through the poverty alleviation oriented group-lending schemes used by over 90% of the MFIs. Indicators of poverty outreach such as low average loan sizes (below USD 200 for 94% of the MFIs and below USD 100 for 77% of them) and high women's participation (above 95% for 52% of the MFIs) further support the depth or outreach of MFIs in the country (more details in Section 2). The problem, therefore, is not really of geographic outreach or depth of outreach. The problem is not lack of funding either.

(b) During the post tsunami period, the influx of funding in Sri Lanka from international bilateral, multilateral and cooperating agencies of every type has been very large. In addition, deposit mobilization today constitutes the major source of funding for MFI at large. In fact, the average rate of deposits to loans is 84% for 29 LAMP deposit taking members. These figures explain, at least partially, why the MFIs interviewed during this Assessment did not identify lack of funding as the most pressing need. Institutional capacity building and an appropriate microfinance regulatory framework were, instead, identified as the most pressing need for improving outreach.

(c) The large influx of funding, with a lack of clear development strategy, has in fact been detrimental to the provision of microfinance services being sustainable and of quality. The end result has been a proliferation of a large number of small and weak microfinance institutions. They provide loans at highly subsidized rates and high transaction costs for the client. Relatively easy access to funding has long prevented them from seeking sustainability. Poor quality service, as proven by the low repayment rates (65% to 85%), is the rule rather than the exception. The outstanding issues with the microfinance sector exist not because there is a lack of funding, but rather poorly managed institutions and low service quality. Even among the large MFIs, their main strategy in terms of funding aims at becoming licensed by the CBSL to mobilize savings.

In the absence of problems with depth of outreach and or funding, bond issuance will not solve the outstanding issues with MFIs in regard to outreach of underserved populations. Nonetheless, bond issuance can still play a role in long-term financing of medium and large enterprises particularly those in rural areas. The financing available is geared towards short-term working-capital loans. Medium-term lending (three to five years) is provided by government banks only to already existing enterprises, and at high rates of return. Financing for long-term investment is not easily available. A mismatch in deposit mobilization and lending terms makes the situation worse. Since most deposits are short-term in nature (savings accounts), banks are unable to offer long or even medium-term loans unless the funding comes from external sources with similar long-term conditions. If intended for long-term investment financing, then, bond issuance would require that Diaspora investors be willing to keep their money invested for several years. The number of Diaspora investors attracted to such a scheme might become substantially smaller, even when providing a 50% DCA guarantee.

3.5.4 Credit Information Bureau of Sri Lanka

The CRIB was created in 1990 by the Parliament Credit Information Bureau Act to provide credit information services to regulated financial institutions. The Bureau is a membership institution and, as such, interested banks and financial companies must buy shares in order to access the Bureau services. Current eligibility criteria include a minimum purchase of 300 shares for commercial and specialized banks, and 100 shares for financial companies at a price of LKR 1,900 per share. In addition, fee charges per consultation also apply:

- LKR 225 per individual if found in the database.
- LKR 100 per individual if not found in the database.
- LKR 400 per institution/company found in the database (audit reports).
- LKR 200 per institution /company if not found in the database.

Since 2008, as a result of an amendment to the Bureau Act, there are no limits to loan size reporting. Credit information on clients with amounts as small as LKR 1.00 can be both reported and accessed on-line. The information services expanded to current accounts (for bounced checks), credit cards, insurance and other financial services provided by any

institution, regulated or not. An important addition was a set of consumer protection policies that enabled individuals to access, and dispute, their credit records. Not only did the type of information available expand, but non-regulated financial service providers, including NGOs, became eligible to join and access the Bureau services. Minimum share requirements for non-banking institutions apply to those non-regulated. The CBSL and the Ministry of Finance must approve all applications.

At present, non-regulated institutions like the Sri Lanka Export Insurance Company and the NDTF are members. None of the MFIs, large or small have joined, despite claims of increasing competition, decreasing portfolio quality and expanding outreach. Misconceptions on information sharing and potential client stealing, lack of transparency and poor understanding of portfolio and risk management, are reasons that are likely to prevent non-regulated MFIs from joining.

3.5.5 Informal Lending

Despite the large outreach and geographical coverage of formal sources of lending, informal lending is widespread throughout the country in general, and in the north and eastern regions in particular. Moneylenders, middlemen, relatives and friends provide small, short-term loans for emergencies, business and other purposes to those unable to access formal sources.

The GTZ 2008 study on outreach of financial services in Sri Lanka[11] reports that 18.3% of 970 surveyed households still use informal sources to meet their credit needs. This percentage increases to nearly 26% for the North Central Province; interestingly enough, it is the lowest for the Eastern Province (13%). Relatives and friends (62%) and moneylenders (26%) constitute the main sources of informal lending (88%). Other common sources are landlords/employers (5%), traders/shopkeepers (3%) and rotating savings associations (ROSCAS) (2%). It is noteworthy that these figures do not include pawnshops that are found widely spread in commercial areas of Colombo and secondary cities. Pawnshops provide jewelry collateralized loans typically for small amounts, as short term immediate disbursements.

Informal loans are typically destined to emergencies. The GTZ study shows that emergencies represent 45% of informal loan destinations followed by income generation (18%), construction and investment (12%), consumption (11%), and debt payments (7%). Loans from informal sources typically involve small amounts and high interest rates.

[11] GTZ, Outreach of Financial Services in Sri Lanka, 2008: A Look at the Demand–side from a Microfinance Perspective.

Table 4: Informal Lending Sources

Sector	Households using Informal Credit (%)	Sources	Number of Loans, As a %	Average Loan Size	
				LKR	USD
Total	18.3	Relatives and friends	62.0	37,252	310
Rural	18.5	Money lenders	26.4	24,649	205
Urban	16.6	Trade/shopkeepers	3.0	15,563	130
Estate	20.8	Landlord/employer	5.3	19,064	159
		ROSCAS	2.2	22,752	190
		Other	1.1	8,429	70
Province		**Purpose**			
Western	14.1	Agriculture, Livestock	8.9	24.670	206
Central	26.0	Business/Enterprise	9.5	84.875	707
Southern	14.0	Construction/Housing	7.6	85.344	711
North Western	18.7	Assets	4.6	36.562	305
North Central	25.6	Consumption	10.8	8.492	71
Uva	18.2	Emergencies	45.0	15.561	130
Sabaragamuwa	23.1	Debt Repayment	7.3	21.778	181
Northern	22.7	Other	6.2	59.189	493
Eastern	13.7				0

Source: GTZ, Outreach of Financial Services in Sri Lanka, 2008.

An average loan size ranges from LKR 8,500 to LKR 37,000 (USD 70 to USD 300) depending on the source (Table 4). Relatives and friends as well as moneylenders report the largest averages with LKR 37,000 (USD 300) and LKR 25,000 (USD 200), respectively.

Table 5: Reasons for Accessing Informal Sources

Reasons	Households As a%
Easy access	75%
Collateral is not required	67%
Flexibility in terms and conditions	34%
No need for loan application; simple procedures	27%
No restrictions on loan destination	21%
Lack of access to forma lenders	20%
No mandatory savings	10%
Can borrow any amount	18%
Low interest rates	8%
Other	3%

Source: GTZ, Outreach of Financial Services in Sri Lanka, 2008.

Contrary to formal sources, informal lenders require no collateral and minimum documentation, and disburse funds immediately. While interest rates charged to the client are typically very high (5% to 20% per day), transactions costs (e.g., costs of documentation, registrations, mandatory training, mandatory savings, travel, processing time) are instead very low. The widespread use of informal lending demonstrates that micro-entrepreneurs and small farmers are willing to, and actually do pay high interest rates if other terms and conditions suit their needs (no collateral, little documentation, and rapid disbursement).

3.6. The Microfinance Regulatory Environment

The CBSL is the regulatory and supervisory body of the formal financial sector. At present the sector is comprised of 24 commercial banks, 14 specialized banks (e.g., development, cooperative banks), 32 finance companies, and 22 registered finance leasing companies. The commercial banks include two government-owned and nine foreign banks. The government also owns five out of the nine specialized banks[12].

Over the past few years, the country has gone through a process of deregulation with a significant impact on the modernization, expansion, and diversification of the financial sector and the services provided. In an effort to expand the provision of financial services to the rural and the poor, the CBSL implemented several rediscount lines easily available at low interest rates. Commercial banks were mandated to channel 5% of their loan portfolio to micro lending. These efforts have certainly translated into the proliferation of microfinance service providers and expanded outreach. However, the soft terms and subsidized rates attached to them have resulted in distortions in the financial sector, creating a high dependency of non-regulated MFIs on government funding, and as such, negatively affecting the provision of microfinance services sustainably. Today, the current

[12] Annual Report, CBSL, 2008.

regulatory environment remains poorly conducive to the provision of microfinance services, in particular, loans and deposits.

On the lending side, micro lending methodologies are largely based on non collateral, minimum documentation and none or basic financial analysis. Current regulations ruling for hard collateral, heavy documentation and deep financial analysis to support the usually large loans of a regulated entity could hardly apply to micro lending without generating costly loan loss provisions. A regulatory environment conducive to micro lending needs to accept innovative forms of collateral (e.g., solidarity group guarantee, home, and business assets), reduce documentation and financial analysis requirements to levels more relevant to the size of the loans, and create a provisioning system according to the risks associated with micro lending. As the vast majority of microfinance service providers are non-regulated, the lack of an appropriate environment does not affect them substantially in as long as they do not seek to "transform" into commercial banks or regulated financial companies. Once they do, the costs of compliance with regulations that are hardly suitable to micro lending operations will force them into serving larger, less costing clients. These same issues might prevent current private commercial banks from servicing very small clients.

On the deposit side, the situation is more difficult for non-regulated MFIs. Most microfinance service providers specialize in group lending methodologies with strong deposit mobilization components. Despite the fact that only regulated institutions are allowed to take deposits from the public, deposit taking is widespread among MFIs including NGOs, and limited liability companies. In this regard, MFIs have found in deposit mobilization a steady and reliable source of internal financing for their program operations. According to LAMP statistics savings represent 84% of the loan portfolios. The combined value of deposits amounts to LKR 4,129,574,261, from a total of 1,417,594 clients.

Finding a solution under the regulatory framework for non-regulated MFIs on deposit taking has proven to be a far more complex task. In 2005, a Microfinance Act was submitted to the CBSL with the support of ADB and LAMP. The Act, unsuccessfully sought to convince the CBSL into licensing MFIs to mobilize deposits.

In summary, the Microfinance Act proposed licensing those MFIs able and willing to meet one of three decreasing levels of capital requirements and geographical scope of operations. The CBSL would supervise, directly or through delegation to a third party (an independent regulatory body set up to this end), the licensed MFIs. The Act made no clear references to what other changes would be needed, in addition to the following licensing fee, to operate microfinance services (acceptable guarantees, documentation, financial analysis and provisions):

1. Nationwide level: LKR 50 million
2. Regional level: LKR 10 million
3. District level: LKR 1 million

All government approval bodies involved, CBSL, Parliament, and the Ministry of Finance, unofficially rejected the Act. Officially, the Act is still sitting in Parliament awaiting

approval. Recently, the Government has brought up again the need to have a regulatory framework for microfinance operations. It has requested the CBSL to draft a new Act to be submitted in six months to Parliament.

The need to have a regulatory framework conducive to microfinance activities remains the key strategy for the future of microfinance. However, from an analytical stand point, the Microfinance Act as originally proposed is conceptually and prudentially flawed due to the following reasons:

1. The role of the CBSL is to regulate, protect and supervise public deposits as well as to provide a regulatory framework that will ensure a sound financial sector. It is not the concern of a Central Bank to supervise donor funding and lending activities;

2. The relatively low levels of capital requirement proposed in the Act would bring into the CBSL supervision an unmanageable large number of small, very weak MFIs. With a number of MFIs ranging from 3,000 to 22,000, the resulting number of licensed MFIs would become too large and costly to supervise. A major issue remains that licensing a large number of managerially and financially weak institutions would only contribute to the weakening of the financial sector. This is a risk the CBSL should not be forced to take;

3. The CBSL should only be concerned about licensing large MFIs and cooperatives that do, or plan to, mobilize deposits on a large scale, provided they meet CBSL's prudential standards attached to sound financial management. MFIs, large or small not interested in deposit mobilization, should not be the concern of the CBSL;

4. The vast majority of MFIs are too small and managerially too weak to effectively mobilize deposits on a large scale. As such, small MFIs that mobilize deposits do not pose a major risk to the public or a threat to the financial system. The risks in managing those deposits are not concentrated in a few, but atomized in a large number of small institutions. The threat lies in the unlikely event that the whole network can collapse at once;

5. The deposit taking cooperatives pose a far larger threat than non-regulated MFIs. The vast majority are also administratively and financially weak, and de facto run their savings operations with little supervision and or regulation;

6. There is a need to differentiate deposit-taking activities in which non-regulated MFIs are involved. Some NGOs have mandatory deposits in their group lending methodology, but groups are required to open accounts in commercial banks where the mandatory savings are maintained. In this case, the MFI is not intermediating, in other words, it is not directly using groups' deposits for relending;

7. Creating another financial entity (MFI) which is licensed, would only contribute to further fragmenting in the financial sector with no justification. The sector already has commercial banks, specialized banks, financial companies, leasing companies,

among others, with different levels of capital requirements and permissible activities. In this regard, financial companies have capital requirements that are sufficiently low as to enable entry of middle sized MFIs (20,000 clients and up) with permissible activities that include deposit mobilization. In fact, the largest MFIs like SEEDS and Arthacharya, with the capacity to meet the capital requirements, are already seeking to establish commercial banks. SANASA already established a commercial bank, namely SANASA Bank. SEWA has established a financial company, SEWA Finance. There is no need for another financial entity; and

8. A microfinance conducive regulatory environment must be set around regulating microfinance as a product, not as an institution. Thereby all types of institutions, commercial banks, regulated financial companies, and cooperatives alike, will be able to provide microfinance services cost effectively and profitably. As aforementioned, micro lending activities require regulatory changes in documentation, financial analysis, guarantees, provisioning and supervision more in accordance with the small amounts involved.

Regulating micro savings, calls for changes in requirements for Knowing Your Client (KYC), documentation for account opening, and branch opening. Again, more relevant to small deposits and the population served. Licensing MFIs alone, without taking into consideration these changes in regulation and supervision, would only contribute to increased operational costs of microfinance services and increased transaction costs for the client, among other unwanted effects. The end result would be on the one hand, institutions shying away from the poorest, smallest clients and, on the other hand, clients shying away from the institutions because of cumbersome, time-consuming and costly loan processing. As per Government instructions, the CBSL must prepare within the next six months a second draft of the Microfinance Act. Ensuring that this new Act contains an appropriate set of regulations that benefit microfinance services, while maintaining the prudential and financial soundness of the financial sector is crucial to the development of the microfinance industry in the country.

4. Main Findings:

1. Large number of donor and financing Agencies: No need for direct funding to MFIs

A large number of donor and financing agencies continue to provide grants and soft financing to microfinance institutions. Yet, government institutions like NDTF, PB and CBSL through its rediscount lines are today the major sources of financing for MFIs at large. In most cases, the soft conditions attached to this funding must be transferred to the client in low interest rates, grace periods and excessive terms and amounts. Often funding is also directed to the implementation of a particular methodology (group lending) or population group (farmers, fishermen, and internally displaced).

While cumbersome and highly conditioned, funding from government and private agencies, notwithstanding, is available even to very small MFIs. But donor intervention, lacking clear strategy and focus, have brought distortion to the financial sector, detriment to the client repayment culture and disincentive to efficiency and sustainability of the MFIs. While decreasing, there is still enough funding available from international and national funding agencies.

In addition to donor funding, a large number of microfinance institutions are intensively involved in deposit mobilization. The deposits to loans ratio is 72.5% for WDF, 92% for SEEDs, and 70% for Arthacharya Foundation. In fact, deposit mobilization represents an average of 81% of the portfolios of 28 of the largest non-regulated MFIs in the country.

The excess of liquidity resulting from deposit mobilization and/or external funding is usually placed in investments and treasury bonds. For example the financial statements of SEEDS and Arthacharya show investments (e.g., treasury bonds and similar instruments) representing 21% and 23% of total assets respectively. Not surprisingly, all MFIs interviewed, identified lack of managerial capacity as the main barrier to growth. None excepting one MFI (BRAC), identified lack of funding as the main barrier.

2. Need for Strengthening MFIs' managerial and financial capacity to provide services efficiently, profitably and on a large scale

In interviews with funding agencies (GTZ, IFC, NDTF and CBSL) and microfinance service providers, they all identified institutional capacity building as the most pressing need for the development of the microfinance sector in Sri Lanka.

As stated early in this document, except SEEDS, WDF, Arthacharya, Samurdhi, BRAC and SANASA, most MFIs are small in scope, and administratively and financially weak. Concepts of portfolio management, best practices and sustainability are not accepted or even understood. MFIs lack professional staff in all areas, particularly finance and accounting. Financial statements and portfolio statistics, when available, lack timeliness, quality and transparency.

Most MFIs and all government direct-lending programs offer subsidized interest rates, excessive terms and amounts that have proven to be highly detrimental to both clients and programs. Soft conditions combined with refinancing, rescheduling and government's debt pardoning have created the perception among clients that loan repayment is at best optional. Repayment rates, which indicate the program's capacity to manage lending and the client's satisfaction with the service rendered, are, by in large, significantly low (60% to 85%). Portfolio at risk rates over thirty days past due (PAR_{30}) are high even for the most successful MFIs like SEEDS (11%), Arthacharya (15%), SEWA Finance (8%), Lak Jaya (10%), and worse for the Government direct lending programs like Samurdhi (16%) and a licensed Specialized Bank such as SANASA (15%).

There is a clear need for capacity building of current microfinance institutions, including regulated ones. Commercial banks, for instance, have the managerial, financial and legal capacity to manage and offer microfinance services in a sustainable manner. They lack however, the technology (methodology) that will allow them to do it on a large scale, profitably and cost-effectively. PAR rates, key indicators to assess service quality and client's satisfaction, are high even for commercial banks that provide microfinance services like PB (10%), BoC (9%), and HNB (8%).

Financial management, MIS, audit, internal controls, portfolio management, risk management, accounting, product diversification, best practices, human resource management, among others, have been identified by donor and MFIs alike as the key areas to address in order to develop the microfinance industry in the country.

3. Need for reducing transaction costs for the client

While interest rates are low, transaction costs for the client are high. Prior to accessing a loan, group applicants must go through a six to twelve week group formation process. This process is time and resource consuming for the client (time and travel costs, costs of time away from work, documentation costs). Compulsory savings pre and post credit and mandatory weekly meetings, also increase the transaction costs for the client. Group loans are heavily collateralized by savings, and as such clients are at higher risk of losing their savings in case of a member's default. Compulsory training programs, usually of very low quality, contribute to a further increase in already high transaction costs. A reduction in the transaction period for loan disbursement for first loans and renewals can contribute significantly to a reduction in transaction costs to the client.

4. Need for development of a regulatory framework conducive to the provision of microfinance services

A regulatory framework that facilitates the provision and expansion of microfinance services was also identified by the institutions interviewed as key to the development of the sector. Over the past few years MFIs and donors have been putting pressure on the Government and CBSL into licensing MFIs to mobilize deposits. A draft of a Microfinance Act was submitted in 2007 to CBSL. Although unofficially, Parliament, CBSL and Ministry of Finance all rejected the Act as it would bring into the CBSL supervision an unmanageably large number of small, weak MFIs.

The Act was flawed since it did not take into account its negative impact on prudential issues and the soundness of the financial sector. It also did not take into account the key aspects that make a regulatory environment conducive to microfinance services. Current regulations ruling for hard collateral, large documentation and deep financial analysis to support the usually large loans of a regulated entity could hardly apply to micro lending without generating costly loan loss provisions.

A regulatory environment conducive to micro lending needs to accept, among others, innovative forms of collateral (e.g., solidarity group guarantee; home and business assets), reduce documentation requirements to a minimum and create a provisioning system more related to the risks associated with the size of loans (small) provided. Similarly, effective mobilization of micro savings requires modifications as well, in the areas of KYC, documentation requirements, taxes, and branch opening, among others. It will also require regulations on electronic banking towards facilitating the implementation of electronic accounts, electronic wallets and the provision of remittances and payment services via cell phone text messages. Changes of this kind will benefit the microfinance sector as a whole and create a stimulus for commercial banks and other regulated institutions to implement, expand and/ or diversify the provision of microfinance services.

Notwithstanding the issues with the Act, there is clearly a need for modification to the regulatory environment surrounding microfinance services. As per Government instructions, the CBSL must prepare within the next six months a new draft of the Microfinance Act. Ensuring that this new Act contains the appropriate set of regulations is key to the development of the sector.

An appropriate regulatory environment will benefit the microfinance sector at large in a sustainable way. It will foster expansion and diversification of already existing microfinance services to the poor, the displaced, rural and/or isolated populations. It will also facilitate transformation of large MFIs into regulated deposit-taking institutions and attract more commercial banks into providing services to the sector.

Regulations on electronic and cell phone banking will have a major impact on the provision of financial services to the isolated and rural. Furthermore, due to strong competition in urban areas, and in view of the end of the armed conflict, MFIs are now talking about expanding their outreach in the Eastern and North Central provinces. Large MFIs like SEEDS, BRAC, and Arthacharya, as well as HNB, NDB and SANASA identified the expansion to these provinces as their next steps to be taken towards the expansion of their programs.

5. Need to facilitate the implementation and further development of electronic wallet systems

Capacity to make payments, transfer money and manage deposits for small farmers and entrepreneurs will accelerate the expansion of financial services by reducing transaction costs to the client and administration costs to the MFIs. Dialog eZ Pay is one such service that will enable even the most isolated client, to open a savings account, deposit and withdraw money, receive loan disbursements, send and receive remittances, pay utility

bills, make loan payments, receive salaries and buy goods and services from the convenience of their homes, by just having a cell phone. With potential gains for both banks and borrowers seen to be substantial, these initiatives should continue to be supported.

Currently, the main barriers to the expansion of eZ Pay are regulatory. The money held in an electronic wallet is, de facto, a deposit and Dialog Telekom is not a regulated financial institution. Until this issue is resolved, eZ Pay can operate only in partnership with commercial banks and other regulated institutions authorized to take deposits. This means that in order to subscribe, a potential client needs to open an account with any of the participating banks. The apparent limitation is that at present only two banks, HNB and NDB are participating. Therefore increasing the number of participating banks seems to be the apparent solution. However, the real limitation is that, due to KYC requirements from the CBSL, account opening can only be done at a bank branch, by bank staff. Neither the client nor Dialog can open a cell phone menu-driven electronic account that would make subscription immediate. The resulting high transaction costs, due to distances to the nearest branch, documentation, travel costs and time, might prevent clients, particularly in rural areas, from subscribing to the service.

The CBSL is looking at possible solutions. The CBSL is keen to find a solution through a special license and seeks to draft regulations on electronic banking and electronic accounts. The timing for these actions still remains uncertain. However, this could be combined with the drafting of the new Micro Finance Act.

5. Recommendations

For long term sustainable development of the microfinance sector, two major areas of intervention are recommended: (1) Supervision and regulation of microfinance activities and (2) Capacity building of microfinance service providers, including commercial banks. Both recommendations are discussed in detail in this section of the document.

The government has been heavily involved in promoting non-financial services (e.g., the NDTF/CBSL Credit Plus Approach that provides training and marketing services; the PB grants program to cooperatives for staff training, and the Pubidini Women's Entrepreneurship Development Workshops). Most microfinance NGOs are also providing non-financial services (e.g., BRAC- human rights, health; SEWA education; CARE-livelihood, health, infrastructure). In addition, GTZ is planning to get involved in this area for the next five years. Therefore it is recommended that future assistance should focus only on the provision of financial services, while leaving government agencies, relief organizations and specialized NGOs to continue assisting in non-financial areas. It should be noted that non financial services tend to increase the transaction costs for the client.

1. Institutional Capacity Building – MFIs and other financial institutions

In order to maximize efficiency and effectiveness, donor agencies should coordinate implementation of this intervention. In addition, to make potential interventions sustainable, it should be implemented through a partner institution that could become, in the short run, the provider of technical assistance and training services to MFIs. There are a few MFI training initiatives that have built capacity over the last few years and need to be leveraged to add further value.

The ADB funded Rural Finance Sector Development Project (RFSDP) implemented through the Ministry of Finance during 2006/2007 also identified the lack of capacity building of the MFIs as a major issue. The Center for Banking Studies (CBS) of the CBSL was entrusted with the Capacity Building component of the Project. CBS conducted nine Training of Trainer (TOT) programs of different Microfinance training modules (four modules) developed by the Consultative Group to Assist the Poor (CGAP)[13]. Approximately 100 trainers participated. Potential trainers were selected from those who underwent the initial TOT program. Those selected had to conduct two retail training programs under the supervision of the accredited CGAP trainer after which 52 were qualified to do further training of those modules. CGAP training modules conforms to international best practices and can be utilized to support the capacity building program. CGAP Micro Finance training modules have been translated into over 40 languages worldwide. In addition to the above mentioned TOT program, CBS also conducted 29 retail training programs of those modules and trained approximately 850 trainees under that project. Of the seven CGAP modules available, the CBS conducted only four modules. Modules that were covered included: Delinquency Management and Interest rate setting (DQIR); Accounting for MFIs; Financial Analysis; and Operational Risk Management (ORM).

[13] Visit www cgap.org for more information.

Once the ADB funded RFSDP was terminated, the GTZ in collaboration with Development Facilitators, a private sector Microfinance Service Organization conducted two training of trainer programs on Accounting and Financial Analysis in the Tamil medium, and also translated two modules to the Tamil medium. Therefore, at present there are four capable trainers each to conduct the training on DQIR, and Accounting and Financial Analysis in the Tamil medium. CGAP also has modules on Product Development and Business Planning. Neither the CBS nor the Development Facilitators have conducted TOT programs on these two modules. The ORM module also does not have an adequate number of trainers.

Capacity building efforts, notwithstanding, must focus on a small group of MFIs (five to ten depending on the funding available) with actual or potential capacity to grow and with financial capacity to expand their services. Potential candidates would include commercial banks and other regulated institutions. A set of local trainers can be trained as a part of building capacity in the selected group. In this regard, development of local capacity to provide quality training would be an integral part of the intervention. The capacity of local trainers should be evaluated if additional capacity is needed support a train the trainers program. Coordination among donor agencies is important to ensure a concerted effort and cost-effectiveness. In addition, working in partnership with an institution to which technical assistance and training capabilities would be transferred, ensures sustainability and permanency in the long run.

Capacity building should be coordinated with relevant stakeholder institutions in preparing a Work Plan. Program implementation would include rollout of the MFI, design of training modules and manuals, and the transferring of know-how to the local trainers and managers. The work plan should outline the procedure to transfer the program to the local implementing partner. This form of assistance could potentially increase outreach of participating MFIs.

Capacity building training packages can be tailored to the needs of individual institutions as identified during the preparation of the work plans. Topics to be covered can include, financial management and analysis, standardized accounting, portfolio management, productivity Management, controlling Loan delinquency, microfinance Best Practices, product diversification, expansion strategies and techniques, mobile/electronic banking as service expansion strategies (eZ Pay Dialog), non-banking correspondents as a service expansion strategy, rural and agricultural lending, risk management, audit and internal controls, zoning distribution, credit information (from credit bureaus) as a risk management tool, time management, loan promotion and marketing, loan analysis and utilization and analysis of credit information from credit bureaus.

2. Institutional Capacity Building – MFIs Accessing CRIB Facilities

In view of the possibility of a new Microfinance Act, two areas of technical assistance become particularly important: promoting the implementation of standardized accounting and the use of credit information from the credit bureau. There is a widespread interest of MFIs of all sizes to have a set of regulations to govern their operations. Yet, there is also a lack of sound and transparent accounting practices throughout the sector. Regulation

should be able to count on standardized accounting for all non-regulated MFIs. A standardized chart of accounts increases transparency; and allows the CBSL, donors, investors and any interested parties to measure performance by unified, internationally acceptable, accounting and financial standards. In order to facilitate this "transformation" into a regulated entity, the adopted chart must resemble and comply with the CBSL accepted chart for regulated financial institutions. This strategy was successfully followed by MFIs in Bolivia and Peru, to convince their central banks that the financial performance of the MFIs could be as good as that of regulated institutions. Today these countries have the best microfinance regulatory frameworks in the world.

The CRIB of Sri Lanka has been operational for many years. Although initially focused on regulated financial institutions, over the past few years the Bureau has increasingly opened access to non-regulated institutions and even commercial sector organizations (e.g., telecommunication companies, department stores, utility companies). Only NDTF has joined the Bureau ever since. Prevalent misconceptions on the use of information have long prevented non-regulated MFIs from joining the CRIB. By in large, MFIs believe that providing client information to the bureau and allowing access to competitors makes the institution vulnerable to client stealing. Efforts need to be devoted to institutional capacity building and to promoting the use and provision of credit information as part of the decision making process on loan applications.

Credit information is crucial to the development of the microfinance sector. The large number of MFIs; government, non-government, regulated, non-regulated, national, and international, have increased competition to levels that, in absence of credit information, can result in excessive client debt and high PAR rates. But, sound accounting procedures and useful credit information could potentially lead to decreases in PAR_{30} rates of MFIs. This is particularly true in urban areas. It is important that donor organizations encourage MFIs to apply for membership at the Credit Information Bureau of Sri Lanka, while negotiating with CRIB of Sri Lanka to include additional credit information related to MFIs.

3. Regulation and Supervision

A recommended area of intervention is regulation and supervision of microfinance activities. The Government's renewed interest in the subject and its request to CBSL for a new Microfinance Act is an opportunity for donor organizations to assist in creating a major impact in the provision of microfinance services, specifically in providing technical assistance to the Central Bank in the drafting of a prudentially and financially sound Microfinance Act.

The assisting organization could provide an expert in microfinance supervision and regulation and CBSL would appoint a team of high ranking officials to participate in the drafting of the Act. In addition, this Team should include representatives from the Ministry of Finance, the AMFISL and donor agencies (in particular ADB, IFC and GTZ).

Discussions on the new Act must include proposals for needed regulations on electronic accounts and cell phone banking. They should also include the needed improvements in

the credit bureau management and services. Organizing a CBSL visit to countries with sound microfinance regulatory frameworks is highly recommended.

A summary of the main recommendations is shown below:

- Regulations on electronic accounts and cell phone banking - work with eZ Pay Dialog and other service providers to incorporate in the new Act, the necessary regulatory changes that would allow the expansion of mobile electronic banking and eZ Pay type of services, and assist Dialog in obtaining permission from CBSL to open EZ accounts electronically on behalf of the commercial banks;
- Lobby to reduce/simplify requirements on loan documentation, analysis and guarantees and justify that the loan provisioning system is adequate in terms of the risks associated with small loans;
- Work with the Credit Information Bureau to facilitate the necessary changes to the regulation, for improving access to credit bureau information services for regulated and non-regulated microfinance providers and for participation of MFIs to credit information services;
- Lobby to deregulate interest rate ceilings and to reduce/simplify KYC and anti money laundering requirements for micro saving accounts; and
- Facilitate the introduction of new bank examination procedures for micro lending.

4. Diaspora Bonds

In the absence of significant problems with depth of outreach and/or funding, bond issuance will not necessarily solve the outstanding issues with MFIs in regard to outreach of underserved populations. Nonetheless, bond issuance can still play a role in long-term financing of medium and large enterprises particularly those in rural areas. Currently the financing available is oriented to short-term working-capital loans. Medium-term lending (three to five years) is provided by government banks only to already existing enterprises that have a high rate of return. Financing for long-term investment is not easily available. A mismatch in deposit mobilization and lending terms makes the situation worse. Since most deposits are short-term in nature (savings accounts) banks are unable to offer long or even medium-term loans unless the funding comes from external sources with similar long-term conditions. If intended for long-term investment financing, then, bond issuance would require Diaspora investors willing to keep their money invested for several years. The number of Diaspora investors attracted to such a scheme might become substantially smaller, even when provided a 50% DCA guarantee.

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