

SOME CRITICAL ISSUES RELATING TO THE COMMERCIALISATION OF MICRO FINANCE INSTITUTIONS IN SRI LANKA

S. M. P. Senanayake
University of Colombo

1. Introduction

The definition of micro finance as given in ADB (2000) includes "the provision of a broad range of financial services such as deposits, loans, payments services, money transfer and insurance to poor and low income households and their micro enterprises". In Sri Lanka however, at least till recently, micro finance is understood to be analogous mostly with micro credit and partly with savings. In this country micro finance is provided by three main sources that include formal, semi-formal and informal sectors. There is no disaggregated data available relating to the relative shares of microfinance services of the formal (including semi-formal) and informal sectors in the country, but CBSL (1999) has estimated that about 57% of the total number of loans and 33% of the volume of loans in the rural sector are still provided by the informal sources comprising friends and relations, landlords, traders, produce buyers, input suppliers, pawn brokers and professional money lenders. This paper, however, covers only the formal institutional micro finance. Formal micro finance institutions include rural banks, co-operatives and non-governmental organisations.

In Sri Lanka some state and private commercial banks (SCBs and PCBs) also provide micro finance services to micro enterprises. However, the size of such services relative to their total transactions is very small. ABD (2000) defines micro finance institutions as "institutions whose major business is the provision of micro finance services". (p. 1)

Charitonenko (2001) defines commercialisation of Micro Finance Institutions as any one or a combination of the following: a) adoption of a pro-profit orientation in administration and operation; b) utilisation of market-based source of funds and c) progression toward operational and financial self-sufficiency². To be a successful commercially oriented MFI the MFIs should try to increase their operational, intermediation and dynamic efficiencies (Aluthge: 2001).

The operational efficiency is the minimisation of the real resources used by the financial institutions in the process of financial intermediation. Under operational efficiency the desired outcome of financial sector liberalisation is the competition in the

¹ Asian Development Bank "Finance for the Poor: Micro Finance Development Strategy", May 2000 p. 1

² Charitonenko S. "Commercialisation of Micro Finance: A concept Paper", Manila 2001 (Mimeo)

financial system (Aluthge: 2001). If competition increases operational efficiency will be enhanced. In a competitive market financial institutions should minimise the costs to become profitable enterprises.

Intermediation efficiency is the efficiency of mobilisation of savings at a positive real interest rate and channelling saved resources through a high positive lending rate. However the interest rates should not rise above the market-clearing rate.

Under dynamic efficiency the desired outcome is increased savings in the economy and a transfer of these funds at a faster rate to growth oriented long-term investment projects. Dynamic efficiency can be achieved in a context of declining inflation.

The paper is arranged as follows. In Section 2 the theoretical background on formal microfinancial institutions is presented. Section 3 covers the macro environment of microfinance and Section 4 deals with demand for and supply of microfinance services in Sri Lanka. Factors affecting the success of Formal Micro Finance Institutions are the subject of Section 5, while Section 6 covers interest rates. Role of the government is examined in Section 7. Section 8 discusses the role of donors while Section 9 presents the concluding remarks.

2. Theoretical Background on Formal Micro Financial Institutions

From late 1950s to late 1970s the micro credit policies and programmes in the LDCs were designed and implemented according to the theory formulated by Clifton R. Wharton, Jr. (1962) who concluded that most of the rural credit market structures in LDCs conformed to the monopolistic market model. Thus the approach adopted by many countries including Sri Lanka during that period depended heavily on breaking the monopoly powers of rural moneylenders by introducing loan schemes through the institutional sources such as co-operatives and state banks at subsidised rates of interest.

With the spread of the views now known as the 'Ohio School', which included economists such as Adams (1984), Gonzalez Vega (1984), Von Pischke (1983) and many others, the policy makers in LDCs were made to understand that the ubiquitous low interest rate policies have undermined the rural development, and that high transactions costs have put a limit to the access of rural borrowers to formal credit sources.

These views had a powerful influence in designing and implementing many micro

credit policies in LDCs in the 1980s and Sri Lanka was no exception. Attempts were made to cut short the procedural delays, bring down the transaction costs to borrowers and lenders, and eliminate the interest rate subsidies. These views were consistent with those formulated by Antony Bottomley (1964) who identified four elements of costs included in the high interest rates charged by moneylenders in the informal sector. These cost items included the opportunity costs of the funds, the administrative costs in granting and recovering loans, the risk premiums and also a premium for inflationary effects.

In the meantime Hoff and Stiglitz (1998) and their followers were instrumental in presenting what is now known as the imperfect information paradigm. This paradigm primarily emphasises the problems of information asymmetry. These asymmetries are characterised by three inter related situations, adverse selection, moral hazard and enforcement. Operation of these mechanisms caused rationed credit and segmented credit markets. This paradigm also points to the poor legal framework, property rights, and poor rural infrastructure which leads to higher transaction costs and serious enforcement problems resulting in rationed credit by formal micro financial institutions. Following Hoff and Stiglitz's ideas Hulme and Mosley (1996) provided theoretical explanations, supported by empirical evidence and examined ways and means of overcoming the problems arising from information asymmetries.

They identified two types of methods for overcoming the difficulties arising from information asymmetry, namely direct methods and indirect methods. Direct methods included intensive loan collection, and incentives for savings and repayment, for the purpose of reducing rates of default. Peer group lending was considered as an indirect method for achieving the same purpose. These ideas have been incorporated, to a large extent, in many micro credit programmes implemented during late 1980s and 1990s.

Another view, which is now known as the structuralist view, has been put forward by Mellor and Desai (1993). They implicitly state that inappropriate organisational structure of Formal Micro Financial Institutions (FMFIs) is a major reason for their poor performance. Lower density of field level units of FMFIs and concentration on providing credit alone by these institutions have been contributory factors to this state of affairs. This view promoted the 'credit plus' approach in development banking, and led to the promotion of multifunctional FMFIs which were encouraged in addition to providing credit to get directly or indirectly involved in providing other services such as collecting deposits (Mobilisation of savings) extension, marketing, sale of inputs, sale of consu-

mer goods, and even repayment of previous loans obtained from other sources.

The current thinking of the multilateral and bilateral donors and lenders and the governments of LDCs is influenced by McKinnon (1973) and Shaw (1973) type of financial liberalisation. Viewed in this theoretical background, the attempt to commercialise micro finance institutions can be seen as extending the financial liberalisation to this sector as well.

3. Macro Environment of Micro Finance

During the period from 1971 -77 Sri Lanka adopted a McKinnon-Shaw type of financial repression in the form of controls and regulations. These were intended to bring about higher economic growth and macro economic stability. However, "such policies aggravated the macro economic imbalance and failed to achieve a satisfactory level of economic growth, basically due to large scale inefficiency in resource allocation (Aluthge: 2001, p. 249). From late 1977 the financial sector reforms of the McKinnon-Shaw type of financial liberalisation was adopted gradually. Accordingly interest rate was raised to market clearing rate, the exchange rate was depreciated several times with a view to promoting exports, entry barriers to the financial system were removed and structures for banking supervision and regulation were updated. This reform process was successful in several respects such as attraction of new institutions (both foreign and local) and new instruments to the financial system in the country, and financial sector grew annually at 5.9% in real terms between 1989 and 1997 (World Bank: 1998). However, this reform process was unable to control the rate of inflation and resulted in high interest rates relative to the return on investment. Thus the response in terms of investment, for example in the manufacturing sector, was unsatisfactory. In the post liberalisation period the real lending rate shows an increasing trend, while the real deposit rate displays a declining trend (Aluthge: 2001). Thus, the margin between the two rates widened over time reflecting some low level of efficiency in the operational, financial intermediation, and dynamic fronts. However, the banks were able to pass on their operational inefficiency to their customers through excessively high interest rates, but experienced declining and highly volatile banking profits.

Although the number of banks and their branches grew rapidly during the post

reform period, the competition among banks remains at best as complacent. "The private sector has taken advantage of the protection offered by the inefficiency of the state owned sector, and has preferred to enjoy high intermediation spreads rather than compete for market share" (World Bank: 1998, p. 3). In a sense, the liberalisation process in the large financial system is still an unfinished agenda. It is in this macro-economic background that one has to look for ways and means of promoting commercialisation of the MFIs in Sri Lanka.

4. Demand for and Supply of Micro-Finance Services

The size of the demand for micro-finance services in the country cannot be estimated accurately due to the paucity of data. According to available statistics (Central Bank: 2000) a large number of people in the poor and low income households and their micro-enterprises are willing to save, have the capacity to save and do have financial savings, although the average amount of savings deposits are small. The entire leading rural sector of MFIs registered a positive growth of savings from 1998 to 1999. The growth rates of savings deposits were 45% for Sarvodaya Economic Enterprise Development Services (SEEDS), 42% for SANASA Development Bank, 15% for the Co-operative Rural Banks (CRBs) and Janashakthi Bank and 8.5% for Regional Rural Development Banks (RRDBs). According to Central Bank of Sri Lanka (CBSL: 1999), 54.3% of the spending units in all sectors had positive savings. On the other hand these customers and those who are dis-saving require micro credit facilities. According to the estimates available (World Bank: 1995) around 23% of the population in the country are poor people consisting of small farmers, tenant cultivators, landless labourers, fishermen, self-employed and unemployed and under employed. They require micro credit for various purposes, including agriculture, animal husbandry, fisheries, small industry, building construction, electricity and water supply, trade and commerce and for consumption needs. However, according to CBSL (1999) most of the rural sector loans (63%) are for consumption purposes. Agriculture accounts for 6.1%, trade and business 6.6%, housing 9.5%, and settlement of debts 4.7%. The share of total loans obtained for industry accounted only for 0.1%. Thus it is apparent that loans going into the real sector is very marginal, implying dynamic inefficiency in the micro finance system.

Although most State Commercial Banks (SCBs) and some Private Commercial

Banks (PCBs) supply micro finance facilities, their micro credit component of the total loan portfolio is estimated in majority of cases at less than 10%. Central Bank publishes information about deposits and advances of a few selected rural sector MFIs including CRBs, Agrarian Service Centre branches of the Bank of Ceylon (ASCs), Samurdhi Bank Societies (SBSs), Janashakthi Bank Societies (JBSs), and Thrift and Credit Co-operative Societies (TCCSs) and Sanasa Development Bank. According to the amounts of deposits mobilised and loans granted it appears that there is a high degree of concentration in the microfinance market. This implies an oligopolistic type market structure of the MFIs in Sri Lanka. The state and co-operative sector dominates the institutional micro credit market. About 95% of the total volume of deposits mobilised in the rural sector in year 2000 were by CRBs (45%), RRDB (33%), and TCCS movement (17%). Similarly the micro credit provision is highly concentrated. Here, the RDB/RRDBs provide about 52% of the total loans granted while CRBs are providing about 22%. TCCSs and SANASA Development Bank account for 13% of the loans and share of Samurdhi Banking Societies works out to 5%. This shows that 92% of the credit is granted by these institutions. In the NGO sector the SEEDS provide 7.7 % of the loans while the share of JBS is only 0.3%. If this assertion is true it points out that competition is imperfect and operational efficiency is weak in the MFI sector as well.

5. Factors Affecting the Success of MFIs

Most micro credit schemes implemented in Sri Lanka with government and/or donor support as is elsewhere in the world, is aimed at creating employment at low cost in labour intensive activities, reducing poverty through increased incomes and promoting equity in income distribution. In achieving these objectives the main instrument used is providing loans at interest rates below market level. One can say this approach is supply driven, and involves complex allocation procedures and leads to credit rationing, high transaction costs, misuse of credit, bribery and corruption and the people outside the target groups getting access to such credit facilities. Some NGOs also provide credit as charity, at zero or very low rates of interest. Not surprisingly, in these schemes the outreach is high, and/or satisfactory. In some cases even the default rate is very low. But the commercial success of MFIs can not be measured only in terms of outreach and repayment rate. It should be measured in terms of

operational, financial intermediation and dynamic efficiency and level of profits. To have positive and non-volatile profits it is necessary to maintain a positive real interest rate structure, accompanied by a positive interest spread or margin. This helps to offer attractive returns to the savers and can result in large inflow of domestic resources. Positive real lending rates (at a reasonable level) induce micro entrepreneurs to demand credit facilities and to invest in most profitable ventures. When MFIs earn positive margins sufficient to cover operating costs, they are in a position to provide more loans to micro-entrepreneurs.

The commercial success of the MFIs also depends on the methods used in risk reduction. For this to happen problems arising from information asymmetries have to be minimised. To minimise the adverse effects from these asymmetries various devices can be used. These include group lending (SHGs) incentives to repay and intensive loan collection. Incentives to repay includes providing progressive loans to those who have repaid previous loans promptly, profit linked bonuses to the MFI staff, and applying penalty rates on overdue loans. The result would be better if a combination of these methods is adopted.

For a successful commercialisation of Micro Finance Institutions (MFIs) some lessons can be learnt from the structuralists as well. A full commercialisation of MFIs also means that they should help in integrating regional and national financial markets. This needs the transferring of excess liquidity to regional and national levels and vice-versa. Market integration of MFIs requires a vertically organised system which would facilitate decentralised decision-making and providing training to the local staff. With integration it is possible to reap economies of scale in financial intermediation. This would also reduce transaction costs with consequent positive implications for financial viability. Vertical integration also helps to overcome weaknesses of segmented credit markets in rural areas. A high density of rural branches of MFIs also affect the Micro Finance Market positively. The positive effects include,

- a) Vertically integrated structures of MFIs increase their accessibility to poor households to obtain their savings and credit needs.
- b) It improves the understanding of specific situations by the MFI staff.
- c) It enables improved loan appraisal, monitoring and evaluation by MFI staff.

Another area, which helps in the successful performance of MFIs, relates to exter-

nality effects. Improvements to infrastructure such as roads, electricity, communications etc. help greatly to the success of MFIs.

One more measure of success of MFIs is whether they are dependent on the subsidies provided by the government or the donor agencies. Jacob Yaran has provided an index named Subsidy Dependence Index (SDI), but in the Sri Lanka context major MFIs are not very much dependant on the subsidies provided by the government or the donors/lenders.

6. Interest Rates

The policy of the CBSL is to maintain deposit rates at levels which would bring down costs of funds to the financial institutions, while at the same time maintaining real positive interest rates in order to give a fair return to the deposit holders. On the other hand the policy on the lending rates is to keep them at a sufficiently low level in order to promote private sector investments in the country. In doing so financial institutions should be able to maintain a positive real interest spread at reasonable levels by improving efficiency and productivity of the banking sector. However, in the case of Sri Lanka, as mentioned earlier, the real lending rates have been on an increasing trend, while real deposit rates are declining, thus widening the interest rate spread over time.

Although the CBSL does not control the micro finance interest rates, and does not impose any ceilings on such rates, at least the rates of larger MFIs like RRDBs, CRBs and TCCS normally depend very much on the lending and deposit rates of the NSB, SMIB and commercial banks. Therefore the interest rate trends in the banking sector influence very much the interest rate structure of the MF sector as well. However most other MFIs decide their own lending and deposit rates, without much influence from the banking sector.

From the experience of MFIs in Sri Lanka, it is clear that the adoption of market rates of interest on savings and loans and advances has helped in mobilising savings in a moderate scale and expanding the borrower outreach significantly. For example, in the case of CRBs the number of deposits has increased from 2.5 million in 1990 to 5.5 million in year 2000 and this is more than a two-fold increase. The amount of savings also increased five fold from SLR 2,497 million in 1990 to SRL 14,806 million in 2000.

On the other hand the number of loans has increased from 456,514 in 1990 to 1.2 million in 1999. The difference between deposits and advances increased from SLR 1,046 million in 1990 to SLR 8,619 million in 2000. Also the MIFs who charge positive real interest rates have also been successful in maintaining relatively high repayment rates. For example, repayment rate of CRBs is around 80%, RRDBs around 73%, TCCSs roughly 85%, SEEDS about 90%, SBSs around 95% and JBSs about 98%.

However, the positive real interest rates are dependent upon the rate of inflation. The figures given by the CBSL (2000) show a progressive reduction in inflation rates after 1996. All the price indices show that inflation has come down after 1996, but only the CCPI and GNPD shows an increase in the year 2000. According to these indices the inflation rates were 4.7% and 4.4% in 1999 and they rose to 6.2% and 6.7% in year 2000. Thus there appears to be some ambiguity in the estimation of the rate of inflation in the country. Estimation of a realistic inflation rate is therefore a *sine qua non* for fixing real positive interest rates in both the larger formal financial system and in the Micro finances sub-sector. Central bank (1998) stated that "Sri Lanka is yet to achieve a sustainable reduction of inflation----- a steady reduction of inflation rate below 5% would be required for the country to disentangle itself from the inbuilt inflation bias" (pp. 99).

The interest rate structure in the commercial banking system also affects the performance of the MIFs because at least some of these MIFs deposit their excess funds with those banks. The downward trend of the real deposit rates offered mainly by the SCBs affects the MIFs adversely. This encourages the MFI's to invest their surplus funds with some formal institutions in the private sector which engage themselves in risky business ventures.

For example the CRBs lend less than half of the funds mobilised by them so far and are left with large amounts of surplus funds. These excess funds had been deposited until recently with the branches of a SCB namely the Peoples Bank (PB). The PB nurtured the CRBs from 1962 "by providing a host of services including banking, supervision of activities, training of personnel and (absorbing) surplus funds." Central Bank (2000: pp. 194). However, as PB was concentrating more on commercial banking from early 1990s most of these facilities were withdrawn. To fill this gap, District Co-operative Rural Bank Union (DCRBUs) were set up in the districts under the auspices of the Co-operative Development Department. They are still to form a national level federation like the SANASA Development Bank. Hence they were compelled

to invest in the debentures of a private institution, which at the moment is at least not financially sound. The surplus funds of the SBSs are also deposited with a lesser-known private bank, although the CBSL in its Annual Report of 1997 mentioned that "it is of utmost importance to take precautionary measures by linking SBSs to a state bank and placing the funds in deposit with such a bank." (pp. 172). This is not to suggest, however, that the MFIs should invest their surplus funds in SCBs alone, it suggests that they should be very careful in investing their surplus funds in more risky ventures. Had there been a vertically integrated structure of these MFIs, the surplus funds could have been transferred to the deficit areas and vice-versa.

7. The Role of the Government

Amongst the various constraints hindering the development of the micro finance sector is the government interference. The government apparently does not permit the MFIs to operate freely. Concessional loans and interest subsidies, loan forgiveness and political hand-outs, mandates and government directed programmes affect the smooth functioning of the MF sector adversely. Some of these actions, particularly loan forgiveness erode the credit discipline of the customers of MFIs. Also, the government directed programmes and some donor-funded projects at times distort the interest rate structure of the MFIs. For example, various government and donor funded credit schemes have different rates of interest, and these are always lower than the interest rates charged by MFIs in their usual lending operations.

The supply driven approach to micro credit involves complex allocation procedures, leading to various malpractice's including credit rationing, misuse of credit and people outside target groups gaining access to such facilities. Thus what is found from the Sri Lankan experience is that the mandates and government directed programmes are generally less successful than the own credit programmes of the MFIs.

There are also deficiencies in the legal and regulatory framework affecting the MFIs. For example, the regulatory framework faced by the co-operative sector including CRBs and TCCSs are restrictive in many ways, and involve unnecessary requirements. The Co-operative Societies Act No. 5 of 1972 gives considerable discretion to the Minister in charge of Co-operatives and Commissioner/ Registrar of Co-operatives. These societies need to obtain approval from them even for staffing decisions,

small capital purchases and granting large loans to customers. The lack of prudential requirements on the other hand reduces the credibility of these MFIs who are operating without proper legal backing. Samurdhi Banking Societies are an example. There are no regulations governing the acceptance of non-member deposits by various non-bank MFIs, which are in fact informal savings and loan associations. Therefore Central Bank (1977) warned, "placement of savings with unregulated and unsupervised informal societies will expose the savers to consequential risk" (pp. 172). At present there are no significant barriers to entry into the micro finance field in Sri Lanka. In fact during the recent past there has been an upsurge of MFIs in the country. However the minimum capital requirement to establish a licensed bank or a commercial bank is still too high. Initial capital requirement for establishing a deposit taking and lending bank is SLR 250 million and for establishing a Commercial Bank it is SLR 500 million. These high capital requirements discourage MFIs who want to have a vertical organisational structure. Thus it is necessary for the government to establish a framework for licensing small banks with realistic capital requirements. Lack of an enabling policy environment and infrastructure also affects the commercialisation of micro-finance sector in the country. As an example the Regional Development Bank (RDB) act contains development and environmental objectives, which are usually outside the purview of RDBs. The less developed infrastructure and the poor performance of other services including the marketing of clients' products, introduction of new technology, providing skills training and extension services also affect the performance of MFIs adversely. Thus some MFIs are compelled to follow a credit plus approach for which, in most cases, they do not have the expertise. It is not the real role of MFIs. MFIs need to concentrate and specialise in providing micro finance services. Therefore it is necessary to adopt other measures by the government and other concerned parties to improve the efficiency and performance in these areas, with the active participation of the private sector.

There is no explicitly laid down government policy for the micro finance sector in Sri Lanka. However the broad policy of the government is the open market economy with a "human face"³, and it has some implications for this sector as well. The poverty

³ What was meant by 'human face' included "commitment to peace, respect for human rights, democratisation of the governance and social justice" (Lakshman: 1997, pp. 11).

alleviation programmes such as Samurdhi came into being because of this policy orientation. Even under the previous regime poverty alleviation was considered to be a main objective. A major poverty alleviation programme namely the 'Janasaviya' was launched accordingly. It provided financial assistance to the "poorest of the poor" and introduced micro credit schemes to the people in poverty, enabling them to commence income-generating activities. The Janasaviya Trust Fund (JTF) was established in 1991 to manage a credit fund for disbursing credit to Participating Credit Institutions (PCI), which included SCBs, RRDBs and CRBs. The JTF was later renamed as National Development Trust Fund (NDTF) and it continued to provide funds to PCIs and various other social services oriented MFIs such as Women's Development Federation in Hambanthota. NDTF funds are still in circulation as loans to the poor by these PCIs. Since most of the IGAs financed in this manner have low returns to investment, it becomes necessary to provide them credit facilities at low rates of interest. Therefore it would be politically difficult for the government to keep completely away from the micro finance sector for some more time to come. Thus, it is most probable that a complete financial liberalisation in the micro finance sector would not be introduced very soon. However, it should be stressed that the government policies are progressing in the right direction, slowly but gradually.

8. The Role of Donors

The bilateral and multilateral donors and agencies provide a large part of the funds used by the MFIs for onlending to their members. The ADB, IFAD, CIDA, WFP and the Government of Japan are some of the major donors for providing such funds to the MF sector in Sri Lanka. The funds provided by ADB alone for 5 development projects amounts to about US\$ 70 million (SLR 5000 million) valued at the 1998-exchange rate. However some of these projects are not specifically aimed at the strengthening of the micro finance activities. Some donors provide outright grants and/or concessional loans for this purpose, while others provide loan guarantees for the owned funds used for lending to the rural poor. Some of the agencies also influence government policies on micro finance, in the areas including charging market rates or cost recovery rates of interest, doing away with refinance schemes, and eliminating interest subsidies.

However, the impact of these donor funded loan schemes to the poor on MFIs is at times mixed. A sample survey conducted by the same author in the southern pro-

vince of Sri Lanka involving 22 PTCCSs came to the following conclusion (Senanayake: 2000): the project under consideration had some positive impacts including increase of funds available for on-lending, purposes of loans diversified, average loan size increased, term lending expanded, quality of loan portfolio improved, amount of savings mobilised increased, profits of the societies and reserves increased and the number of borrowers increased. However in the case of some PTCCSs there were some negative impacts as well. These included: the proportion of borrowed funds of total funds of the societies increased, collateral requirements became difficult, procedure of lending was made more complex, loan evaluation process became more difficult, the repayment rate declined, delayed payments increased, and cost of lending increased. Most of these deficiencies stem from issuing relatively bigger loans than hitherto given. Some of the PTCCSs had a very small capital base and were accustomed to releasing loans to members adopting simple procedures. Although some of the officers of the PTCCSs were given training in loan appraisal by the project, most of them still lack knowledge and experience in these matters. Since most PTCCSs are poorly staffed with only one person as the manager, their workload was also increased. Only 5 societies in the sample had only 1 clerk each to help the manager. Hence it is difficult to take follow up actions on the loans issued, and as a result, repayments were either delayed or defaulted by some borrowers.

This shows that providing funds for onlending by donors is not enough. The support from donors is needed in improving the performance of this sector on a market based or commercial approach. Thus the critical areas of support could be in the training and technical assistance, support for regulatory and supervisory systems development, support for changing legal framework, financial infra structure development, Management Information Systems (MIS) development, and policy support.

9. Concluding Remarks

Commercialisation of the micro finance sector has to be achieved through the commercialisation of deposit mobilisation and lending operations. This implies the marketisation of both these operations, and increasing of efficiency and competitiveness.

In Sri Lanka larger MFIs such as RDBs, CRBs and TCCSs compete among themselves and with banks including NSB, SCBs and PCBs in mobilising savings in the micro finance sector. On the other hand some of the MFIs depend on those banks for

depositing surplus funds available to them. Therefore there is a tendency for the MFIs to fix the deposit and lending rates based on those offered and charged by the banks. As mentioned earlier, in the banking sector the real rates of interest paid for deposits show a declining trend while those charged for loans show an increasing trend. This trend is visible in the MF sector as well. It implies that at present financial intermediation efficiency of the larger MFIs is also at a low level. With the involvement of these MFIs in government and donor funded credit schemes they are compelled to follow the interest rates decided by those institutions, in which costs of funds as well as lending rates are lower than their own deposit and lending rates. Thus it is necessary for the MFIs too to separate such activities from their normal activities, and concentrate more on normal activities based on market conditions, and try to earn significant margins to cover their operational and overhead costs. A cost recovery approach would also ensure non-volatile profits to the MFIs.

The TCCS movement already has an organisational structure that is conducive in integrating village level; district level and national level micro finance markets. Similar structures will also be necessary for some other MFIs; particularly the CRBs. Up-scaling of the activities is necessary in the case of many MFIs if they were to fully commercialise their operations. They should also be encouraged to introduce new instruments, and adopt new technology. The micro finance sector in Sri Lanka at present suffers from inadequate capacity of the MFIs, lack of proper financial infrastructure and defects in the regulatory framework among other things.

It should also be noted that the micro finance sector is a relatively less developed sector in Sri Lanka. Looking at the numbers of clients who rely on informal sector sources, and examining poverty statistics it can be concluded that there is a massive latent demand for micro finance services in the country. At present a large share of the prospective clientele remain outside the purview of MFIs. Thus it is possible for the MFIs to serve this mass market and increase outreach by providing a quality service. There are a number of sustainable or potentially sustainable MFIs in Sri Lanka and they should aim at reaching a wider clientele by improving the efficiency, reducing transaction costs, and improving the quality of service. It has now become necessary to adopt a market-based approach to micro finance to replace the charitable approach, in order to alleviate the poverty in the country.

References

- Adams, Dale W, Graham D.H. Von Pischke (Eds) (1984), *Undermining Rural Development with Cheap Credit*, Westview Press, Boulder.
- Aluthge, Chandana (2001), *Financial Sector Liberalisation in Sri Lanka - A Macro Level Inquiry into Capital Accumulation, Investment, Growth and Stability*, Virji Universiteit, Amsterdam.
- Asian Development Bank (2000), *Finance for the Poor: Microfinance Development Strategy*, Manila, The Philippines.
- Bottomley Antony (1971), *Factor Pricing and Economic Growth in Underdeveloped Rural Areas*, London.
- Central Bank of Sri Lanka (1977,1999, 2000), *Annual Reports*, Colombo, Sri Lanka.
- Central Bank of Sri Lanka (1999), *Report on Consumer Finances and Socio Economic Survey 1996/1997*, Part 1, Colombo, Sri Lanka.
- Charitononke, S. (2001), *Commercialisation of Microfinance - A concept Paper*, Manila, The Philippines (Mimeo).
- Gonzalez - Vega (1984), "Cheap Agricultural Credit: Redistribution in Reverse", in Adams D. W (et. al) *Undermining Rural Development with Cheap Credit*, Westview Press, Boulder.
- Hoff K., Stiglitz J. E. (1993), "Imperfect Information and Rural Credit Markets: Puzzles and Policy Perspectives" in Hoff, Stiglitz and Braverman (eds), *The Economics of Rural Organisations: Theory, Practice and Policy*, New York: Oxford University Press.
- Hume D, Mosley P. (1996), *Finance Against Poverty*, London and New York: Routledge.
- Lakshman W. D. (1997), Introduction in Lakshman W.D. (ed), *Dilemmas of Development*, Sri Lanka Association of Economists, Colombo.
- McKinnon R. I. (1973), *Money and Capital in Economic Development*, Washington D.C.: The Brookings Institution.
- McKinnon Ronald I. (1989), "Financial Liberalisation and Economic Development. A Reassessment of interest rate Policies in Asia and Latin America", *Oxford Review of Economic Policy* Vol. 15 No. 4 Winter.
- Mellor J. W., Desai B. M. (1993), *Institutional Finance for Agricultural Development* International Food Policy Research Institute, Washington D.C.
- Senanayake S. M. P. (2000), *Impact Evaluation Study of ADB Assistance to Rural Credit in Sri Lanka. A Report submitted to Asian Development Bank*, Manila, The Philippines.
- Shaw, Edward S. (1973), *Financial Deepening in Economic Development*, New York: Oxford University Press.
- Von Pischke J. D., Adams D. W, Donald G. (1983), *Rural Financial Markets in Developing Countries: their Use and Abuse*, Baltimore: Johns Hopkins University Press.
-

Von Pischke J. D. (1978), "Towards an Operational Approach to Savings for Rural Development" in *Savings and Development*, Volume 2.

Wharton C. R. Jr. (1962) "Marketing, Merchandising and Money Lending" in *Malayan Economic Review*, Vol. 7.

World Bank (1995), Sri Lanka Poverty Assessment Report, No. 13431-CE, Washington D. C.

World Bank (1998), Sri Lanka Financial Sector Reforms, Washington D. C.

Abstract

This paper discusses some critical issues relating to the commercialisation of microfinance sector in Sri Lanka. It presents a theoretical background on Formal Microfinance institutions, the macro environment of Microfinance, demand for and supply of microfinance services and factors affecting the success of MFIs. The critical issues identified, relate to interest rates, the role of the government and the role of the donors. The paper emphasises the fact that commercialisation of microfinance sector has to be achieved through the commercialisation of deposit mobilisation and lending operations. This implies the marketisation of both these operations and increasing of efficiency and competitiveness.

While not implying acceptance, payment of fees, responsibility for loss or return, the Editor encourages the submission of manuscripts concerning money, financial intermediaries, financial techniques, and experiments in savings mobilization in developing countries. Manuscripts submitted for publication (two copies) should be in English, 4,000 - 10,000 words in length with a 200-400 word summary, typed on one side only of the sheet and double-spaced. Footnotes should be indicated by consecutive numbers throughout the paper. References in the text should be quoted by the author's last name and year of publication, e.g. Shaw (1973) or (Shaw, 1973). The title should be as compact as possible. Submission of the paper implies that it is an un-published work, not yet submitted for publication elsewhere. Sections and subsections of the paper should be indicated in cardinal numbers (e.g. 1.; 1.1; 1.2; etc.). Mathematical formulas should be numbered consecutively as [1], [2] etc. Figures should be limited in number and submitted in a form ready for the printer. References at the end should be listed alphabetically and quoted as follows:

- for articles: Galbis Vicente, "Monetary and Related Policies in Ministates", *Savings and Development* Vol. VIII, No. 4, 1984, pp.291-350;
- for books: McKinnon Ronald, *Money and Capital in Economic Development*, The Brookings Institution, Washington D.C., 1973. All communications should be sent to the Editor:

"GIORDANO DELL'AMORE" FOUNDATION

Via L. Manara, 15/17 - 20122 MILANO (Italy) - Tel. 02 5418441- Fax 02 55193005
e-mail: publications@fgda.org - <http://www.fgda.org>

Signed articles do not necessarily reflect the opinion of *Savings and Development* or of its Editor and no responsibility is accepted for them.

Bien que cela ne signifie pas l'acceptation ou le paiement de frais, et que toute responsabilité soit déclinée pour la perte ou la restitution, la Rédaction souhaite l'envoi de manuscrits concernant la monnaie, l'intermédiation et les techniques financières, et les essais pour la mobilisation de l'épargne dans les pays en voie de développement. Les articles (deux copies) devraient être rédigés en Anglais, d'une longueur de 4.000 à 10.000 mots avec un résumé de 200 - 400 mots. Toute communication devra être adressée à la Rédaction:

FONDAZIONE "GIORDANO DELL'AMORE"

Via L. Manara, 15/17 - 20122 MILANO (Italie) - Tel. 02 5418441- Fax 02 55193005
e-mail: publications@fgda.org - <http://www.fgda.org>

Les articles portant signature ne reflètent pas nécessairement l'opinion de *Savings and Development* ou bien de la Rédaction et toute responsabilité est déclinée par ceux-ci.

RASSEGNA TRIMESTRALE

REGISTRATA PRESSO IL TRIBUNALE DI MILANO AL N. 102 DEL 27.3.1974
DIREZIONE, REDAZIONE, AMMINISTRAZIONE
FONDAZIONE "GIORDANO DELL'AMORE" - VIA L. MANARA, 15/17 - 20122 MILANO
TEL. 02 5418441 - FAX 02 55193005

Direttore responsabile

FELICE TAMBUSI

Fotocomposizione

Edienne Industria Grafica - Bernareggio (Mi)

Stampa

Edienne Industria Grafica - Bernareggio (Mi)



ISSN 0393 - 4551