CASE STUDY ON PROFITABILITY OF MICROFINANCE IN COMMERCIAL BANKS

HATTON NATIONAL BANK

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DAI
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TABLE OF CONTENTS

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EXECUTIVE SUMMARY

OBJECTIVE

While an increasing number of specialized microfinance institutions (MFIs) have shown that microfinance can be profitable (usually following years of subsidies for start-up and innovation) and an increasing number of banks have entered the microfinance market, literature and data on the profitability of microfinance in commercial banks are essentially nonexistent. This is due to the limited number of banks that offer microfinance on a commercial basis, the difficulty of obtaining proprietary information on banking operations, and difficulties in accurately costing and measuring the profitability of a specific product within multiservice finance intermediaries. However, if microfinance is to continue to expand and attract private, commercial investors, including banks, the profitability case must be explicitly demonstrated in a variety of institutions and environments.

The objective of this case study is to measure the profitability of a microfinance unit related to a private commercial bank, regardless of the business model chosen. Hatton National Bank (HNB) in Sri Lanka was selected as the subject of this case study because, as an Asian commercial bank with microcredit operating as an integrated product line, it provides an organizational and geographic contrast to CREDIFE,[1] the subject of the companion case study on profitability written under this project.

BACKGROUND

HNB has offered a microcredit product for 15 years, although profitability has not been the driving force. Until recently, HNB has defined the success of its microfinance program not in terms of profitability, but in terms of a long-term commitment to economic and social development.

Since its inception close to 100 years ago, Hatton National Bank has prided itself on providing banking services that further economic development in Sri Lanka, evident in its corporate logo, “HNB: Your Partner in Progress.” In 1989, HNB launched its microloan program, called Gami Pubuduwa (GP), or Village Awakening, with the aim of alleviating poverty among the rural community. However, bank management has come to recognize the business and profit potential of microfinance and has begun to take steps to measure profitability and scale up microfinance operations.

This case demonstrates that the focus on social responsibility and community development can only be sustained with a strong commitment from senior bank management and only for so long. Eventually, profitability becomes an issue if resources are going to be made available for the microfinance program to expand to achieve enough outreach and volume to make its contribution to the bank’s profitability significant.

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[1] Credife in Ecuador is a microfinance service company associated with Banco del Pichincha, which is the majority shareholder.

MICROFINANCE OPERATIONS AND RESULTS

The GP program is fully integrated into HNB's operations as an additional product offered by the bank. The GP program is part of the Development Banking Unit, which also handles rural credit and reports to the Personal Banking Division. The 72 GP field officers are located in branch-based and more rural village-based units that depend on the branches operationally. They report directly to the branch managers, who also approve the majority of the GP loans.

As of June 30, 2004, GP had almost 11,000 outstanding borrowers, of whom approximately 80 percent were men, with a portfolio of 743 million Sri Lankan Rupees (SLR), or approximately US$7.4 million. In addition, GP field officers are responsible for cross-selling other bank products in villages. Savings mobilization is one of their primary responsibilities, and on June 30, 2004, over SLR 900 million (US$8.8 million) in outstanding savings deposits were attributed to the GP field officers. GP field officers also provide villagers with information on other loan products provided by HNB, such as housing loans and pawn loans. In addition to providing banking services to rural microentrepreneurs, GP has a focus on skills development, training, and community organization. HNB's microfinance program has grown 26 percent over the past 18 months in terms of clients served and 35 percent in terms of loan portfolio. The emphasis has been on controlled growth, establishing client loyalty to HNB, and increased efforts to recover past due loans and create a high-quality portfolio. HNB management's recent decision to improve collections processes and set larger portfolio targets for the GP field officers was made with an eye toward profitability.

PROFITABILITY

As the largest private commercial bank in Sri Lanka, with a return of 15 percent on average shareholders' fund in 2003, HNB has been able, until recently, to ignore analyzing the profitability of its microcredit operations, which represented only 0.55 percent of the bank's assets and 0.93 percent of the bank's portfolio as of June 30, 2004. HNB only began to estimate the profitability of the GP program in 2003 when the Deputy General Manager of Personal Banking became responsible for the program. Estimates still are not exact, however, because the bank's management information system (MIS) cannot calculate profitability by product, except for credit cards and leasing, which have a separate MIS. The bank's initial manual profitability estimates calculated for GP have not included any head office expenses or imputed any costs other than the cost of funds and the direct costs of the GP field officers.

Working with HNB's Development Banking Unit, with input from other bank departments, the researchers were able to construct a more complete income statement for the GP product. Calculations showed that the GP program had a net profit of SLR 1.0 million (US$9,761) for the period ending June 30, 2004, on an annualized basis, and a net profit in 2003 of SLR 6.8 million (US$66,374). Additional profits from savings mobilization, cross-selling other bank products and services, and graduating GP clients to other areas of HNB are not quantifiable at this time.

Despite efficient microlending operations, the bank's microfinance operations are barely profitable because of the relatively low interest rates it charges. Operating efficiency ratios of 5.5 and 5.2 percent in 2003 and 2004, respectively, are impressive compared with traditional microfinance institutions. However, the interest rates of 9 to 14 percent per annum on GP loans, compared with the 20 percent other MFIs in Sri Lanka charge, resulted in net financial margins of only 6.7 percent in 2003, which dropped to 5.3 percent in 2004, barely sufficient to cover operating expenses. The return on portfolio and profit margins for the GP program are lower compared with the same ratios for HNB as a whole.

CHALLENGES

Now that HNB has accepted the initial upfront costs of the GP program, the next test is long-term sustainability, implying not only cost recovery but also profitability. In the last year, GP was repositioned within the bank into the Personal Banking Division and was assigned a new Deputy General Manager; Gami Pubuduwa is now poised to expand. Once the bank's MIS can segregate and properly allocate costs and the complete contribution of GP clients (including savings and graduation to other product lines), and profitability of the GP program can be proven and sustained, management projects that resources will become available to expand the program's outreach. For GP to sustain significant returns, the net interest margin must improve. HNB's primary challenge is to create a pricing strategy for its GP loans that is consistent with its profitability targets, while remaining competitive. At the same time, steps to focus and increase staff productivity related to the GP product would contribute to growth and profitability of this product line and client segment.

1 INTRODUCTION

As more and more commercial banks become intrigued by the idea of entering the microfinance market, the lessons learned from some of the more experienced players become useful in the decision-making process. Even if a bank enters the microfinance market for socially responsible reasons, the long-term viability of the microfinance program is eventually defined by its contribution to the bank's profitability. Determining cost and revenue drivers is key to ensuring that resources are available and properly allocated; costs, both actual and imputed, are fairly assigned; and pricing strategies accurately reflect profitability goals. Once the bank is convinced that the net operating margin of microfinance products can be high relative to other products in the bank, the challenge becomes growing the volume so that the absolute net income is also significant.[2]

The objective of this case study is to measure the profitability of a microfinance unit, regardless of the business model chosen (see Box 1). As with any profitability analysis, understanding the costing methodology used is important. While not the focus of the case study, the details of the methodology used are described in the text. Of the two primary options for product costing, allocation-based and activity-based, the former served as the foundation for this analysis because of its relative simplicity.[3]

Many challenges exist in any cost allocation exercise, such as which costs should be allocated (only marginal costs, or indirect costs, too?) and how to allocate costs (based on number of loans, size of portfolio, staff time?). As commercial banks develop more sophisticated management information systems (MISs) and understand the importance of measuring product profitability, an in-depth analysis using activity-based costing becomes appropriate. If the bank's institutional vision is that microfinance must contribute to the bank's net income just like any other product line, then a costing exercise becomes a priority. Ironically, the necessity to prove that microfinance is a profitable business sometimes provides the impetus for the bank to measure the profitability of all of its products.

Hatton National Bank (HNB) in Sri Lanka was chosen as the subject of this case study because, as an Asian commercial bank with microcredit operating as an integrated product line, it provides an organizational and geographic contrast to CREDIFE,[4] the subject of the other case study on profitability written under this project. Hatton has offered a microcredit product for 15 years, although profitability has not been the driving force. Instead, the Managing Director, now also

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[2] For a more detailed discussion of the drivers of bank entrance into microfinance and factors for success, refer to Robin Young and Deborah Drake, *A Primer for Banks Entering the Microfinance Market*, an AMAP/FSKG publication, available at www.microlinks.org.

[3] For a description and discussion of these models, refer to Monica Brand and Julie Gerschick, *Maximizing Efficiency: The Path to Enhanced Outreach and Sustainability,* ACCION Monograph Series No. 12, Washington, DC, September 2000; and the CGAP Product Costing Web site at www.cgap.org/productcosting.

[4] Credife in Ecuador is a microfinance service company associated with Banco del Pichincha, which is the majority shareholder.

Box 1: Models of Commercial Bank Entry into Retail Microfinance[5]

Internal Unit

- Operates within the existing bank structure as a division or new product
- Loans and other operations are on the bank's books

Examples: Bank Rakyat Indonesia (BRI), Banco do Nordeste (Brazil), Banco Salvadoreño and Banco Agrícola (El Salvador), and Hatton National Bank (Sri Lanka)

Financial Subsidiary

- May be wholly owned or a joint venture with other investors
- Conducts loan origination, credit administration, and all aspects of financial transactions
- Loans and other operations are on the books of a financial subsidiary
- Licensed and regulated by the banking authorities
- Separate staffing structure, management, and governance from the bank

Examples: Bangente, owned 50% by Banco del Caribe (Venezuela); Micro Credit National S.A., owned by Unibank (Haiti)

Service Company

- Nonfinancial company that provides loan origination and credit administration services to a bank
- Promotes, evaluates, approves, tracks, and collects loans
- Service company employs the loan officers and the bank provides the support services (human resources, IT) for a fee
- Bank funds and disburses loans and repayments are made directly to the bank; loans remain on the bank's books and are regulated and supervised according to banking laws
- Company is not regulated or supervised by banking authorities; there is no separate banking license
- Negotiates detailed agreements with the parent bank that assign cost, risk, responsibility, and return to each party

Examples: Credife, established by Banco de Pichincha (Ecuador), and Sogesol, created by Sogebank (Haiti)

Strategic Alliance

- Can take many forms; some of the most common are banks financing portfolios of specialized microfinance institutions and providing operational support in terms of disbursements and collections through bank branches
- Negotiates detailed agreements with the parent bank that assign cost, risk, responsibility, and return to each party

Example: ICICI Bank (India)

Chairman of the Board, insisted that Hatton take responsibility for bringing banking services to the rural communities, where 70 percent of Sri Lanka's population lives. Until now, HNB has defined the success of its microfinance program, known as Gami Pubuduwa (GP), not in terms of profitability, but in terms of a long-term commitment to economic and social development. Because HNB is the largest private commercial bank in Sri Lanka and is profitable—with return on average shareholders' funds over 15 percent in 2003—it has been able, until recently, to ignore analyzing the profitability of its microcredit operations, which represent only 0.55 percent of the bank's assets.

Because they mobilize savings, cross-sell other bank products, assist in branch operations, and graduate microcredit clients to small and medium-sized enterprise (SME) products, HNB had considered its microcredit field officers—and clients—to be very valuable assets to the bank,

[5] Based on ACCION InSight No. 6, "The Service Company Model: A New Strategy for Commercial Banks in Microfinance," September 2003; and Young and Drake, *A Primer for Banks Entering the Microfinance Market*.

regardless of their cost or potential to generate a profit in the short term. Management analyzed the profitability of the GP program for the first time in 2003, and is now interested in calculating the profitability more precisely as it looks to microcredit to make a significant contribution to the bank's bottom line going forward. The bank was particularly interested in participating in this study because it expected that the results would serve as a guide for HNB managers as they think about measuring GP profitability in the future.

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2 CONTEXT

2.1 THE ECONOMY

Sri Lanka is an island nation located just south of India. With a population of approximately 19 million, Sri Lanka had an estimated gross domestic product (GDP) per capita in 2003 of US$937. Over 70 percent of the Sri Lankan population lives in rural areas and 22.7 percent of the population lives below the official poverty line.[6] These individuals do not always have access to banking services. There has been strong GDP growth over the past few years (estimated at 7.5 percent in 2003)[7] as the country recovers from the armed conflict suffered between 1983 and 2002.

2.2 REGULATORY ENVIRONMENT

Currently, specific microfinance regulations do not exist in Sri Lanka. As a result, microfinance is being practiced by a wide variety of institutions, from nongovernmental organizations (NGOs) to cooperatives to private commercial banks to state-run banks. Only the banks are subject to any sort of prudential regulations for minimum capital requirements, capital adequacy, liquidity, reserves, or loan loss provisioning. These regulations include:

- Minimum capital: SLR 500 million (US$4.9 million)
- Capital adequacy ratio: 10 percent of risk-weighted assets
- Liquidity: 20 percent of deposit liabilities
- Loan loss provisioning: 20 percent for substandard loans, 50 percent for doubtful loans, and 100 percent for loss loans.

There are no formal interest rate ceilings. Recently, the government has begun to develop and discuss potential regulations for microfinance institutions (MFIs). The Central Bank has developed an outline of such regulations, which has formally passed to the Ministry of Finance for comment and approval;

however, the Ministry of Finance has stated its view that because the role of establishing regulations and supervising financial institutions lies with the Central Bank, it is not necessary for either the Ministry of Finance or Parliament to participate in the process.

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[6] The Department of Census and Statistics has defined the Official Poverty Line as at the per capita expenditure for a person to be able to meet the nutritional anchor of 2,030 kilocalories, or SLR 1,423 per person per month. Source: Announcement of the Official Poverty Line, Department of Census and Statistics, Sri Lanka, June 2004.

[7] Figures from HNB 2003 Annual Report.

2.3 GOVERNMENT INVOLVEMENT

Two state-owned commercial banks in Sri Lanka, Bank of Ceylon and People's Bank, have full-fledged microfinance programs and have provided credit to the rural poor for decades through various agricultural credit schemes. In the early 1980s, the government formally began to provide microfinance through the Janasaviya program, a second-tier lending program that on-lent funds to NGOs and other organizations at subsidized rates of interest. Although this program terminated in the early 1990s, it did play an important role in the creation of the microfinance market in Sri Lanka. Today, microfinance programs sponsored by the state include the Samurdhi program, which has achieved significant outreach throughout the country, and cooperative rural banks.

Government involvement has set the tone for microfinance in Sri Lanka—pressuring banks to reduce interest rates on loans provided to microentrepreneurs, even when subsidized funds are not available. As a result, HNB is offering its microfinance loans at rates much lower than its NGO competitors', offering the microfinance loans at "market rates"—rates similar to those offered on SME, mortgage, or other loans that often have subsidized funding available and are quite distinct from microfinance loans.

At the same time, government interest in poverty alleviation also has led to widespread debt forgiveness (especially at times of elections), which threatens to damage the microcredit market in Sri Lanka because many microfinance clients are unable to differentiate between government-funded loans, which most likely will not need to be repaid, and loans provided by other institutions, which will need to be repaid if microfinance is to be sustainable in Sri Lanka.

2.4 THE MICROFINANCE MARKET

According to a Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) study conducted in early 2004, the formal microfinance sector in Sri Lanka is composed of commercial banks—mainly People's Bank and Hatton National Bank—the National Savings Bank, regional development banks, and SANASA Development Bank, which together have almost 900 branches. The semi-formal MFIs are the more than 300 cooperative rural banks with 1,196 outlets; approximately 8,500 thrift and credit cooperative societies; 970 Samurdhi banking societies; approximately 200 local or international NGOs; numerous government rural credit programs; pawnshops; and more than 4,000 post offices that collect savings. Informal or noninstitutional service suppliers are also numerous and include savings associations, rotating savings and credit associations, funeral or death-benefit societies, traders, moneylenders, suppliers, friends, and relatives.[8]

According to the GTZ study, these players were servicing approximately 1.65 million borrowers at year-end 2000. In research conducted for the current study, market saturation in the areas targeted by the GP program was not evident in discussions with HNB staff and in field visits to the more remote areas served by HNB. Interviews the researchers conducted with microentrepreneurs and GP field officers indicated a lack of real competition in the areas served by GP. In fact, the market being served could be much further expanded.

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[8] This information was provided as background in Martina Wiedmaier-Pfister and Ellis Wohlner, *Microinsurance Study of Sri Lanka: Microinsurance Sector Study, Sri Lanka*, Responsible: Dr. Dirk Steinwand, GTZ GmbH, Division 41 Financial Systems Development, Eschborn, Germany, 2004.

However, given this context of extensive microcredit supply in Sri Lanka, GP is still quite a small-scale, niche program, serving a borrower base of approximately 11,000 clients as of June 30, 2004, with a portfolio of SLR 743 million (US$7.3 million). The largest private MFI in Sri Lanka is Sarvodaya Economic Development Services Ltd (SEEDS), which serves a different niche (of smaller-scale microentrepreneurs) than GP. Its primary clientele is the membership of the Sarvodaya Shramadana Societies, community-level societies formed out of the Sarvodaya Movement that evolved in the late 1950s to take on the responsibility for the well-being of the communities. These societies provide the conduit for SEEDS activities.[9] On June 30, 2004, SEEDS had an active borrower base of 160,000, with a portfolio of SLR 1,800 million (US$17.6 million).[10]

The Government of Sri Lanka and international development agencies have provided a great deal of funding for bank and NGO poverty alleviation programs in the country. HNB has accessed such funding (known as refinancing schemes) for its rural credit and other development banking projects; however, as of mid-2004, the GP loans were 98 percent financed by the bank's internal funds (customer deposits).[11]

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[9] Saliya J. Ranasinghe, "The Case of Sarvodaya Economic Enterprise Development Services (Guarantee) Limited – SEEDS," Paper presented at TA 5952: Commercialization of Microfinance, Sri Lanka Country Workshop, October 24–26, 2001, Lighthouse Hotel, Galle, Sri Lanka.

[10] Information obtained from SEEDS management.

[11] GP management is currently in talks with the Central Bank to access some refinancing funds provided by the Japanese development agency for lending in the north and east regions of the country, which were the most affected by the internal conflict that ended in 2002.

3 THE MODEL

Hatton National Bank has opted to integrate microfinance into its traditional banking operations rather than establish a separate subsidiary or new company to conduct the microfinance activities. As explained below, microfinance does not even exist as a separate division within HNB; rather, the GP product falls within the Development Banking Unit and is fully integrated into branch operations.

3.1 ORGANIZATION ORIGIN AND LAUNCHING OF THE MICROFINANCE PROGRAM

HNB was established more than 100 years ago, with an orientation to servicing the financial needs of the plantation industry of tea cultivation and related activities. Its historical exposure to rural finance through banking services to small farmers, dairy operators, fisheries developers, and agricultural-product processors complemented its participation in government-promoted small- and medium-scale industry financing schemes.[12] HNB was one of the first private commercial banks to employ agricultural experts as banking officers in the 1980s, which gave it an early competitive advantage.

When the Sri Lankan government formally began to encourage microfinance through the Janasaviya program in the 1980s, HNB stakeholders found a number of the program's restrictions unappealing and did not participate. However, this first government push toward microfinance played a significant role in HNB's decision to develop its own microfinance program later in the decade. Additionally, youth uprisings throughout the country in 1989 added to the bank's motivation to provide alternative activities for disenfranchised youth in the rural villages.

Since its inception, HNB has prided itself on providing banking services that further economic development in Sri Lanka, evident in its corporate logo, "HNB: Your Partner in Progress." This attitude is apparent at all levels of the bank, from the Chairman of the Board to the microfinance field officers. Branch managers explain that their goal is to help bring banking to all the people of the country and to help improve living standards, especially in rural areas.

There is a great commitment to the GP product within the bank, starting from the top. The current Managing Director and Chairman of the Board, Mr. Rienze Wijetilleke, is the champion of the program within the bank. When GP was first established in 1989, it was Mr. Wijetilleke who determined how the program would operate, and he has convinced others of the importance of GP in fulfilling the bank's social responsibility. Despite the high-level commitment, a number of senior-level managers within the bank—specifically, financial-oriented staff members who tend to focus on the bottom line—were not convinced initially of the value of the GP program, especially because it was presumed to be losing money. Over the years, Mr. Wijetilleke and the performance of the GP program itself have convinced senior managers, including the Chief Financial Officer, that the program is a factor in both the development of more remote regions of the country and the transformation of these individuals into "bankable" customers, thus contributing to the long-term profitability of the bank.

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[12] Joselito S. Gallardo, Bikki K. Randhawa, and Orlando J. Sacay, *A Commercial Bank's Microfinance Program: The Case of Hatton National Bank in Sri Lanka*, World Bank Discussion Paper No. 369, The World Bank, Washington, D.C., 1997.

According to bank management, the GP program was formulated to provide banking services and social development to the rural poor. In addition to providing loans to rural microentrepreneurs and mobilizing deposits, GP focuses on skills development, training, and community organization. The basic function of GP loan officers, known as GP field officers, is seen as understanding "the needs of the villagers and providing them with the necessary advice to achieve their aspirations."[13] GP field officers work closely with village leaders and potential clients to identify opportunities for start-up businesses and business expansion.

GP field officers also cross-sell other bank products. Savings mobilization in the villages is one of their primary responsibilities, and on June 30, 2004, over SLR 900 million (approximately US$9 million[14]) in outstanding savings deposits were attributed to the GP field officers.[15] In addition, GP field officers provide villagers with information on other loan products provided by HNB, such as housing loans and pawn loans.[16]

3.2 PRODUCT RANGE

In addition to the full range of HNB's commercial banking services, the GP program offers one microloan product. The GP loan is an individual loan product, although at times loans are provided to community groups working in the same industry, such as fishing women, and the group members cross-guarantee each other's individual loans. The loans range from SLR 25,000 to SLR 750,000 (US$244 to US$7,320); however, in special instances, loans over SLR 750,000 to qualified long-term clients have been approved. In general, the principle of GP within HNB is one of graduation—clients are expected to become "bankable" after a time with the GP program. The bank anticipates that

clients, or microenterprises, will expand to have needs beyond those covered by the loans provided by the GP program. They will then be passed to the Project Finance Division in the bank, which handles SME loans.

Each GP client is required to open and maintain a savings account (with a nominal minimum balance). Although HNB does not track the above-mentioned cross-selling, bank staff and management believe that a fair number of clients access a variety of credit products and actively use savings accounts and other savings products.

GP loans may be for working capital or the purchase of fixed assets related to the client's business. The GP program accepts two guarantors as sufficient security on loans up to SLR 100,000 (US$976). Over that amount, the range of securities accepted includes mortgage guarantees and movable assets.

HNB is reviewing the possibility of introducing two additional microfinance products to attract new market segments. The first product would involve remittances. Studies have shown that on average, 10 percent of Sri Lanka's population lives overseas for two to three years as migrant workers. Although the workers send money home to support their families, HNB believes that if these people

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[13] Information provided by HNB's Development Banking Unit staff.

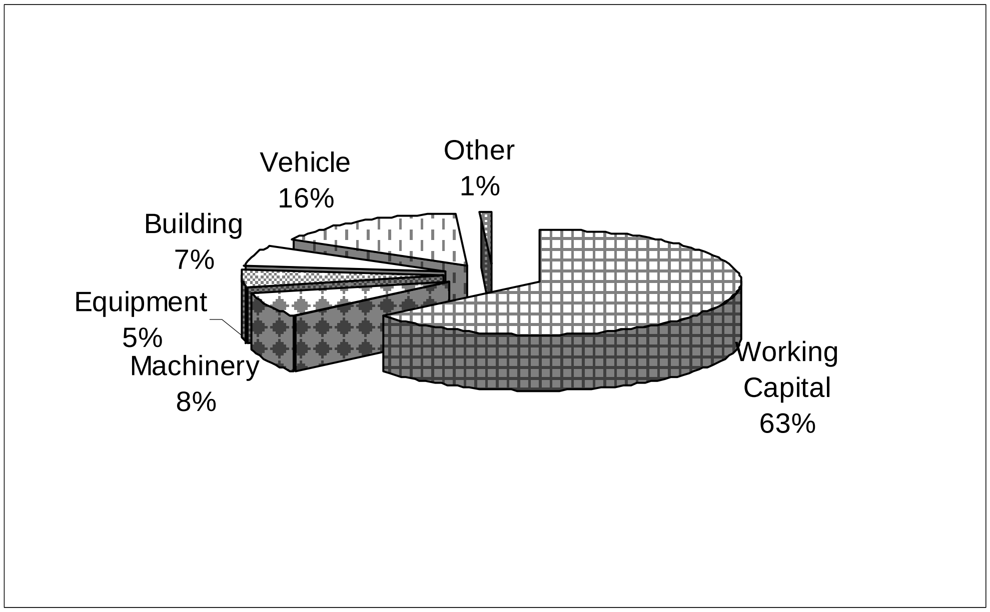
[14] The SLR/USD exchange rate at June 30, 2004, was approximately 100/1.

[15] Savings mobilized by GP field officers do not necessarily correspond to GP loan clients.

[16] Worldwide, overlap often exists between microloan products and pawn loan products; low-income clients are "targets" for both. Interestingly, in a visit to a GP village unit, the only posted advertisement within the unit was for HNB's pawn loan product.

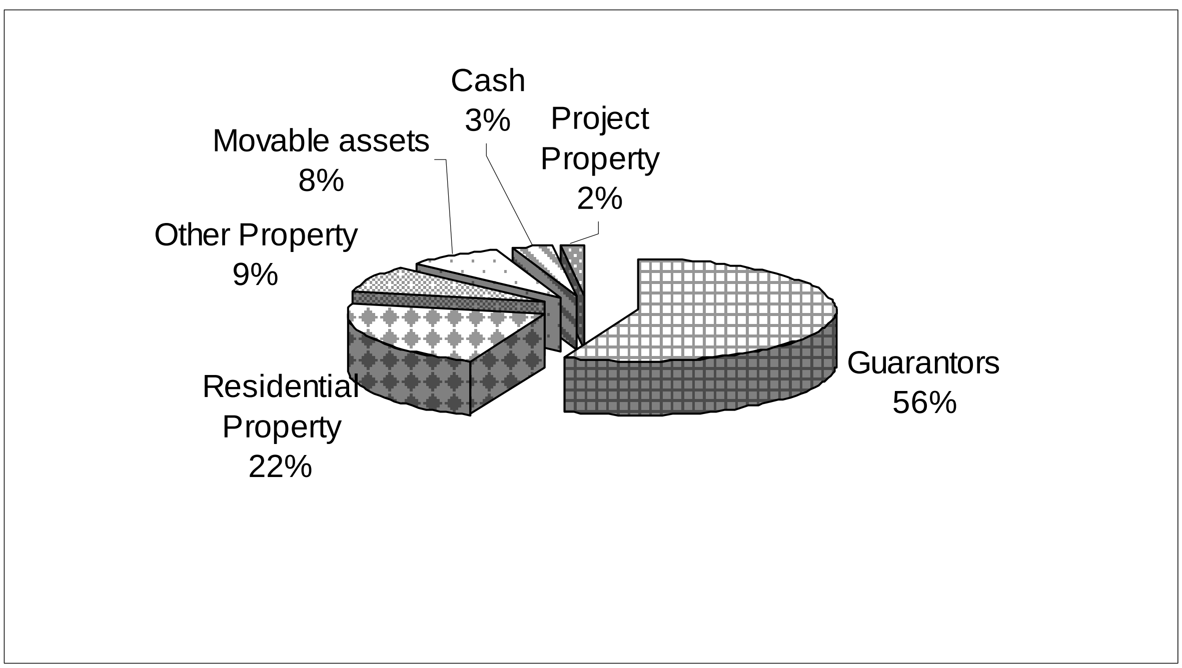
saved some capital and started microenterprises when they returned, the bank could supplement their savings with microloans. The other segment that HNB wants to target for microloans is retirees, who, at age 55, may want to stay active and start a microenterprise.

FIGURE 3.1: LOAN PORTFOLIO BY UTILIZATION OF LOAN PROCEEDS



Source: "Village Awakening," HNB Review Report 2003

FIGURE 3.2: NUMBER OF LOANS BY TYPE OF GUARANTEE



Source: "Village Awakening," HNB Review Report 2003

3.3 OWNERSHIP

At year-end 2003, the bank had 17,122 shareholders—4,778 with voting shares and the remainder (12,344) with nonvoting shares. The largest shareholder was Standard Finance Limited, with 15.69 percent ownership. The 10 largest shareholders own over 50 percent of the total shares and 70 percent of the voting shares.

3.4 OPERATIONS

As previously mentioned, the GP program is fully integrated into HNB's operations as an additional product line offered by the bank. The GP program is part of the Development Banking Unit, which is under the Personal Banking Division. (Prior to 2002, GP was part of the Project Finance Unit, which now reports to the Corporate Banking Division.) HNB operates through a network of 108 branches throughout the country, plus 38 customer centers and 6 mobile banking units. Eighty-four of the 108 branches have a GP portfolio.

Development Banking staff members are responsible for the GP loan product as well as rural credit loan products; HNB considers rural credit and microfinance to be separate business segments. Even though many rural credit borrowers have similar characteristics to the GP clients, the credit methodology differs. More subsidized funding is available for rural credits, so the average interest rate is lower than for GP loans. Also, many rural credit products are offered depending on the funding schemes available. Further, the maximum rural credit is US$300,000, while the maximum GP loan is only US$7,500. For these reasons, rural credits are not included as microfinance loans in this case study.

It is estimated that head office staff members actually spend more time on the rural credit products, which, as illustrated in Table 3.1, represent approximately two-thirds of the loan portfolio managed by the unit. The head office staff only get involved in the actual loan analysis process when approving larger loans; the majority of its time is spent fulfilling reporting requirements for funders of the rural credit products, which are heavily reliant on subsidized funding schemes.

TABLE 3.1: TOTAL PORTFOLIO MANAGED BY DEVELOPMENT BANKING UNIT

June 30, 2004

	SLR MM	% Total
GP	743.4	34%
Rural Credit	1,444.8	66%
Total	2,188.6	100%

Some GP field officers manage more than one unit. The 72 GP field officers are located in 79 branch-based units and 24 village units.[17] (The village units are more remote and depend on the branches operationally.) The field officers report directly to the branch managers, although loan portfolio and client targets are set by the Development Banking Unit. GP field officers are responsible for the entire process, from finding appropriate clients to analyzing the credit and eventually collecting it. They also prepare and send monthly reports to the Development Banking staff, including portfolio activity reports and profitability reports.

Both GP field officers and agricultural officers (AOs) offer GP and rural credit loans. The GP field officers spend 60 percent of their time on GP and rural credit loans combined, according to management estimates. The bank does not track the breakdown of time allotted to GP versus rural credit, but estimates based on the number of loans and portfolio size indicate that 65 percent of the 60 percent, or 40 percent of GP field officers' total time, is spent on GP loans as of June 30, 2004. That leaves 20 percent to rural credit and the remaining 40 percent to other field officer branch business, including significant deposit mobilization, collections on non-Development Banking loans, and other operational details.

TABLE 3.2 DISTRIBUTION OF GP OFFICERS' TIME

GP Lending	Rural Lending	Other Branch Business
40%	20%	40%

As of June 30, 2004, 13 of the bank's 28 AOs in the branches, who are responsible primarily for rural credit products, devote a portion of their time to 1,193 GP clients with a total portfolio of SLR 53.6 million (US$523,182). Thus, the AOs are responsible for 11 percent of all GP clients, and 7 percent of the total GP portfolio.

TABLE 3.3 DISTRIBUTION OF GP CLIENTS AND PORTFOLIO

Between GP and Agricultural Officers

	GP Officers	Agricultural Officers
GP Clients	89%	11%
GP Portfolio	93%	7%

At the village units, villagers receive information about the GP program and other bank services, make loan payments, and deposit funds into savings accounts. Withdrawals from savings accounts,

[17] As of June 30, 2004, GP was active in 84 HNB branches. In addition to the 79 branch-based units, a number of the 24 village units are affiliated with five additional branches that do not have branch-based GP units.

including withdrawals of loan funds, must be done at the branch. Although today there are only 24 village-based units, 14 village units that were initially established for GP have been transformed into full-fledged branch units or customer centers. This exemplifies one of the main strategies of the GP program: to bring banking to the rural villages of Sri Lanka, providing not only microcredit, but financial services in general.

The presence of the GP field officers in the villages, whether they are branch- or village-based, is strong. The village units are located centrally, in modest, sparsely furnished buildings that are often left unlocked when the GP field officers are out so that villagers can wait inside for their return.

4 PERFORMANCE ANALYSIS

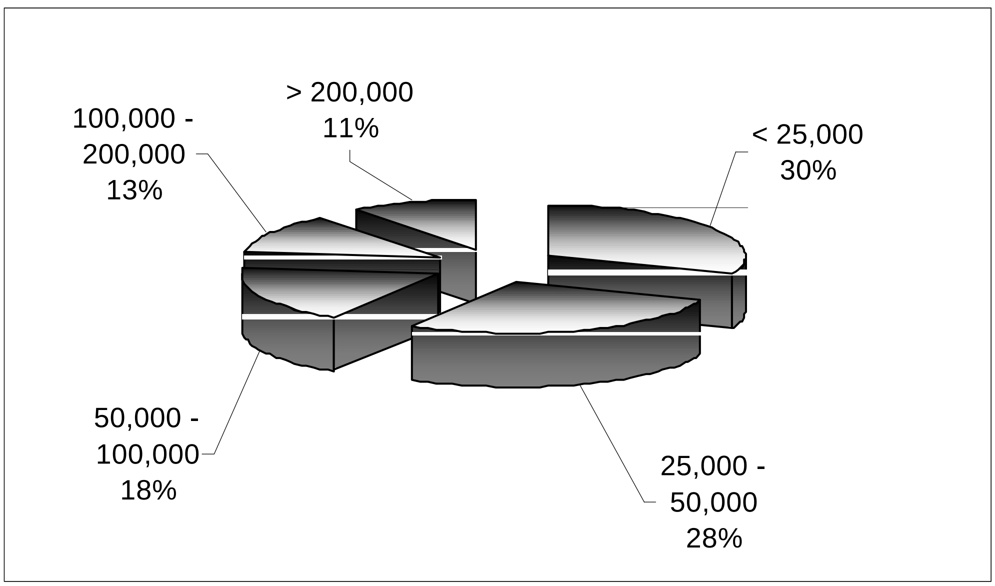
4.1 OUTREACH

As of June 30, 2004, HNB was serving 10,697 clients with its GP loan product. As of December 2003, 80.3 percent of the borrowers were men, 18.5 percent were women, and 1.2 percent were joint and/or under a business name. The outstanding loan portfolio on June 30, 2004, was SLR 743 million (approximately US$7.3 million), for an average outstanding loan balance of SLR 69,494 (US$678). Comparative analyses of microfinance institutions in Sri Lanka have shown this to be a relatively high loan balance, which HNB management has explained to be a result of a number of factors, including:

- A strategy to foster small industry development and employment in rural areas;
- The growth of long-term clients; and
- A strategy to increase profitability.

However, as Figure 4.1 illustrates, close to one-third of GP loans outstanding at December 31, 2003, had been disbursed for amounts less than SLR 25,000 (US$244), and 59 percent of loans had been disbursed for amounts less than SLR 50,000 (US$488).

FIGURE 4.1: CLASSIFICATION ACCORDING TO LOAN SIZE, 12/31/03 (SLR)



Source: "Village Awakening," HNB Review Report 2003

In terms of number of clients served, HNB's microfinance program has grown 26 percent over the past 18 months—from 8,496 on December 31, 2002, to 10,697 on June 30, 2004. HNB had as many as 10,200 clients in 1997, but the number of clients dropped after an electrical power crisis and severe drought in

1998. HNB has recovered this client level, and although the growth has not been explosive, it has been the result of a strategic decision on the part of bank managers involved in the GP program to hand-pick clients and prioritize establishing strong client and community relationships to ensure loyalty to HNB and high portfolio quality. In addition, the last couple of years have seen increased efforts to recover past-due loans.

FIGURE 4.2: CLIENT BASE GROWTH, 12/02 TO 6/04

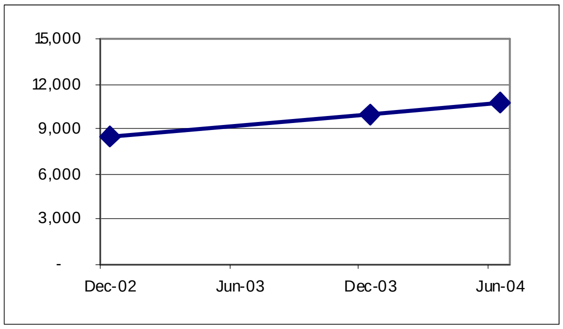
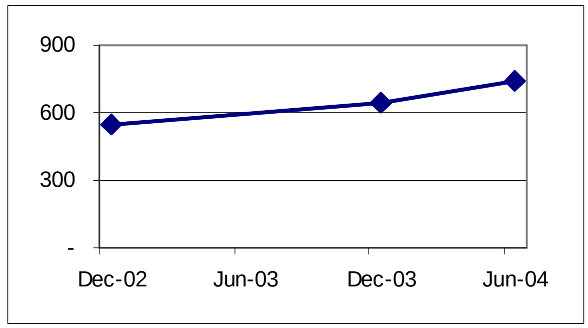


FIGURE 4.3: PORTFOLIO GROWTH (SLR MM), 12/02 TO 6/04



At the same time, the loan portfolio has increased at a slightly faster pace—35 percent between December 31, 2002, and June 30, 2004. This has been a conscious decision on the part of HNB management, who set larger portfolio targets for the GP field officers, with an eye toward profitability. Although a detailed, technical analysis of the product's profitability does not exist, the management team has recognized that the amount of time GP field officers devote to small loans is not resulting in very efficient portfolio management. As a result, the maximum GP loan size has been increased from SLR 500,000 (approximately US$5,000) to SLR 750,000 (approximately US$7,500), and GP field officers are encouraged to disburse larger loans to clients who have the demonstrated need for and capacity to repay larger amounts.

4.2 FINANCIAL PERFORMANCE

4.2.1 EVOLUTION OF A PROFITABILITY CULTURE AT HNB

As explained above, the Managing Director's perspective as to the bank's social responsibility, rather than the potential profitability of the GP program, set the stage for microcredit at HNB. A senior manager of the bank was quoted as admitting, "Numbers are not important" when reviewing the contribution of the GP program. Instead, poverty alleviation, rural entrepreneur development, and rural infrastructure development were the primary factors that led HNB to enter the microfinance market. Because of presumed losses from the GP program during its first several years of operations, some senior managers within HNB questioned the viability of the bank's entrance into microfinance and wanted to get out of this market, but HNB's social commitment prevailed. Now, the Managing Director recognizes that the GP program must be profitable on a long-term basis, given HNB's duty to use its deposits wisely and the importance of the program's long-term viability.

Although the bank obviously reviews the profitability of HNB as a whole, its MIS currently does not calculate profitability by product. (The bank is able to calculate profitability for credit cards and leasing products, which have separate systems.) Though HNB is in the process of implementing a new MIS that will allow product and customer profitability calculations, it now compares its total actual monthly performance to its plan and analyzes the variances accordingly. With the new system in place, Development Banking will be able to analyze the costs of the GP product and use the information to make strategic decisions regarding pricing, efficiency, and expansion.

Because an in-depth analysis of the costs affiliated with the GP product has not existed until now, product pricing has not taken all operating costs into consideration. Instead, the range of rates is set based on "market rates" for other HNB products, and what HNB thinks that microentrepreneurs can pay. Within that range, factors such as subsidized funding and risk play a role. Though the GP rates, which run between 9 and 14 percent per annum, are supposedly "market rates," they are not established according to formal market studies for microcredit loans, and preliminary research indicates that other MFIs in Sri Lanka charge on average 20 percent per annum.

4.2.2 PROFITABILITY OF THE GP PROGRAM

HNB began to estimate the profitability of the GP program in 2003 when the Deputy General Manager of Personal Banking became responsible for the program, but to date, internal profitability estimates have not included any head office expenses or any costs other than the cost of funds and the direct costs of the GP field officers. This method is also used at the branch level to report GP profitability. However, branch managers do have profitability goals, and the microfinance field officers who report to them submit monthly profitability reports to both the branch managers and the Development Banking head office. Therefore, field officers and branch managers have begun to recognize the importance of the program's profitability while maintaining that it is not the driving force for Gami Pubuduwa at HNB.

Working with HNB's Development Banking Unit, with input from the Research and Planning and Accounting departments, the researchers were able to construct an income statement for the GP product. Due to MIS limitations and the necessity to estimate allocations based on staff time, many assumptions are included in the profitability calculations. In order to determine GP's revenues, only interest earned on the portfolio is included. Because of difficulties in gathering specific data on documentation fees and other sources of income such as cross-selling, no revenue from these is included. In terms of expenses, two options for the cost of funds are considered, the provision for loan loss is established using the bank's standard policy, and other expenses are allocated based on an analysis and distribution of staff time and/or portfolio. These include direct expense, such as salary and benefits of GP field officers, as well as other personnel expenses, including salary and benefits of branches and head office staff, and operating expenses from branches and head office. A secondary level of analysis, which is beyond the scope of this paper, would require a more detailed activity-based costing exercise for the bank to determine the exact level of its costs that should be allocated to the GP operations. The following sections walk through the details of the application of the allocation-based costing methodology used.

Key Income Components:

(a) *Interest earned.* The interest earned on GP loans is straightforward, and actual numbers are available from the accounting system. GP interest income represented less than 1.0 percent of HNB's total interest income during both 2004 and 2003, which is not surprising as the portfolio represents only 0.55 percent of the bank's assets and 0.93 percent of its portfolio as of June 2004.

TABLE 4.1: INTEREST EARNED ON GP LOANS (IN SLR MM)

	6/30/04 (annualized)	12/31/03
Interest Income	SLR 90.6	SLR 90.4

(b) *Documentation fees.* Actual amounts of documentation fees received, which are based on the amount of a loan disbursed, are not available in the accounting system. As of June 30, 2004, the fee structure is as follows:

TABLE 4.2: DOCUMENTATION FEE STRUCTURE

GP Loan Size	Documentation Fees
Up to SLR 100,000	SLR 250
SLR 100,001–500,000	SLR 1,000
More than SLR 500,000	SLR 1,500

Because they are not significant and the number of disbursements is not reported in amount ranges—making it difficult to estimate—the fees are not included as income in this analysis.

(c) *Deposit mobilization.* The only other significant income consideration is the treatment of deposits mobilized by GP field officers. This figure is available in the system, because the GP field officers place their code on the accounts that they handle. The challenge in calculating profitability arises because only a portion of these deposits can be attributed to GP clients and that detail cannot be extracted from the current MIS.

As of June 30, 2004, the deposits mobilized by GP officers amounted to SLR 901.4 million (US$8.8 million), compared to a GP loan portfolio of SLR 743.4 million (US$7.3 million). Table 4.3 presents the options that exist for treatment of these deposits. The options represent decreasing costs and/or increasing revenues as one goes from Option 1 to Option 4. The Development Banking Unit advocates using Option 2, which is reasonable and conservative compared with the other options. This is also the option utilized by the researchers for this study. Thus, no revenue is recognized for deposit mobilization. Nor are reserve requirements figured into the calculation.

TABLE 4.3: OPTIONS FOR TREATMENT OF DEPOSIT MOBILIZATION

Options for Treatment of Deposits	Cost of Funding Portfolio	Revenue for Excess Deposits
1. Deposits are not regarded at all	Pool or transfer pricing rate[18]	None
2. Deposits fund entire portfolio	Interest paid on deposits	None
3. Deposits fund entire portfolio and earn revenue	Interest paid on deposits	Pool rate less cost of funds
4. Deposits fund entire portfolio and earn revenue	Interest paid on deposits	Pool rate

d) *Other unquantifiable positive effects on HNB income*. Cross-selling other products and graduating clients to SME products are touted as benefits that the GP program delivers to the bank. Perhaps the new MIS will help to quantify the additional income for which the GP program can claim responsibility, but since they are not tracked in the current system, GP cannot receive credit in shadow accounts.

In summary, the only revenue allocated to the GP program is the interest on the GP portfolio.

Key expense components:

(a) Cost of funds. The decision regarding cost of funds is whether to use the pool rate or the average interest rate paid for deposits. (See discussion above on Deposit Mobilization.) The impact of this decision on costs is significant: using the average deposit rate instead of the pool rate results in SLR 10 million (US$97,609) less in financial costs in 2004 on an annualized basis. Option 2 is being applied in this case study.

[18] The pool rate is the internal rate of funds that treasury charges different areas; it is based on the average cost of funds plus a premium.

TABLE 4.4: COST OF FUNDS TREATMENT OPTIONS (IN SLR MM)

Treatment Options	6/30/04 (annualized)	12/31/03 (12 months)
1. Cost of funds using the pool rate	53.8	44.9
2. Cost of funds using the average deposit rate	43.8	42.0
Difference	10.0	2.9

(b) *Provision for loan loss.* Although portfolio aging is available for the GP portfolio,[19] HNB does not provision separately for the GP portfolio. The loan loss provision expense can be calculated based on the bank's general provisioning standards and the GP portfolio quality at December 31, 2003, and June 30, 2004, as follows.

TABLE 4.5: PROVISION FOR LOAN LOSS (IN SLR MM)

	Change in Portfolio at Risk during First Semester 2004	Provision Percentage	Additional Provision
Substandard (6-12 months)	2.9	20%	0.6
Doubtful (12-18 months)	3.1	50%	1.6
Loss (> 18 months)	2.8	100%	2.8
Total for six months	8.9		4.9
Total (annualized)			9.9

Given that specific microfinance regulations do not exist in Sri Lanka, HNB applies the same commercial loan provisioning standards to the GP loan product as it does for all of its other products. As is evident in Table 4.5, the provisioning requirements in Sri Lanka are not as conservative as those traditionally set for microloans. However, with average GP loan terms of 36 months, HNB is satisfied with the current provisioning standards.

Since portfolio aging data are not available for December 31, 2002, the estimated provision expense for 2003 is calculated using the same provision expense ratio of 1.42 percent (provision expense divided by average portfolio) as for the first semester 2004.

[19] Portfolio at risk over 90 days for GP was 9.06% as of December 31, 2003, and 9.75% as of June 30, 2004.

(c) Direct expense (salary and benefits) of GP field officers. Because GP field officers do not dedicate 100 percent of their time to the GP program, only a portion of their expense is allocated to GP. While it is estimated that they spend 60 percent of their time on loans, they also manage rural credits. Since only 65 percent of GP field officers' clients and portfolio are GP (as opposed to rural credit), only 40 percent of their salaries (65 percent of 60 percent) are related to GP business. The assumption chosen significantly affects the expenses for the GP program, as follows:

TABLE 4.6: GP FIELD OFFICER EXPENSES (IN SLR MM)

	6/30/04 (annualized)	12/31/03 (12 months)
GP Staff Cost (100%)	34.2	30.1
GP Staff Cost (60%)	20.6	18.1
GP Staff Cost (40%)	13.6	12.0

(d) Allocation of other personnel expenses (including salary and benefits).

- Branch personnel:
  - *Branch Managers*. In interviews, several branch managers estimated that they spend between two and four hours per week on "pure" GP business, or 5 to 10 percent of their total time. Since the estimate is more anecdotal than scientific, 5 percent has been applied to this calculation of GP profitability. If the branch has an assistant branch manager, it is assumed no additional time is spent on GP, because the manager and assistant manager would split the responsibility of supervising the GP field officer, and the branch manager would still approve GP loans.
  - *Agricultural Officers*. Since AOs manage GP loans (1,193 as of June 30, 2004), a portion of their salaries must also be allocated to the GP program. Like the GP field officers, the AOs spend approximately 60 percent of their time on credit. Based on the proportion of GP loans to total loans managed by them, 13 percent of the 60 percent (or 8 percent) of the total agricultural officer personnel budget is a GP expense.

TABLE 4.7: BRANCH PERSONNEL EXPENSES FOR GP PROGRAM (IN SLR MM)

	6/30/04 (annualized)	12/31/03*
Branch Manager Staff Cost (5% of 84 branch managers)	4.0	4.0
Agricultural Officer Staff Cost (8% of the agricultural officers' cost)	2.1	2.1

* The same salary and level of effort has been applied for 2003 and 2004.

- *Development Banking head office staff* includes the senior manager, five regional project managers, and six administrative staff members. Allocating personnel costs to GP according to the proportion of the value of the GP portfolio to the total portfolio the unit manages means 34 percent of the total personnel expenses are allocated to the GP program. (If the number of loans is used as the allocation base, the percentage would increase to 44 percent, but this is less accurate than allocating by portfolio because only the larger loans receive head office attention. The operational aspects are handled entirely by the branches, as are approvals of the majority of GP loans.)

TABLE 4.8: DEVELOPMENT BANKING HEAD OFFICE STAFF EXPENSES FOR GP PROGRAM (IN SLR MM)

	6/30/04 (annualized)	12/31/03*
Development Banking Head Office Staff (34% total staff budget)	2.9	2.9

* The same cost and level of effort have been applied for 2003 and 2004.

(e) Allocation of operating expenses.

- *Branches.* Because information on branch operating costs must be procured manually at HNB, branch operating costs for this analysis are estimated based on the operating expenses of three representative branches with the GP program. Based on the proportion of the GP portfolio to the overall branch portfolio in the three branches, the portion of branch operating expenses to be allocated to GP was estimated, as follows:

TABLE 4.9: GP BRANCH OPERATING EXPENSES (IN SLR MM)

	6/30/04 Annualized	12/31/03
1. Average Operating Expenses for Chilaw, Ratnapura, and Tangalle Branches, net of salaries already allocated to GP (1)	15.0	14.1
2. GP Branch Operating Expenses (1 x 84 branches = 2)	1,256.3	1,183.9
3. Average GP participation in total loan portfolio (3)	1.01%	0.97%
GP Branch Operating Expenses (2 x 3)	12.7	11.5

- *Development Banking head office*. The accounting office estimated the monthly cost in 2004 charged to Development Banking for the premises, lighting, and telephone in the head office. Using the same allocation basis as for head office personnel expenses, 34 percent of total Development Banking head office expenses correspond to GP.

TABLE 4.10: GP DEVELOPMENT BANKING (DB) HEAD OFFICE OPERATING EXPENSES (IN SLR MM)

SLR MM	6/30/04 (annualized)	12/31/03
Total DB head office expenses	1.68	1.68
DB head office expenses corresponding to GP: 34%	.57	.57

* The same cost has been applied for 2003 and 2004.

Results

The estimated profit and loss statement for the GP program shows net profit of SLR 1 million (US$9,761) for 2004 on an annualized basis, and a net profit in 2003 of SLR 6.8 million (US$66,374)—figures hovering just above breakeven.

TABLE 4.11: ESTIMATED GP PROFIT AND LOSS STATEMENT (IN SLR MM)

	2004 (annualized)	2003 (12 months)
Interest income	90.6	90.4
Funding cost	43.8	42.0
Provision expense	9.9	8.5
Net financial income	36.9	39.9
Staff cost of GP field officers	13.6	12.0
Other personnel costs	9.0	9.0
Operating expenses, branches	12.7	11.5
Operating expenses, head office	0.6	0.6
TOTAL operating expenses	35.9	33.1
Net profit (loss)	1.0	6.8

The crucial question is then, Why has the GP profitability fallen in 2004, compared to 2003? If the revenue and expense items are calculated as a percentage of the average loan portfolio, the answer becomes apparent.

TABLE 4.12: ESTIMATED GP PROFIT AND LOSS STATEMENT CALCULATED AS A PERCENTAGE OF AVERAGE LOAN PORTFOLIO (IN SLR MM)

	2004 (6 mos.) annualized	2003 (12 mos.)
Interest income	13.0%	15.1%
Funding cost	6.3%	7.0%
Provision expense	1.4%	1.4%
Net financial income	5.3%	6.7%
Staff cost of GP field officers	2.0%	2.0%
Other personnel costs	1.3%	1.5%
Operating expenses, branches	1.8%	1.9%
Operating expenses, head office	0.1%	0.1%
TOTAL operating expenses	5.2%	5.5%
Net profit (loss)	0.1%	1.1%

Often, a key to increasing profitability at traditional, standalone MFIs is improving the operating efficiency ratio (total operating expense/average loan portfolio). However, as shown in Table 4.12, GP's operating efficiency ratio is quite low, undoubtedly because it is a unit within a commercial bank and the greatest portion of fixed costs is absorbed by other areas of the bank with larger portfolios. This allows for the GP program to take advantage of the bank's infrastructure, branch operations, and management, and to be more efficient than its peer MFIs. Even with this advantage, the GP program has barely reached breakeven—primarily because interest rates are not set taking into account operating and financial costs or competitors' rates for microfinance products; rather they are set to reflect the market for other loan products offered by HNB.

Although GP's operating efficiency ratios of 5.2 percent in 2004 and 5.5 percent in 2003 may be considered impressive in the context of a traditional MFI, the net interest margin (net financial income/average portfolio) of 5.3 percent in 2004 just barely covered expenses. The low net interest margin is a result of the comparatively low interest rates charged on GP loans. Changes in market rates for housing and other loans—used by HNB management as a benchmark to set GP interest rates—have caused interest rates to fall in 2004. As of June 30, 2004, the range of interest rates charged on new GP loans is between 9 and 14 percent per annum.

HNB's present challenge is to create a pricing strategy for its GP loans that is consistent with its profitability targets while remaining competitive. A near-term initiative identified by the Deputy General Manager is to confirm that the GP interest rate is appropriate to cover costs and provide a profit margin to the bank, while still being affordable to the microentrepreneurs. Until now, HNB management has been reluctant to raise interest rates to the level of rates charged by NGO competitors (above 20 percent per annum), believing that microentrepreneurs cannot afford to pay higher rates. Management is now coming to terms with the evidence that microentrepreneurs are able to pay slightly higher rates, which can lead to sustainable programs.

4.2.3 GP PROFITABILITY COMPARED TO HNB'S PROFITABILITY

As mentioned previously, comparisons with the profitability of other bank products cannot be made at this time. Instead, the imputed profitability of the microfinance program can be compared to the bank's return on portfolio and profit margin. The comparison cannot be totally accurate because assumptions were made about provision expense and staff time allocations and no write-offs were attributed to the GP program.

Not only are the return on portfolio and profit margins for the GP program lower than the same ratios for the bank as a whole, but GP's contribution to the bank's bottom line accounted for only 0.62 percent of the net income before tax in 2003, and 0.09 percent in 2004 (annualized June 30, 2004 figures).

TABLE 4.13: GP PROFITABILITY COMPARED TO HNB PROFITABILITY (PRE-TAX)

	6/30/04 (annualized)		12/31/03	
	HNB	GP	HNB	GP
Return on portfolio (Net income/average portfolio)	1.44%	0.14%	1.57%	1.14%
Profit margin (Net income/gross income)	10.31%	1.10%	10.25%	7.52%

4.2.4 GP PROFITABILITY COMPARED TO OTHER ASIAN MFIS

Portfolio quality has not been discussed in this case study, but when comparing HNB's microfinance portfolio to other Asian MFIs', it is clear that there is room for improvement. Poor portfolio quality is a drain on profitability, and HNB is presently focusing on reducing its portfolio-at-risk. If provisions for loan loss and write-offs were tracked by product, the effect of portfolio quality on the bottom line would be more transparent.

In the context of comparing the GP program to other Asian MFIs, it also is interesting to compare additional components that affect profitability, such as efficiency and productivity. GP field officers manage, on average, 203 loans each, but only 130 of the loans are microfinance loans. (The remaining loans are rural credit loans.) Since the GP field officers only dedicate 40 percent of their time to GP loans, their productivity on their GP portfolio is quite limited. Assuming their role within the branch is modified radically to allow them to dedicate 100 percent of their time to microfinance, which is customary in much of the microfinance industry, they could raise the 130 GP loans per officer ratio to close to 325 loans per officer. If the average term of GP loans were to become substantially less than the present average of three years, fewer than 325 loans would be handled per officer because of the burden of renewals, but the average would be more in line with the microfinance industry.

TABLE 4.14 GP INDICATORS COMPARED TO OTHER ASIAN MFIS

	HNB-GP* (2003)	MicroBanking Bulletin “Asia Medium” peer group (2002)
Operational self-sufficiency	121%	111%
Portfolio yield	15.1%	33.3%
Portfolio-at-risk > 90 days	9.1%	1.6%
Operating expenses/Average portfolio	5.5%	26.6%
Borrowers/Field officer	203*	265

* Including rural credits

5 ACHIEVEMENTS OF AND CHALLENGES FACING THE MODEL

5.1 ACHIEVEMENTS

In its first 15 years of existence, HNB's GP program has anecdotally demonstrated significant impact on the lives of poor microentrepreneurs in rural Sri Lanka. Countless stories exist of microentrepreneurs who first approached HNB as a result of marketing by GP field officers and now are accessing larger loans and other bank products, saving significant funds, growing their businesses, employing more people, and sending their children to school and even university.

The GP program also has achieved national and international recognition for its work in the rural areas of Sri Lanka, which previously had been ignored by the mainstream banks, as seen in many countries throughout the world. It is expensive for banks to operate in rural areas—the distances alone impede many banks from even considering entry into remote villages, which are often too small to make any significant impact on the bank's bottom line. HNB, however, recognized many years ago that although it may require a large upfront investment on the part of the bank, the individuals living in the remote areas represent the future of the bank and of the country.

5.2 CHALLENGES

Now that the GP program has survived 15 years and HNB has accepted the initial upfront costs, the next challenge is long-term sustainability, implying not only cost recovery but also profitability.

HNB, as a privately held bank, knows that its thousands of shareholders demand acceptable returns on their investments. Until now, the GP project has been seen as part of the bank's corporate social responsibility program, yet the Deputy General Manager responsible for the program, as well as many others within the bank, now see it as a profitable venture. The challenge facing the bank today is to prove that profitability and increase it, not only as a return on the investment, but also as a significant contributor to the bank's bottom line.

6 CONCLUSIONS

HNB is proud of its Gami Pubuduwa program, which has served the rural microenterprise sector in Sri Lanka for 15 years. In the last year, GP was repositioned within the bank and assigned a new Deputy General Manager; it is now poised to expand. Once an appropriate cost allocation method is chosen, the bank's MIS can segregate and properly allocate these costs, and the profitability of the GP program can be proven and sustained, management projects that resources will become available to increase GP's outreach by 2006 to reach 20,000 clients.

As an internal unit, the GP program can continue to use HNB's head office departments, including human resources, marketing, legal, operations, information technology, and so on. Taking advantage of HNB's market presence, infrastructure, funding capabilities, and management support gives the GP program a competitive edge over the NGOs in Sri Lanka that are providing microfinance. Still, improvements in efficiency and productivity by the GP field officers will increase the profitability of Hatton's microfinance products.

For GP to contribute to HNB's bottom line, management will need to analyze the performance of the program closely. The bank will need to decide whether additional profitability should be attributed to GP for mobilizing "excess" savings, cross-selling other bank products and services, and graduating GP clients to other areas of the bank. For GP to sustain significant returns, the portfolio yield must improve. Management has recognized the need to analyze the program's costs and potential increases in client interest rates while keeping them competitive—even below rates charged by standalone competitors.

6.1 LESSONS

Some key lessons learned from HNB's experience of having a microfinance product offered as part of the bank's Development Banking Unit include the following:

- Focus on social responsibility and community development can only be sustained with a strong commitment from senior bank management and only for so long. Eventually, profitability becomes an issue.
- Since GP is a product within the bank, the bank has been more concerned with overall profitability than with the allocation of profits among departments or products. Similarly, branch managers are not concerned with differentiating product contribution to the branch bottom line, as long as the branch as a whole is profitable.
- The field officer job description affects priorities. The time that GP field officers spend on non-credit-related activities (40 percent) is what the branch managers value most. Branch managers believe that GP officers are vital to the branch because of their contributions to deposit mobilization, development of potential multiproduct users, branch operations, community development, and goodwill.
- Career paths for field officers also affect the image of microfinance within the bank. Currently, the goal is to "mainstream" GP field officers into the branch system as assistant branch managers or branch managers.

6.2 ISSUES FOR THE FUTURE

Though Hatton National Bank had begun to determine the profitability and contribution of microcredit to the bank, a process that was advanced during the course of this study, a more detailed analysis could provide important data for future decision making. An exercise to more accurately determine the full cost and contribution of GP to the bank should include a detailed process mapping and activity-based costing exercise for all products offered through the branches to accurately determine the profitability of diverse activities. An analysis of GP in terms of cross-selling other bank products, including deposits, and client graduation to other bank departments would provide added data on the full contribution of GP to the bank. For ongoing monitoring and decision making, a profitability management system should be incorporated into the MIS.

If microfinance is to contribute significantly to the bank's bottom line, the bank will have to take steps to bolster productivity and growth of GP. Defining job descriptions, business targets, and incentive systems to focus staff on the GP-specific client segments and product lines would be a step in this direction. If the microfinance program became large enough so that there were career opportunities at HNB in microfinance, the specialized training of the GP field officers could be used in microfinance management positions, helping motivate and retain good GP staff.

Finally, developing a new pricing strategy for GP loans would help boost financial margins on this portfolio. Management intends to conduct a market study to better understand competitors' product terms and pricing. Using information on competitive pricing, allocating newly identified costs, and determining how to treat deposits mobilized by GP field officers, HNB plans to establish a pricing strategy and policy for GP loans.

Advances in the enabling environment in which HNB operates would enhance not only the quality and growth of HNB's program, but also the other microfinance suppliers, ultimately creating a more developed microenterprise market in Sri Lanka. Development of competitive and innovative retail financial intermediaries, an appropriate legal framework, industry infrastructure and support, and the microenterprise sector itself all present opportunities for advancement in Sri Lanka. Improving these factors of the microfinance industry is not a task that one institution can undertake and would require a concerted effort on the part of various industry stakeholders. Development of a network of institutions involved in microfinance that collaborate in advocacy of market-driven strategies and industry development efforts, information sharing for benchmarking, and market research would advance microfinance in the country. Establishment of a legal framework that includes prudent and appropriate regulations for microlending and mechanisms that facilitate contract enforcement especially for nontraditional collateral would be particularly beneficial and encouraging for regulated lenders expanding into the microcredit market. Creation of a credit bureau inclusive of all lending institutions would help reduce risk and assist clients to develop formal credit histories and access financing at better terms than are currently available. Finally, development of training and consulting services for microfinance providers would help build retail capacity and innovation.

6.3 HNB RECOMMENDATIONS FOR OTHER BANKS

HNB's recommendations to other banks contemplating entering microfinance and to banks struggling with making microfinance a significant contributor to the bank's profitability include:

1. Identify microentrepreneurs' needs and create enthusiasm in the communities for microenterprise development. Develop trust and loyalty in the loan officer-client relationships.
2. Engage senior management in the initial planning and foster ongoing support. Find a senior "champion" who believes not only that microfinance can be good for the development of the country, but also that it can and must be profitable to the bank and provide an acceptable return to its investors.
3. Know specific institutional limitations. In the case of HNB, information technology has limited the ability to assess and analyze product profitability. Human resource challenges include providing specialized training and focused responsibilities for the microfinance field officers and developing appropriate career paths for them.
4. Insist that governments have a role in requiring banks to share the social responsibility of making banking accessible to the poor and rural populations. Although this may be controversial in some countries where government involvement has proven detrimental to private sector goals, in the context of Sri Lanka, HNB leaders recognize the importance of incentives to enter the microfinance sector.