

# AN OVERVIEW OF THE MICRO FINANCE SECTOR IN SRI LANKA

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## 1. Introduction

In Sri Lanka micro finance is understood to be analogous with micro credit. On some occasions savings mobilisation is also considered as an essential sub component of micro finance. However, when broadly defined micro finance includes not only credit and savings but also credit insurance and money transfer facilities.

As in many other Less Developed Countries (LDC), in Sri Lanka too micro finance services (mostly credit and savings facilities) are made available through two main sources including formal and informal sectors. The formal sector includes Commercial Banks (both state owned and private), Regional Development Banks, Co-operatives, and other sources including various NGOs. The informal sector comprises friends and relations, landlords, traders, produce buyers, input suppliers, pawnbrokers and professional moneylenders. Within the informal sector not only is there a wide variety of lenders but also a variety of lending arrangements. Those include interest free loans mostly from friends and relatives, pawning of immovable property mostly gold and jewellery, mortgaging of assets mostly land, and cheettu [Rotating Savings and Credit Associations (ROSCAs)]. Leasing of land without any legal documents is also common in the rural sector. Under this arrangement the lessee has the user right of the land until the full amount of the loan is repaid. About 57% of the total number of loans and 33% of the volume of loans are still provided by these informal sources (CBSL: 1999). However this situation can be regarded as a big improvement compared with the year 1957 when 92% of the total number of borrowers were dependent upon this source of credit which were borrowed most of the time at exorbitantly high rates of interest. This paper however, concentrates on the micro finance services provided by the formal and semi-formal institutions.

The objectives of this paper includes a) to provide an overview of the history of formal sector micro finance services in the country, b) to examine the demand for and supply of micro finance, c) to identify the sources of funds of micro finance institutions, and their constraints and prospects, and d) to examine the role of government and other agencies in facilitating a viable and sustainable micro finance sector in Sri Lanka.

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## 2. Historical Background

The provision of micro credit to small farmers and self employed in rural areas dates back to 1911, when steps were taken to form co-operative credit societies in the island. The lending by government to these groups was done through the Local Loans and Development Fund (LLDF). Immediately after the Second World War provision of small credit was handled first by the Land Commissioner's Department and later by the Food Production Department. These departments could not handle the credit schemes effectively, and therefore the government in 1967 decided to channel small agricultural loans through a state Commercial bank, namely the Peoples Bank. This scheme was known as the New Agricultural Credit Scheme (NACS). During the initial years of the NACS, the quantum of loans granted and recovery of loans improved considerably but in the early 1970's they both dwindled. With the introduction of the NACS the involvement of Central Bank in providing agricultural credit can be seen. The lending rates were determined by the Central Bank. It lent funds at 1.5% to the Peoples Bank and that bank provided loans to Co-operative Societies at a rate of interest of 5% , to be on lent to farmers at 9%. The CB also provided refinance facilities and a credit guarantee to reimburse 75% of the defaults. Due to its small coverage and poor repayment rates the NACS was replaced in 1972 by a new scheme known as Comprehensive Rural Credit Scheme (CRCS). There were many new features in this scheme, but two of them are closely related to the subject of this paper. They were:

- a) To fulfil a whole range of credit needs of the farm household and not limited to crop production alone; and
- b) To relate the farmers' savings to their credit needs.

With the introduction of the CRCS, the bank of Ceylon (a State Commercial Bank), and the Hatton National Bank (a Private Commercial Bank) also emerged as lending banks.

However, the performance of CRCS was very similar to that of NACS in many respects. Large amounts of money were granted annually as loans but recovery rates were consistently poor, thus leading to a gradual decline in the number of

borrowers eligible for credit.

In 1977 a new government took office and steps were taken to grant loans to previous defaulters as well. Thus, in 1977/78 Maha season the amount of loans granted increased to Rs. 420 million but default rates increased to 81%. These high delinquency rates signalled the need to apply more stringent criteria in rural lending, and accordingly the 75% credit guarantee hitherto provided by the Central Bank was withdrawn and lending banks were instructed to grant loans only to non- defaulting farmers. Also the lending banks and co-operatives were granted permission to prosecute wilful defaulters. These measures caused a sharp decline in the quantum of loans granted and hence the government introduced a New Comprehensive Rural Credit Scheme (NCRCS) in 1986. This scheme too had some new features. Amongst them one was the introduction of a role-over refinance facility to the banks against wilful defaults and the other was the facilitation for submitting a single loan application for six successive seasons. This "arrangement simplified the application procedure while reducing the borrowers' (transaction) costs." (Attanayake: 1998 p. 8). In the initial years the coverage and the recovery rates improved. However the amount of loans granted and the recovery rates dwindled later. The total amount of loans granted in the 1997/98 cultivation year stood at Rs. 443 million and recovery rate was 65.3% (Central Bank: 1998)

The shortcomings of the state sponsored rural credit programmes in Sri Lanka are too numerous and have been discussed by many authors. (Central Bank: 1969, 1972, 1981; Carr and Wanasinghe: 1982; Fernando: 1979 & 1982; Senanayake: 1984; Fernando N.A.: 1987; Attanayake: 1998 and Vidanapathirana: 1989).

In summary, most of the government-sponsored schemes have failed to achieve the desired objectives. The fairly heavy dependence of borrowers on non-institutional sources still remains.

The establishment of Co-operative Rural Banks (CRBs) in 1964 marked the emergence of micro-finance services to those who were involved in self-employment activities outside agriculture in the country. Later in the 1970's National Youth Services Council (NYSCO), Women's Bureau, Central Bank of Sri Lanka, and Sarvodaya Movement (an NGO) started channelling micro credit facilities to

people who were involved or interested in commencing self-employment activities. The results of this supply driven approaches to micro credit were mixed. (Senanayake *et al.*, 1987). The successive governments promoted most of these credit schemes in order to curb rising levels of unemployment in the country.

The concerted attempts to achieve the objective of poverty alleviation through micro credit programmes commenced in 1990 with the active involvement of the Central Bank. The Canadian International Development Agency (CIDA), International Fund for Agricultural Development (IFAD) and the Sri Lanka government jointly funded this scheme. The aim of this project was to establish a cost effective "credit delivery system" for the alleviation of poverty among the poorest of the poor in four districts, namely, Matara, Galle, Puttalam, and Kandy. This project which has already come to an end relied mainly on the linkage banking system based on the strategy of group lending to achieve its objectives. The "Janasaviya", a major poverty alleviation programme launched to provide financial grants to the poorest of the poor in the country also had a credit component to persuade its beneficiaries to commence income generation activities. The Janasaviya Trust Fund (JTF) was established in 1991 to manage a credit fund for disbursing credit to Participating Credit Institutions (PCI) who at that time were the Peoples Bank, Bank of Ceylon (both are state commercial banks), Regional Rural Development Banks (RRDBs) and the Co-operative Rural Banks (CRBs). The JTF, which was later renamed as National Development Trust Fund (NDTF), continued to provide funds to PCIs and various other social service organisations such as Women's Development Federation at Hambantota. The funds provided to them are still in circulation as loans to the poor by these PCIs. The present government too is preparing various programmes to alleviate poverty and unemployment in the country. The most noteworthy programme amongst them is the Samurdhi Programme, which replaced the Janasaviya Programme in 1995. The details of the Samurdhi Banking Societies are given later in this paper.

### 3. The Demand Side of Micro Finance

The extent of demand for micro finance services when defined to include savings, credit, credit insurance and money transfer facilities etc. is a relatively unknown area in the financial system of the country. The existing MFI's have

been more effective in mobilising savings than providing credit, which implies that there is a huge demand for savings facilities within this sector. The fact that only about 43% of the loans are provided by the institutional sector, shows that there is a heavy demand for micro loans, which also is not tapped fully yet. Further a large volume of money transfers from relatives working outside their villages and abroad is taking place in this market.

The demand side of the micro finance sector consists of small farmers, fishermen, landless labourers, self employed, unemployed and under employed. Most of these categories belong to poor households in all the three sectors, namely rural urban and estate. Since poverty and unemployment is higher in rural areas these services are required more in rural areas although there is a need to strengthen such services to poor in urban and estate sectors as well.

According to the government's poverty alleviation programme, the country's poor are estimated at between 30% to 35% of the population. In 1994, it was found that between 700,000 and 850,000 of Sri Lanka's almost 1.2 million families were living below the poverty line. According to these estimates about 6.2 million people living in Sri Lanka can be categorised as poor. However World Bank (1995) found that poverty in Sri Lanka is declining and during 1990-1991 it was around 22.4% of the population. According to this estimate about 4 million people lived in poverty during the year 1998. Hence, there is a large market for mobilising small savings, providing micro credit and other financial services. The poor people save in a number of institutional sources as explained in Section 3. Among these the Banks (NSB, PB, BC, RRDB, HNB etc.) co-operatives (CRBS, TCCSS) and other semiformal institutions including NGOs are more prominent. They also save with the informal arrangements such as ROSCAS. At present most savings are kept in cash, but some people do save in kind as well (e.g. jewellery and gold).

### 4. Supply Side of Micro Finance

#### 4.1 Major Suppliers

The major suppliers of micro finance, largely micro-credit can be classified as

was done earlier, to two broad categories namely formal and informal sources. According to Consumer Finance and Socio-Economic Survey of the Central Bank, during 1996/97 informal sources accounted to roughly 57%. Compared with the figures given by Department of Census and Statistics which showed that in the year 1957, 92% of borrowers relied on informal credit sources this can be considered as a big improvement. This is a result of the expansion of formal institutions into the rural areas after 1970's. (Attanayake: 1998).

In the formal banking sector Commercial banks (both State and domestic private) are still a major source in channelling credit schemes implemented by the CBSL and other agencies to micro-enterprises and poor households. The Peoples Bank, Bank of Ceylon (both State Commercial Banks) and the Hatton National Bank (a domestic private bank) are in the forefront in implementing such schemes. The Surathura loan scheme inaugurated by the government in 1996 is a case in point. This program is aimed at providing credit facilities to the educated unemployed to undertake self-employment activities. The NCRCS is also implemented by these 3 banks to date, and two other private Commercial banks namely Commercial Bank and Seylan bank are also involved in the NCRCS. It is pertinent to note that the Hatton National Bank (HNB) has introduced a special micro-credit scheme on its own from 1989 targeting unemployed youth by the name *Gami Pubuduwa* Special Scheme (GPSS). However, micro-credit component of the total loans outstanding in these banks are estimated at less than 10% of their total loan portfolio.

The Regional Development Banks (RDBs) formerly known as Regional Rural Development Banks (RRDBs) are also a source of supply of micro finance. With the amalgamation of some of the district based RRDBs to provincial based RDBs the total number of RDB branches were reduced to 80, at the end of 1998. However, the remaining RRDBs also have 16 branches in rural areas. These RDBs have been issued licences to function as specialised banks under the banking Act (Central Bank: 1998).

Micro finance facilities are provided also by the Co-operative sector. Two types of institutions are involved in mobilisation of deposits and providing credit facilities namely Co-operative Rural Banks (CRBS) and Thrift and Credit Co-operative Societies (TCCS). The CRBs, which are affiliated to Multi-purpose Co-operative societies, numbered 1,264 at the end of 1997. CRBS have been more suc-

cessful in mobilising savings but their record is poor in lending to the rural people. The TCCS were first established under the Co-operative Societies Ordinance of 1911. However, most of these societies were inactive in the few decades after the World War II but the movement was revamped in 1970's and 1980's and are registered with the commissioner of Co-operative Development under the Co-operative Societies Act No.5 of 1972. It now serves a useful function in mobilising savings and extending micro loans to their members. This movement has three tiers, namely primary societies, district societies, and a federation at the National level. The TCCS is also involved as a linkage agency in various credit schemes implemented with the assistance of the donors. These include Integrated Rural Development Projects (IRDP), Small Farmers and Landless Credit Project (SFLC) and Janasaviya Trust Fund (JTF) loan scheme.

The other semi-formal suppliers of micro finance services include SEEDS, SBS, Isuru Development societies, Janashakthi Banking Societies and Tea Shakthi Movement.

#### 4.2 Deposits and Loans

Table 1 provides information on savings mobilised and loans granted by different micro finance institutions in the country in 1998. It can be seen that CRB's account for 44.5% of the value of savings in this sector but its share of the total value of loans granted worked out to 22.1%. Thus CRBs are more concerned with savings mobilisation rather than lending. The major shares of the loans also come under pawning of jewellery. The average size of a savings account was around Rs 2,358 as at December 1998 and they are deposited by about 4.8 million customers. As at end of 1998 number of loans of the CRBS stood at 1130,717 while the total value of loans was Rs. 6055 million. This means that the average size of a loan is around Rs. 5,000. These figures show that only about a half of the funds mobilised are granted as loans so far. Disaggregated data are not readily available to ascertain the number of females who have obtained loans from the CRBs.

The RDBs/RRDBs provide roughly about 52% of the loans granted to the rural sector by institutional sources according to the available statistics. They are also the second largest in terms of savings mobilisation. About one third of the

savings in the rural sector are placed with RDB/RRDBs. The value of total deposits was Rs. 11,234 million. Since the average size of a loan is about Rs. 6,000 the outreach of the RRDB's can be considered as more widely than that of the CRBS. As at December 1998, the total outstanding loans of the RDB/RRDBs stood at Rs. 9,194 million. This is because these institutions concentrate more on the underprivileged sections of the rural community and adopt innovative approaches in lending. Their involvement with SFLCS was also a contributory factor.

**Table 1: Deposits and Advances – Selected Rural Sector Institutions 1998 (Rs. Millions)**

	CRB		ASC Branches		RRDB		TCCS		SEEDS		JBS		SBS*		Sanasa Bank	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Total Savings	10,518	44.5	316	1.3	7,827	33.1	3,506	14.8	293	1.2	43	0.2	458	1.9	678	2.9
Savings	9,093		256		1,881		1,543		227		13		-		115	
Special Savings	-		29		111		762		85		15		194		1	
Fixed Deposits	2,445		32		5,835		443		-		1		-		410	
Shares	-		-		1		758		-		15		263		151	
Total Loans	3,907	22.1	170	1.0	9,194	51.9	1,868	10.5	1,352	7.6	58	0.3	827	4.7	339	1.9
Agriculture	341		16		4,158		232		319		29		57		10	
Animal Husbandry	149		1		155		96		48		13		1		1	
Fisheries	-		-		20		-		-		3		177		-	
Small industry	213		3		644		74		89		4		-		99	
Housing etc.	2,011		3		179		202		-		6		-		32	
Projects/Commerce	406		70		1,152		409		96		-		-		155	
Others	787		77		2,887		914		798		3		593		43	

\* Includes loans given under Samurthi Development Loans (Sasana) and Samurthi Entrepreneur's Loans (Savana)

Source: Central Bank of Sri Lanka: 1998

However, after the withdrawal of refinance facilities by the CBSL these institutions faced financial hardships and therefore had to undergo a restructuring process. In the restructuring process the ownership of RRDBs was diversified to enhance the capital base (in addition to the CBSL the two state commercial banks, the NSB and the ETF became major shareholders). Professionalism was introduced to the managerial cadres to improve the efficiency in operations. Although RDB/RRDBs provide services to many female clients, a sex-wise distribution of depositors and borrowers are not readily available.

The TCCS and Sanasa Development Bank (SDB) together accounts for about

18% of the savings of the rural financial institutions. The TCCSs are involved in other credit schemes implemented by CBSL, National Trust Fund Loan Scheme (NTFLS), Small Farmers and Landless Credit Scheme (SFLC), and in some Integrated Rural Development Projects such as Kegalle and Matara. Therefore, the share of TCCS and SDB accounts for about 12% of the total value of loans going into rural sector. They were also actively involved in disbursing loans under the GOSL Million Houses Programme, Janasaviya Trust Fund Loan Scheme, and later National Development Trust Fund Loan scheme. Over the past few years the amount of savings mobilised and loans granted show a progressive increase. After the establishment of the Sanasa Development Bank (SDB) several Loan Schemes targeting specific categories of borrowers were introduced in selected areas in the country. At the end of 1998, 1516 micro loans amounting to Rs. 21.2 million had been granted by the SDB under its micro credit schemes (CBSL: 1998). The value of loans given by the TCCS movement was Rs. 1868 million at the end of 1998. A very positive feature of the TCCS movement is that it maintains a very high loan recovery rate (estimated at 85%) due to effective loan monitoring and follow up action. Also, the TCCSs have very low administration costs. It has been found that in 1986 the administration costs have been around 2.8% of the loans outstanding (Vidanapathirana: 1987).

The average size of deposits is very small in the TCCS movement, i.e. around Rs. 5,000. Hence their outreach is very wide. There are 7816 primary societies with a membership of about 1 million and the number of District level TCCS Unions is 34. They cover Entire Island including North and East. Also more than half of the members are women, (53%), and around one third of the members come from poor families.

All the members have savings with the Primary TCCSs and almost all of them are borrowers as well. According to the officials of the Federation of Thrift and Credit Co-operative Societies, which is the Apex body of the TCCS movement, all credit granted by TCCS are micro credit and around 90% of the deposits are micro deposits. Also from all the deposits totalling Rs. 3,500 million 60% is deposited by women members. The FTCCs officials put the average size of a loan at Rs. 25,000. However, many primary societies operate with lower credit limits depending on the value of assets of those societies.

The interest rates of both savings and lending are decided by the primary

societies themselves, taking into consideration the interest rates of the other financial institutions such as commercial banks, RDB/RRDBs and the National Savings Bank (NSB). They also receive advice from FTCCs and DTCCSs in fixing interest rates. Therefore interest rates vary across societies and districts. The deposits rate in 1998 was around 16% on average and lending rate was around 18% Hence the average interest rate spread is only 2%.

A number of NGOs are also involved in micro finance services. Amongst them the Sarvodaya Economic Enterprises Development Services (SEEDs) can be considered as a major MFI. SEEDs was established in 1986, and at present there are about 2,000 primary societies with a total membership of around 150,000 households. In 1998 SEEDs was converted to a limited liability company thus enabling it to build up its own identity and cater to micro and small scale borrowers. SEEDs is also a participating lending institution under a number of donor funded credit schemes and has introduced a number of loan products targeted for rural poor. At the end of 1998, the total savings stood at Rs. 293 million and disbursed about 100,000 loans to a value of Rs. 1,352 million. The recovery rate of loans granted by SEEDs is very high, (90%). Among the members of the Sarvodaya societies about 70% are women and therefore this implies that most of the loans are also given to women. The SEEDs disburse about 8% of the total volume of credit granted to the rural sector.

The Janashakthi Bank Societies (JBSS) are an integral part of the services provided by a local NGO, whose activities are carried out in one district in the country, namely Hambantota. The Women's Development Federation (WDF) was started in 1989 involving women of low-income families after a socio-economic survey was carried out under the *Janasaviya* programme. This survey showed that the principal reason for poverty in the Hambantota district was the very poor health status, and therefore most of the incomes earned by poor families in the Hambantota district was spent on health care services. Thus it was realised that awareness and consciousness raising among the poor mothers had to be undertaken. As a result 124 mothers from 124 villages were given leadership training and 124 Women's Societies were formed. The presidents of these 124 societies met in December 1989 and formed the NGO called Women's Development Federation (WDF).

Following the Grameen Bank example the Groups of Five' were organised in

each village. In 1998 there were 5399 such groups. In a given village or hamlet there were about 10-12 groups and these groups have organised themselves into Women's Development Societies. There were 458 such societies in the same year. The Janashakthi Bank society is organised by the combination of Women's societies from 4-12 villages. Members need this consolidation for maintaining economic viability while promoting maximum participation. In 1998 there were 67 JBS with a membership of 26,519 women. It is compulsory for each member of a Bank Society to buy Rs. 500 worth of shares in the Bank. Members can pay Rs. 10 per week for 50 weeks and complete payment. In addition members can have individual or collective group savings in the Bank Societies. The main functions of the JBS are deposit mobilisation and lending. They provide loans for disasters, consumer needs, housing, etc. There is an insurance scheme associated with loan schemes as well. The Community development projects funded by various donors are implemented by the WDF through village WDSS.

According to the accounts of JBS only five are operating at a loss. The salaries of the employees of this loss making JBS are paid by the WDF. This programme is operating in 5 Divisional Secretariat Divisions in the Hambantota District. There are another 6 DS divisions in which JBSS are not functioning. If the services of JBSS are expanded to these divisions too, the membership can be increased to about 40,000. There are various kinds of savings schemes operated by JBSS. They include member savings, non-member savings, and children's savings (Kekulu Ginum ). In addition there are fixed deposits and group fund deposits. For the share capital of members, 8% interest is paid annually. Children's savings are mobilised at 12% while other saving are paid an interest rate of 10% p.a. As at end of the year 1998, total savings with JBS amounted to Rs. 43 million. The loans are given for various purposes, including agriculture, self employment, small business, distress, consumption, housing, fisheries, etc. The total amount of loans given was Rs. 58 million at the end of December 1998. This shows that the quantum of their loans exceed the total savings. This is facilitated due to funds received from other sources, particularly donors. The funds received from donor agencies are also on lent to the members. A grant received from Sri Lanka-Canada Development Fund by the WDF has been given as a loan to JBSS at 12% interest p.a. Banks on lend these funds to members at 36% interest p.a. The recovery rate of the loans given stands at 90% or above.

Samurdhi Bank Societies (SBS) were set-up as an integral part of the Samurdhi Movement (a poverty alleviation programme implemented by the government) under the Sri Lanka Samurdhi Authority Act in order to mobilise savings from and granting loans to members for undertaking income generation activities. As at end 1998 there were 639,106 members in the SBSS and all of them were poor by definition. Out of this, about 61% were women. As at the same date, 639,106 shares of SBS to the value of Rs. 263 million had been issued to the members. The SBS accept deposits from members and non-members both, and also group deposits (Self-Help Groups). The SBS members are formed into SHG's and the number of groups at the end of 1998 was 75,110. The value of total deposits as at the same date was Rs. 194 million and out of this Rs. 97 million (or about 49%) was in-group deposits. There are 3 types of member deposits, namely members' deposits, children's deposits and Diriya Matha (courageous mother) deposits. The average size of an individual deposit is about Rs. 500. However an average size of group deposits is Rs. 434,832. Average interest rate paid for deposits was 9.36%. SBSS disburse loans to members to engage in various incomes generating activities including agriculture, fisheries, small trading, consumption and distress relief purposes. The SBS's charge market rates range from 30-36% on these loans. Since about 60% of the total funds consist of membership shares the Weighted Average Costs of Funds (WACF) remained at 7.35% p.a. As at end 1998 the SBSS have disbursed 68,474 loans to their members to a value of Rs. 238 million. Thus the average loan size is about Rs. 3,471. The overall loan recovery rate of 96% is being maintained by the SBSS to date.

There are a number of other small-scale NGOs operating in the micro finance sector, either exclusively or as part of a wider programme aimed at alleviating poverty. Most of them are registered as NGO's either under section 21 of the Companies Ordinance of 1988 or registered with the Department of Social Services (DSS). These NGO's operate in all the three sectors in the economy, namely urban, rural and estate sectors. Some operate as providers of cheap credit on the basis of charity. Funds for these activities come from both local and foreign charitable organisations. Some other operates on highly commercial lines. One NGO operating in low-income settlements in Colombo (The Women's Bank), for example, pays an interest rate of 2% p.m. for savings and charge 4% p.m. on loans, but maintains a high repayment rate. This NGO deals exclusively with poor women and their experience shows that credit discipline is high among the poor.

A few commercial banks also provide micro finance services through direct lending and lending through conduits. Some of these schemes are described below. The Samurdhi movement has introduced a few other loan schemes namely SASANA (1997), SAVANA (1998), Samurdhi leasing programme, and Accelerated Samurdhi Animator Credit Programme, all of them are funded by the government and channelled through the two state commercial Banks, namely the Bank of Ceylon and Peoples Bank. The total number of loans granted through SASANA and SAVANA stood at 82,725 to the value of Rs. 589 million. The recovery rate of SASANA Scheme is about 66% while that of SAVANA is about 98%. Also about 18% of the borrowers have fully settled their loans. The interest charged is 10% p.a. Samurdhi leasing programme was introduced in 1998 by the government in order to provide financial facilities to micro enterprises to be carried out by educated unemployed youth. The government allocated Rs. 200 million for this programme which is being implemented through the Peoples Leasing Company Pvt. Limited (PLC), a subsidiary of the Peoples Bank. This scheme aimed at providing the animators and the beneficiaries of loans to purchase equipment and vehicles such as three-wheelers, two wheel tractors, water pumps, fax machines, video cameras, printing machines and public address systems etc. under a special leasing facility. Up to the end of 1998, 508 loans to the value of Rs. 122 million have been granted by the PLC. The recovery rate however has been estimated at 50%.

There is also an Accelerated Samurdhi Animator Credit Programme (ASACP) which is being implemented by the two state commercial banks in 34 Divisional Secretariat divisions in the country. Under this scheme 398 Samurdhi Animators have been appointed as Village level Money Lenders and an overdraft limit of Rs. 10,000 is granted for an Animator by the Banks. He or she then carries out lending activities among the target group. The maximum value of the loans is being worked out in the following manner:

- a) Rs. 1000/= per person for development activities
- b) Rs. 500/= per person for consumption/distress

The Banks charge 1.5% p.m. from the animator and 1% p.m. is deducted as loan risk fund. The rate charged from the borrower is 4.5% p.m. (or 54% p.a.). By end of 1998, a total of 94,197 loans worth Rs. 78 million had been granted

under this scheme. The recovery rate has been around 97.5%, and the surplus generated by the animators works out to more than Rs. 1 million.

Also, the Savings of Samurdhi families are accumulated in personal savings accounts with the two banks. By the end of 1998 the Bank of Ceylon and Peoples Bank had opened 1,905,108 compulsory savings deposits to the value of Rs. 5,052 million.

Another credit scheme implemented by the State Commercial Banks and one domestic private bank, namely Hatton National Bank, is known as Self-employment Promotion through Micro Enterprise Credit (SURATHURA Scheme). Under this scheme the three banks give loans to unemployed youth. This programme was introduced with refinance facilities from the government in September 1996, with an allocation of Rs. 350 million. The loans are collateral free and the interest rate was fixed at 10% p.a. The total loan allocation was fully utilised by 1997 and therefore this programme was extended in September 1997. However, this scheme is not specifically targeted for the poor unemployed alone, but most part of it has so far gone to them. The phase II had a target of 10,000 borrowers to a value of Rs. 500 million. However, in the phase II government withdrew its refinance facility and the 3 banks were expected to fund this scheme by themselves. Since the costs of funds and administration is too heavy the government agreed to pay an interest subsidy of 10 percentage points in respect of performing loans to the lending banks so that they can on-lend at 10% interest to the borrowers. During the phase II the 3 banks provided loans to 15,116 borrowers to a total value of Rs. 575 million. However the recovery rates were not very impressive; BC 65%, PB 67% and HNB 45%.

As mentioned earlier the Hatton National Bank (HNB) is a domestic private bank in Sri Lanka, whose involvement in rural development dates back to the year 1972. It started a new credit scheme named **Gami Pubuduwa** (village awakening) in 1989 in order to extend bank's assistance to the rural youth that are exploring self-employment activities. This scheme, which has been described as a linkage banking method, developed by the HNB in which the bank envisaged an extending micro finance services to a large number of borrowers through community based voluntary organisations through a process of social mobilisation. This scheme is funded by the HNB by utilising its own resources. It has been commended by local as well as international agencies alike as an innovative

scheme introduced for the benefit of poor unemployed using a more market-oriented approach by a private commercial Bank. The CBSL has described the HNB initiative as a "hybrid scheme" (CBSL: 1997).

This means that, while locally based community organisations are utilised for introducing potential borrowers, monitor loans take follow up action and help the bank to recover the loans on due dates. The scheme has on the other hand introduced a bare-foot banker cum advisor (**Gami Pubudu Upadesaka**) who is a permanent employee of the bank to work closely with the NGO's and the borrowers. At the end of 1998, about Rs. 876 million have been granted under the GPSS to about 27,500 small borrowers to engage in small and micro projects. The total outstanding loans at the end of 1998 numbered 10,957 to the value of 276 million. The cumulative recovery rate is estimated at 97.2%. As at the beginning of March 1999 there were 69,747 deposits mobilised through this scheme amounting to Rs. 746 million. 89 Gami Pubuduwa units and 104 Gami Pubuduwa Upadesaka's (GPUs) who carry out credit delivery and recovery activities affiliated to 74 branches of the HNB implement this scheme. With a view to reinforcing the operational aspect of GPSS, there are 16 cluster Leaders under whom the 89 GP units are formed.

The Isuru Project or the small Farmers and Landless Credit Project was introduced in 1989 by the CBSL with the assistance received from donors including International Fund for Agricultural Development (IFAD), the Canadian International Development Agency (CIDA), and from funds mobilised by GOSL through CBSL. This project was implemented in 4 districts in the country and was aimed at improving the economic conditions of rural poor within a framework of a free market economy. The Project envisaged adopting the credit plus approach in order to achieve its objectives, and consisted of the provision of a number of support services to back the provision of micro credit. It was commenced in 1989 and ended at the beginning of 1998. Several NGOs were engaged in this project as participating agencies to assist in social mobilisation and lending. Sanasa, Sarvodaya, the Women's Bureau and a few other NGO's participated in this project, and RRDB's functioned as the Banker to the project. The achievements over the project period 1989-97 are given in Table 2.



**Table 2: Isuru Project: Achievements 1989-97**

	Total
No of Villages Surveyed	2312
No of SHGS Formed	5580
No of Beneficiaries Covered	52,993
No of Woman Beneficiaries	35,711
Group Savings (Rs. Mn.)	61.4
Total Amount of loans (Rs. Mn)	415.76
Average size of a loan (Rs.)	9228
Cumulative Recovery Rate	94.0%

Source: CBSL, 1998

The supply of foreign funds ended in 1997 and the CBSL, with the concurrence of the donors, introduced a new scheme by recycling the recoveries of past loans and with their consent continued to operate the SFLCs from 1998. After the take over, the small SHGS were clustered into 168 Isuru Development Societies (IDS). These were registered with the Registrar of Companies under the society ordinance, as limited liability corporate bodies. Hence they are empowered to raise funds by issuing shares, and mobilise savings of the members. They also function as retail loan disbursement institutions by linking with a formal bank. As at end 1998 the number of IDSs in the 4 districts where it is implemented was 168 with a total membership of 6,174. The value of the share capital was Rs. 2.9 million and the value of total savings stood at Rs. 2.4 million. Rs. 6 million worth of loans was given to 13,170 members by the end of 1998.

##### 5. Sources of Funds for Micro Finance Institutions

Since 1996 the strategy of the government has been to gradually move away from a system of government funded credit schemes to a system of self funding credit schemes by banks for the benefit of rural populations. Both the NCRCS and the Surathura Phase II are now funded from the resources of the commercial banks. During 1998 the loans granted amounted to Rs.442 million in respect of 10,343 farmers. The total number of loans granted in 1996 were 30,816 and the value of loans stood at Rs. 586 million. However under the Surathura Phase II number of loans granted increased from 9,039 in Phase I to 15,116 loans in 1998. The value of loans also increased from Rs. 350 million to Rs. 575 million.

On both these schemes, the government provides an interest subsidy of 10 percentage points to enable the participating credit institutions to on lend at a rate of 12% under NCRCS and at 10% under Surathura Phase II. However, the GOSL still continues with revolving fund projects under SFLCS, and Kegalle District integrated rural development project.

The next source of funding consists of international agencies and schemes operated with the funds obtained from the Asian Development Bank (5 schemes), Japanese government (1 scheme), IFAD/ CIDA (2 schemes) and IFAD/ SIDA/ WFP (1 scheme). The funds provided by ADB alone for the 5 schemes amounts to about US \$70 million equivalent to Sri Lanka Rs. 5,000 million valued at the exchange rate in 1998. Some of these however are not specifically aimed at the strengthening of the micro finance activities.

Although the CRBs are functioning as conduits for some of the donor and government funded credit schemes they nevertheless have a large surplus of deposits but give very few loans on their own. The TCCS, SEEDS, JBS etc. also receive donor funds, but they have their own loan schemes, which are funded by internally generated resources. Disaggregated data are not available to ascertain the relative shares of each of these sources. However, the key informants expressed the view that donor and government funds account for about 70% of the micro loans disbursed in a given year. Also, the share of loans granted from own funds of the MFI's has been increasing gradually during the recent past.

AS mentioned earlier, the bilateral and multilateral donors and local and international NGO's provide the major share of funds for on lending by the MFIs. Some donors provide outright grants and/or concessional loans for this purpose, while others provide loan guarantees for their own funds used for lending to the rural poor. Several agencies also influence government policies on micro finance, in areas of charging market rates (or cost recovery) of interest, doing away with re-finance schemes, and eliminating interest subsidies. Some donors also provide grants for institutional capacity building and technical assistance to micro finance institutions.

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## 6. Lessons Learnt

One of the important lessons learnt from the activities of the MFI's in Sri Lanka is that adoption of market interest rates for savings as well as credit has helped in mobilising savings in a moderate scale, and expanding the borrower outreach. The MFI's who charge market rates of interest also have been successful in maintaining high loan recovery rates exceeding 90% (JBS, SBS, TCCSS are examples). This shows that clients are more concerned about the timeliness and ease with which they can obtain a loan, rather than obtaining cheap loans.

The supply driven approach to micro credit involves complex allocation procedures leading to various malpractices (credit rationing, obtaining credit by those who are not in the target group, misuse of credit etc.). Thus, what is found from the Sri Lankan experience is that the mandates and government directed credit programmes have been generally unsuccessful. It is also important to provide quality service to clients at lower costs. This does not mean that they should operate with a small margin, in fact to be sustainable they should charge interest rates that cover their costs. In certain donor funded schemes TCCS's in Sri Lanka earn only a 4% margin, but officials of TCCS are satisfied with this margin since their administrative and overhead costs are small. However, in the case of its own loan schemes, the TCCS is adopting a commercial approach to micro finance.

The Sri Lankan experience also shows the need for improved financial governance and policy environment, by extending financial liberalisation into the micro finance sector. This is because some of the concessionary credit schemes are dragging the banks and NGO's to increase the outreach, which ends up by giving loans mostly to not so poor. But the outreach should not be the sole criteria in evaluating the success of MFI's. The sustainability is also important in judging the success.

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## 7. Constraints and Prospects

### 7.1 Constraints

There are a number of constraints affecting the development of the micro finance sector in the country. Amongst these the first and the major constraint is the government interference. The government apparently does not permit the rural financial market to operate freely. Concessional loans and interest subsidies, loan forgiveness and political handouts, mandates and government directed programmes affect adversely the smooth functioning of the micro finance sector. The directed programmes and donor funded schemes at times distort the interest rate structure of the micro finance sector. For example various government and donor funded credit schemes have different rates of interest, and these are always lower than the interests charged by the MFI's in their own schemes.

The second constraint is the deficiencies in the legal and regulatory framework affecting the MFI's. For example the regulatory framework faced by the co-operative sector (TCCS and CRB's) is restrictive in many ways, and involves 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. The societies have 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 societies as deposit taking institutions, and prevents them from attracting deposits in a large scale. On the other hand some NGO MFI's operate without any legal backing (e.g. Samurdi Banking Societies). Also there are no regulations governing the acceptance of non-member deposits by various MFI's which are not banks. The third constraint is that the minimum capital requirement to establish a commercial bank or a licensed bank is still too high. Initial capital requirement for establishing a commercial Bank is Rs. 500 million, and for establishing a deposit taking and lending bank it is Rs. 250 million. 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 underdeveloped rural infrastructure is the fourth constraint faced by the micro finance sector in Sri Lanka. As an

example the recently passed RDB act contains development and environmental objectives which are usually outside the activities of the MFI's. However, it should be stressed that present government policies are progressing in the right direction, though gradually. (Refinance schemes are done away with, and self-funding credit schemes are promoted.)

The fifth constraint in the micro finance sector is the less developed infrastructure and poor performance of other facilities, such as marketing of clients' products, supply of material inputs, introduction of new technology, providing skills training, and extension services. Thus, many MFI's 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 the micro finance sector, and therefore other measures need to be adopted by the government and concerned parties to improve the performance in these areas, with the active participation of the private sector.

The sixth constraint is that some of the schemes (donor funded and government directed credit schemes) are not cost effective when administrative costs, inflation, opportunity costs of the funds, risk premium, etc. are taken into consideration. If such costs are higher than the on-lending rate or interest margin the MFI's activities are not sustainable. Thus, there is a need to device ways and means of reducing administrative costs' and thereby the transaction costs.

Lack of a proper information system is the seventh constraint faced by the micro finance sector. At present there is a tendency for the same person to borrow from multiple sources and end up with not repaying the loan. Lack of capacity in the self-help groups, primary MFI's Head offices of the MFI's and Central Bank, affect the performance of the sector adversely. Thus training facilities and technical assistance is required to help capacity building in these institutions.

#### 7.2 Prospects

Micro finance sector is a 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 clientele remain outside the purview of MFI's. Thus it is possible to serve this mass market, and increase the outreach by providing a quality service. There are a number of

sustainable or potentially sustainable MFI's 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.

#### 8. Government Policy

There are no specifically written down government policies aimed at the micro finance sector. However, the commitment of the government to follow open economic policies with a 'human face' indicates that the MFI sector is expected to adopt a commercial approach to lending and deposit mobilisation. However there are no rules or regulations that prevent some NGO's in adopting a charitable approach to lending to the poor.

However, there is some macro economic policies, which exert influence on the micro finance sector in the country. Major concern here is on the monetary policy, which has a bearing on deposit and lending rates. From 1997 the CBSL is attempting to maintain financial market stability and price stability. The relaxation of policy in 1997 included the reduction of Statutory Reserve Requirements (SRR) on domestic currency from 15% to 12%. The SRR on foreign currency deposits lent domestically also was reduced from 15 to 12%. Another initiative was that the SRR on foreign currency deposits placed abroad was brought down to zero level from 5%. These measures were aimed at increasing the quantum of credit granted to the private sector by the commercial banks through reduced lending rates.

Another policy adopted by the CBSL in recent years was the policy of not granting refinance under the Medium and Long term Credit facility or any other short-term facility. This measure was introduced in 1994 with the termination of refinance facility under the NCRCS. The CBSL strategy was to substitute commercial bank funding for cheaper CBSL refinance. The primary aim of introducing these measures was to restrain the growth of reserve money, which would lead to the build up of inflationary pressure in the economy. However, under the NCRCS the government pays an interest subsidy of 10% to the lending banks,

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thus enabling the banks to on-lend at 12% interest to the farmers.

The interest rate policy of the government is to maintain deposit rates at levels, which would bring down the cost of funds to the banks, while at the same time to maintain real positive rates in order to give a fair return to the deposit holders of the banks. As a result of the reduction of treasury bill rates and because of the availability of liquid funds in the market (as a result of the reduction of the SRR), commercial bank deposit rates have come down by 4-7 percentage points after 1996. The Weighted Average Deposit rate decreased from 14% in December 1996 to 10.7% in December 1998. However the inflation rate in 1998 was 9.4%. This is suggestive of a slightly positive real interest rate of the banks. The lending rate policy of the CBSL on the other hand is to keep them at a sufficiently low level in order to promote private sector investments in the economy. This also requires the maintaining of gross interest rate spreads of the banks at reasonable levels by improving the productivity and the efficiency of the banking sector.

However most non-bank MFI's decide their own deposit and lending rates but the larger MFI's like CRBs and TCCs are guided by the rates of commercial banks, the NSB and SMIB. Some NGO type MFI's operate with higher deposit and lending rates varying from 2-5% per month. The CBSL has not imposed any ceilings on these interest rates because the government does not control micro finance interest rates.

Another aspect of the government policy on micro credit is the "relief" provided by the government to defaulting borrowers.

In October 1994, the government announced that it was offering a relief facility to farmers who had failed to repay their past loans. Under this scheme defaulting farmers were permitted to pay 25% of the principal sum of the overdue loan, and get eligible for a fresh loan. Once this is paid the balance sum of 75% plus the accumulated interest was to be written off by banks in a joint programme with the CBSL and the government. At the end of 1998 a cumulative number of 32,359 farmers had benefited from this relief scheme. Apart from these interventions there is no national policy on micro finance sector at present. The financial reform and liberalisation programmes are needed to be introduced in to this sector as well.

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## 9. Conclusions

Most of the small farmers, landless, fishermen, self-employed and unemployed still depend largely on informal sources for their credit needs. There are signs of improvement in this situation due to the expansion of existing formal, co-operative and semi-formal institutions to the rural areas and the emergence of a large number of alternative financial intermediaries such as NGO's. The economic growth experiencing in the country has brought down the number of people who are absolutely poor.

However, the micro finance sector in Sri Lanka suffers from inadequate capacity of the MFI's, lack of proper financial infrastructure, and defects in the regulatory framework among other things.

Support from various donors is needed in improving the performance of this sector on a market based (or commercial) approach.

The critical areas of support could be in the areas of training and technical assistance support for regulatory and supervisory systems development, support for changing legal framework, financial infrastructure development and Management Information systems development and policy support, rather than providing funds for on-lending purposes.

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### Abstract

*This paper provides an overview of the history of formal sector micro finance services, and examines the demand for and supply of micro finance in Sri Lanka. It also identifies the sources of funds of Micro Finance Institutions (MFI), examines the constraints and prospects of such institutions and reviews the role of government and other agencies in facilitating a viable and sustainable micro finance sector in the country. The paper shows that micro finance sector in Sri Lanka suffers from inadequate capacity of MFI's, lack of proper financial structure and the defects of the regulatory framework among other things. Support is needed in the areas of training and technical assistance, regulatory and supervisory system development, modification of legal framework, development of financial infrastructure and above all policy support rather than providing funds for on lending purposes.*

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