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SUSTAINABILITY AND OUTREACH ASSESSMENT OF MICRO FINANCE IN SRI LANKA

CASES OF SARVODAYA ECONOMIC ENTERPRISE DEVELOPMENT
SERVICES LTD AND GAMI PUBUDUWA

Author: Chamila Herath

Supervisor: Alia Ahmad

Abstract

Asymmetric information and risk are two main problems in credit markets. These problems are even higher in developing credit markets. Formal financial sectors in developing countries are still growing and are reluctant to provide credit to poor. Micro credit is considered as an effective strategy to overcome this problem and to give poor opportunities to access financial services. Therefore there is a strong need for continuous operation of micro- credit programs. However, many micro credit programs face difficulties in achieving main goals of sustainability and outreach. This study aimed at assessing these two main aspects of success of micro credit programs. A comparison was done between two micro credit programs: SEEDS, Sarvodaya Economic Enterprise Development Services Ltd, and Gami Pubuduwa, a program operated by Hatton National Bank in Sri Lanka. The results showed the program operated by the private commercial bank was achieving success faster than the program by community based organization in relation to sustainability indicator, but SEEDS was in ahead in reference to outreach measures. Findings evidenced the importance of profit orientation and targeting “economically active poor” for the success of micro credit programs. The study was based on primary and secondary data collected during two weeks period of field work activities in Sri Lanka.

Keywords: Micro credit, Outreach, Sustainability, SEEDS, HNB, Gami Pubuduwa.

Words 10 281

List of Abbreviations

BD	Banking Division
Bn	Billion
ESD	Enterprise Services Division
GNI	Gross National Income
GP	Gami Pubuduwa
HNB	Hatton National Bank
LKR	Sri Lankan Rupee
LTTE	Liberation Tigers for Tamil Elam
MFI	Micro Finance Institutions
MIS	Management Information Systems
Mn.	Million
SEEDS	Sarvodaya Economic Enterprise Development Services Ltd
SL	Sri Lanka

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Forward

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Chamila Herath

Sustainability and Outreach Assessment of Micro Finance in Sri Lanka: Cases of SEEDS and GP

1. Introduction

Interest in microfinance as an instrument of poverty reduction is being gained much attention. This can be critical element of an effective poverty reduction strategy. Improved access to finance by poor enable them to enjoy better quality of life by regulating their consumptions, building assets, enhancing their income earning capacities, regularly sending their children school. Over one fourth of total population in the world presently lives income below one US\$ a day (UNDP, 2006). Provision of micro credit to these poor people has been shown as one of the best alternatives to reduce poverty and increase quality of poor all over the world, especially in developing countries.

Democratic Socialist Republic of Sri Lanka is situated in the South of India and has population of 19 million, approximately. The country has achieved the highest social development indicators in the region, South Asian, and these are particularly due to the government's prime spending in the social sector: education, gender, safe water and sanitation (Duflors Erik et al., 2006). Despite these developments the country is having a civil conflict, between the government and Tamil guerrilla organization, LTTE, for more than two decades. In 2004 the tsunami, largest natural disaster ever met, caused huge damages. These may particularly have contributed to government's difficulty to reduce poverty and inequality. More than 70 percent of the population lives in rural areas where livelihood is based mostly on agricultural activities. Approximately 22.7 percent of the total population lives below the national poverty line of LKR 1423 per month according to year 2002 estimation (Central Bank Annual Report, 2005). However the current national poverty line is LKR 2254 as of the end of March 2007, according to Department of Census and Statistics Sri Lanka. These Considerable proportion of people living below the national poverty line are considered as *un-bankable* and do not always have access to banking services.

1.1. Background

There are evidences to prove that access to financial services effectuates economic prosperity at all levels- from individual level to national economic level- more specifically, provision of financial services to poorer segment of the population is an effective strategy for development (Claessens, 2005). Providing opportunities for access to financial services to the poor raises economic wellbeing and social development alike and on the other hand one could argue that micro credit institutions all

over the world have not been able to produce very significant impact, except in certain cases, for instance, in Grameen Bank in Bangladesh, on poverty-stricken section of the population. Neither the economic impact of a micro credit program on poor may not be rigorously observed in a shorter time period nor can its impact on social development of poor be recognized, but there is yet an improvement of situation of the needy that cannot be observed in shorter time gap (Honoham, Patrik, 2004)

Provision of financial services to poor can thus be regarded as one of the main strategies of development efforts, but formal financial sector institutions are reluctant to supply financial services to poor considering higher costs and risk involved when transacting with the destitute. There is also less room for use of mechanisms such as collateral and interest rate to lessen the problems arising from asymmetric information- adverse selection and moral hazard- among the poor. Therefore there is a higher possibility that the needy to be kept away from the formal credit market.

Micro credit programs primarily based on the group lending approach are deemed as an effective strategy to lessen the problems of asymmetric information that typically exists in credit markets. However, these credit programs are operating with many problems, and difficulties and only a handful of organizations are showing signs of success towards goals of self – sustainability and outreach targets, but achieving sustainability and outreach goals are fundamentals that ensure the long run provision of services to poor to provide them the way out of poverty.

Moreover, there is a recent tendency that commercial banks entering in to micro microfinance industry as an initiation of scaling down their operation to “bottom line” as it is, for instance, in Latin America, Indonesia (Bank Rakyat Indonesia), Brazil, and Sri Lanka. Nonetheless, trying to serve the bottom line, poorer section, by commercial banks is still at an early stage of experimentation.

1.2. Aim of the Study

There are few studies focusing on micro finance institutions in Sri Lanka: Dias(2001), Hewavitharana (undated), Mithrarathna(2003)(ctd in Clombage, 2004).An impact assessment survey conducted by Open University of Sri Lanka in collaboration with Lund University, Sweden(Colombage, 2004). In 2005 United States Agency for International Development, USAID, measured the profitability of the micro finance unit related Hatton National Bank of Sri Lanka. In a broader study Duflos, Ledgerwood,

Helms & Moyart (2006) ascertain the different factors affecting the micro finance industry in Sri Lanka and assign the identified factors under three levels of the financial system- micro, meso, and macro.

Charitonenko and Silva in their study (2002) have found that micro finance institutions in Sri Lanka needed to be operated on commercial basis as many of them have reached sufficient level of sustainability for commercialization and have further provided some recommendations to go along with the commercial continuum. On the contrary, Duflo et al.(2006) in the study on variables affecting micro finance industry in Sri Lanka show that many of micro finance institutions are lacking self-sustaining capacities, specially microfinance programs operated by non- governmental organizations, NGOs. Joselito et al. (1997) assess the viability of micro credit program in a traditional banking environment reviewing Gami Pubuduwa-Peoples Reawakening. However, current studies have not sufficiently addressed outreach and self -sustainability of micro credit programs; and there are no studies available comparing outreach and sustainability of the two types of micro credit programs that operate under different legal environments, therefore, this study is aimed at filling this lacuna.

The objectives of the study are:

1. Study operational sustainability and outreach of Sarvodaya Economic Enterprise Development Services (Guarantee Limited)-SEEDS- and Gami Pubuduwa – Peoples Awakening- program by Hatton National Bank of Sri Lanka.
2. Do a comparative analysis between SEEDS and Gami Pubuduwa based on outreach and operational sustainability indicators and to identify what are the pros and cons of each type on the basis of sustainability and outreach indicators.
3. To assess which type of micro credit program is more effective in reaching typical target group of micro credit program.
4. To find out what factor are needed for consideration for the development of micro credit organizations in Sri Lanka.

1.3. Methodology and Approach

As an attempt to laying down the foundation for the study, first, a theoretical frame work based on previous studies conducted on financial markets in the absence of perfect information is presented. Secondly, theory on micro- credit institutions is introduced as an introduction to the main topic. And finally, a frame work based on selected indicators of self sustainability and outreach is formulated for the purpose of analyzing data of the two cases. The study is based on the preliminary and secondary data collected during two weeks of field work in Sri Lanka. During this time Interviews were conducted based on semi and unstructured questionnaire to acquire quantitative as well as qualitative information and the questionnaire was directed at officials at different levels. Secondary data is used most part for analyzing the performance of these organizations.

Further, empirical materials for the two cases were gathered during several visits to head offices of two institutions between November and December in 2006 in Colombo, capital of Sri Lanka. However, existing data at the commercial bank on their micro credit program isolated from the main banking activity was limited; therefore, some of the information was collected at interviews at the bank's head office in Colombo. SEEDS, the community based institution, was quite generous to provide secondary data in form of annual ,quarterly reports and other documents prepared for internal management purposes.

1.4. Reliability and Validity

It is always a problem of reliability and validity when using the data especially when they are self reported. To ensure reliability and validity of self reported data, efforts were taken to obtain the same data at least from two different persons within same organization during visits and also to compare the findings with results of other studies.

1.5. Limitations

The study was conducted during a two weeks period which is a very short period for an extensive data collection. The limited time period made it impossible to cover branch level study which could have

helped to do an extensive comparison. It would have been ideal if a survey on income level of individual client was done for real impact assessment and client characteristics. Also, some form of communication was done with field officers of the two institutions. Unfortunately, this was beyond the scope of the study.

1.6. Ethical Consideration

Care was taken to ensure obtain consent before recording the names in the paper. No name of interviewee has been mentioned without their consent and the study ensures the confidentiality of some personal views expressed at communication visits.

1.7. Disposition

Chapter two presents the theoretical framework and conceptual framework for the study. The third chapter presents two micro finance institutions that have been studied for the analysis in Sri Lanka. Chapter 4 analysis the data based on the frame work developed and presented in chapter 3. The last chapter presents the summary and the conclusion.

2. Theoretical Framework

2.1. Finance and credit Market

The growth and development of an economy depend upon investments. Finance needed for these investments is provided through financial intermediation; that is transferring of resources from savers to investors. This function of intermediation is carried out by capital markets and commercial banks in an economy. An effectiveness and efficiency of these services provided by a financial system depend on the level of development of that system; lower development of a financial system increases cost of transaction.

Finance, economic growth and development

Finance is considered as a dynamic of economic growth and is also regarded as an important determinant of poverty and income distribution, and social- sector development in a country. Lack of access to finance is thus a barrier for growth at any level: macro-economic level, small or large scale enterprises, household, or individual level. At the household level access to finance will help to have evenly spread income, insure against risk, and give more opportunity for investments (Claessens.S, 2005). This accessibility is particularly more useful for the poor and is vital to increase their income, reduce poverty, reduce income inequalities, and enhance their social development, education, health, and access to quality water and sanitation.

Theoretical and empirical studies show that there is a positive relationship between development of financial intermediaries and income equality in an economy. Clark, Xu, & Zou (2003), show that their findings are consistent with the above relationship. Moreover, Galar & Zeira (1993), Banerjee & Newman (1993) conducted similar studies where they have developed theoretical models in this regard, and draw similar conclusions.

The overall development of financial intermediary of a country reduces the poverty and income inequality, and also has a positive impact on social indicators such as children's school enrollment, child mortality and reduces child labor (Zaman, H, 2004). These positive impacts may not perhaps appear as direct improvements of income, accumulation of assets in a shorter time frame. Micro

finance institutions play important role facilitating these financial services especially micro credit to improve economic and social standing of a country.

Credit market, information and transaction cost

Capital markets engage in exchange of shares and bonds with maturity of more than two years. It includes primary and secondary market; and in a primary market initial shares are issued whereas in a secondary market existing shares and bonds are traded. The credit market consists of financial intermediaries such as banks, financial companies and insurance companies, banks, and other type of financial institutions. These institutions intermediate transferring resources from savers to users-investors. Interest is the price of credit and is determined by supply and demand forces in the credit market. Theoretically, interest rate should be high enough for savers to postpone the consumption and low enough for investors to borrow; assuming that investors have best investment opportunities to earn enough profits to cover higher interest rate costs. Thus, credits are efficiently allocated making both the parties- savers and investors- better off without making any of the parties worse off. This is called achieving "Pareto efficiency" in the credit market. However, credit markets are characterized by risk and imperfect and asymmetric information that directs to credit markets' failure that is inability of the market forces to achieve "Pareto efficiency". Asymmetric information is defined as "when two parties enter a contract, one may have information that - if it were known to the other party- change the nature of the contract" and is highly prevalent in credit markets than any other market (Calomiris & Himmelberg,1990:140).

Transactional cost

Transaction cost emerges whenever goods and services are economically exchanged. Accordingly, this cost of transaction includes values of goods and services that are exchanged, cost of searching those goods and services, finding information, policing and enforcement (North.D.C, 1990).Thus, payments for acquiring information will be a vital part of transaction cost and in some markets acquiring information is very costly and/or even unattainable. The situations of high cost and impossibility of acquiring information would lead to imperfect and asymmetric information and these could sometimes direct to change the "nature" of equilibrium of markets (Varian.H, 1999). Credit rationing in credit markets is an example for such a situation where equilibrium is not determined by the market forces

due to imperfect information. In credit rationing instead of letting market forces to determine equilibrium, banks themselves engage in distributing credits changing the nature of equilibrium in the market (Stilitz.E.J& Weiss A, 1981).

Asymmetric information and adverse selection

Asymmetric information" refers to situations where the type of the agents is not observable so that one side of the market has to guess the nature or the "quality" of a product based on the behavior of the other side of the market" (Varian, 1999). In a credit market lender may not have the same information about particular borrower than that borrower himself possesses. Thus, symmetrical nature of information possession-between a borrower and a lender- leads to the problem of adverse selection as a result of being it difficult to assess the exact nature of the risk profile of a potential borrower to price the risk. If the interest rate does not correspond with the particular borrower's risk profile then adverse selection arises. If the prevailing interest rate is a higher rate for low risky borrowers then the borrowers with projects of high probability of success will not tend to borrow because if projects became successful a large proportion of the profit could be paid as interest expenses reducing his share of profit. Moreover, when the lenders do not have perfect information to assess the exact quality of the borrower, banks would decide to lend lower amount to a low risk borrower and it will reduce the profit for the bank (Besley T., 1994).There is also a possibility that high risk projects tend to be attracted, because lender will not be able to assess the real risk features due to imperfect information and this will result risky loan portfolio for the bank.

Screening

Screening is a strategy used by lenders to avoid the complications of adverse selection. In the process of screening the agent- the lender- who has less information about the borrower tries to get as much information as possible. Interest rate and collateral are two devices used to screen out prospective borrowers (Stiglitz E.J & Weiss .A, 1981, 393).

However, in practice banks use "credit rationing" to avoid to "destruction" in the credit market resulting from being unable to observe the quality of borrowers, but credit rationing leads too little

trade in the credit market. These would result in lower investments made in the economy, slower growth, eventually high social cost (Varian, 1999, 645)

Moral hazard

Moral hazard “refers to situations where one side of the market cannot observe the *actions* of the other side” (Varian, 1999). This can also be defined as “the incentive by someone (an agent) who holds an asset belonging to another person (the principal) to endanger the value of that asset” because the agent bears less than the full consequence of any loss (Chaves & Gonzalez-Vega, 1994). Moral Hazard is the second model of problems that arises from asymmetric information. This occurs when agents –the borrowers– would not act in the best interest of the principals –lenders– instead act the other way that causes loss to the principals when a loan contract is entered into. There is always a possibility that the selected borrowers would act other way than as in the contract that causes default of payment. This adversely affects the loan portfolio of the bank resulting of a default of a borrowed amount and is a high cost to the lender which immensely increase total transaction cost. Moral hazard is a problem related to monitoring, therefore, if monitoring is expensive, banks will try to offer smaller loans. Thus, offering smaller loans to minimize cost of moral hazard may result in less investment in the economy and eventually reduce economic growth.

Mechanisms to minimize adverse effects of asymmetric information

Problems related with adverse selection and moral hazards are solved by direct and indirect mechanisms: monitoring, interest rate and collateral. Interest rate is used as a screening device; Banks charge interest rate high enough to cover both risk and return, but this may lead to reduce profitability of banks in two different ways. First, high interest rate means higher cost to the borrowers because a large proportion of the borrower's profit of the project goes to the bank as interest expenses. Hence, higher cost of interest rate discourages low risk borrowers invest in projects with borrowed funds. Secondly, high interest rates encourage investments in high risk projects; at higher interest rates it will be profitable only projects of higher rates of return, but the risk for bad debt is higher for high return project. Thus, borrowers with high risk projects tend to borrow at higher interest rates which will

reduce the quality of the loan portfolio. Therefore, credits are granted at an interest rate low enough to attract low -risk borrowers and borrowers with secure collateral (Stiglits & Weiss A., 1981 & 1983).

Collateral

Collateralization is one method of solving the problems of adverse selection and moral hazard. Fixed assets such as lands, buildings, machinery, and property are the most common form of collateral. Lender will use collateral as a mechanism of differentiating lower and higher riskiness and will be signaled by borrowers with lower probability of default accepting collateral requirements. Accordingly, collateral which will probably take the form of fixed asset in formal credit market is a way of signaling which will also help “self -selection” by lenders (Bester.H, 1987). Further, collateral works as “an incentive mechanism” for borrowers where they will invest in lower risk projects. However, selection of lower risk investments by borrowers will depend on the value of the collateral. To overcome this problem lenders tend to accept collateral higher than value of the loan, as motivation for the borrower to adhere to loan agreement. Moreover, collateral will solve the problem of repayment where a lender can claim an asset which is furnished as the security for a loan, but in order to recover the lent amount assets should easily be able to value and to sell at least to recover the face value of a loan. Generally, the problem with the poor is that either they do not have valuable assets or have some assets that may not be accepted as collateral by formal institutions because another major problem in most developing countries -especially among the lower-income group- is that they lack well codified assets which would limits the usefulness of asset as collateral. Assets with poorly defined property rights will not easily be conveyed to another kind of asset- cash- in case of default. Thus, lack assets and/or assets of weakly codified property rights will prevent poor accessing credits from formal credit markets (Besley .T, 1994).

Credit market in developing countries

Credit markets in developing countries are mostly at a stage of growing. Also, other complementary institutions such as credit information bureau that supports to reduce the cost of asymmetric information presumably cater services only for formal institutions at a higher cost and infrastructures

which will specifically enhance the efficient and effectiveness of credit markets such as communication, information technology are still developing. Therefore, the problems of asymmetric information in these markets are higher than in the developed markets.

Besides less developed infrastructure majority of the population in those countries live in poverty and are illiterate, and either they do not have or lack assets to produce as collateral when money is borrowed. These people may have irregular income and even if they have a property the right to the property may have weakly defined, and they live in rural, remote areas there probably lack the access to efficient communication methods. Therefore, formal financial institutions such as banks and other financial institutions are reluctant to provide financial services to poor people because lending money to poor involves high uncertainty, risk, and costs, and they, poor, need small amounts as loans which also increase administrative cost (Hoff, K & Stiglitz, 1990). As an alternative method to reduce these uncertainties, risks and costs, and also to provide them the access to credits in the institutionalized sector, micro credit programs which employ “Grameen model” of group lending programs attract poor using other strategies to overcome problems associated with information asymmetries that typically exists in the rural credit market.

2.2. Micro finance theory

Micro finance can be defined the provision of banking services to lower income people, especially the poor and the very poor (Duflos Erik et al, 2006). Accordingly ,the focus here is not just institutions that provide small scale loans with “credit plus services“, and the word “micro finance” is used more broader sense. Hence, micro finance services include:

- small loans
- informal appraisal of borrowers and investments
- collateral substitutes
- access to repeat and larger loans depending on the repayment performance
- steam line loan disbursement and monitoring
- secure savings products (Ledgerwood, Joanna ,2000).

Micro Credit, on the other hand, refers to a small amount of money lent to a client by an institution, and the average micro credit amount tends to be below per-capita national income. Thus it should be differentiated micro credit from micro finance; micro finance includes all financial services *including micro credit*.

The providers of these services can be by a commercial banks, (private or government), licensed specialized banks, cooperative rural banks, finance companies, registered companies, cooperatives and NGOs. Although micro finance services target poorer section of the society, these services are not provided to "ultra poor", or “ economically inactive” sections of societies because it is too costly to serve this group, therefore, in many developing countries they are supported by governments.

The above mentioned financial services may be provided to different extent, depending on the missions of institutions. Those services can be categorized under four main headings: Financial Intermediation, Social intermediation, Enterprises development services, and Social services. MFIs use different approaches depending on extent that they provide those main categories of services.

Financial school of thought or minimalist approach

The main idea of this thought is that viability and sustainability of MFIs are depended upon effective and efficient delivery of financial services. Their main aim is to bridge the "missing gap" that resulted from credit market failure due to high transaction cost. Accordingly, they bank the “un-bankable poor”, may be in rural or remote areas. Self -sustainability of MFIs is the only means to serve the clients demand. According to David Hulme & Paul Mosley (2005), MFIs must operate efficiently enough that reasonable, affordable and competitive interest rates can be charged to cover the cost. Hence, these organization to be viable and sustainable, they must cover the cost enforcing interest rates to cover the cost.

Poverty lending thought or integrated approach

The main goal of MFIs is to reduce the poverty and, thereby, accelerate economic growth and social development; however, self sustainability is not disregarded although loans are granted at an interest rate below the market rate. There are few means of reaching the poor; individual lending approach,

Grameen bank solidarity group lending, Latin American solidarity group lending, village banking and self-reliant village banks (Lerdgerwood, 2000)

Challenges faced by micro credit institutions

Micro credit institutions face several challenges in achieving goals. Difficulty in achieving higher clients outreach, achieving financial viability, costs minimization and increasing revenue, difficulty of charging higher interest rate to cover cost, higher dependency on donor funds, low repayment, low business volumes, high political involvement in form of governments' inefficient subsidy programs, and lack of framework for supervision and regulations are several difficulties faced by micro credit institutions (Raviz, M.R, 1998).

Duflos.E et al., 2006) identify the problems faced by MF sector in Sri Lanka at three different levels: Micro level, meso, and macro level. Further, the common features characterizing the micro credit sector are: Lack of range of services provided by these organizations, lack of transparency, lack of proper supervisory and regulatory framework, difficulty to achieve balance between sustainability and outreach, high involvement by governments in the MF sector, government use as public finance source, lack of trained staff, and specialization in financial services, lack of cost consciousness, high default rates, and poor outreach and impact.

2.3. Sustainability and Outreach

Sustainability and outreach are two long term goals that micro credit institutions eventually strive to achieve (Joanna, Ledgerwood, 2000, 34). Sustainability can be defined as “generating enough revenue to cover the costs of providing financial services” (ibid, 2000). Achievement of sustainability has been one of the important goals of micro credit organizations because reduction of poverty can only be achieved if these institutions generate excess earning over the total cost in the long run. There are two means of achieving sustainability: either by minimizing costs or by increasing revenue from credit activities. First, minimizing major cost components; operating costs or administration costs, financing costs and provisions for loans losses can be identified as three major cost components. Higher rate of loan recovery and interest rate are also major determinants of sustainability. Raising interest rate to a level high enough to cover total cost is considered as the other method of achieving this objective (Cull,R, Demirguc-Kunt, & Morduch J, 2006). Three major parts of sustainability include operational, financial, and organizational sustainability (Cull, R., Demirguc-Kunt, & Morduch J, 2006). Financial

sustainability is the viability of providing financial services to the poor in the long term. Operational self sustainability is the ability to cover operational costs with its earned income. Organizational sustainability is depended upon factors such as organizational processes, systems, governance, staffing, proper legal system, frame work for reporting (Ajari, Nair, 2005).

Sustainability

Operational Self Sufficiency

Operational Self sufficiency ratio is an indication of an institution's ability to generate revenue through its usual operating activities to cover operating expenses: administrative costs, bad debts (loan loss provisions). There are several ratios that indicate an organization's ability to cover operating cost (Ledgerwood, 2000)

$$\text{Operational Self - Sufficiency} = \frac{\text{Operating (Credit) Income}}{\text{Operating Expenses (Credit) + Financing Cost}}$$

Outreach

Outreach is a common indicator in measuring the success of a credit program and is measured in terms of areas covered, number of membership, volume of lending, and levels of savings. This is one of the most important aspects of micro credit programs and it shows if these institutions are achieving the goals that they are started for (Ledgerwood, 2000).

Table 1 Framework for the assessment of outreach based on CGAP 1997 Yron, Benjamin and Piprek.

Credit institution:	Period					
	2001	2002	2003	2004	2005	2006
Total outstanding balance Mn.						
- Rural credit						
- GP						
Number of currently active Borrowers						
Loans growth in						
- Mn.						
- Percentage						
Loan size in Rs.						
- Minimum						
- Maximum						
- Average						
Average term of loan (Months)						
Nominal interest rate %						
- HNB						
- Refinancing						
Average disbursed loan as a percentage of GNP						

3. Micro credit initiatives in Sri Lanka

3.1. Need for sustainability and outreach in Sri Lanka

Although the country has achieved social-sector development comparable level to the developed countries current economic growth rates have not been sufficient for a considerable reduction in poverty and inequality. Approximately 50% of the population lives under the poverty line of 2\$ a day parameter and 7% of 1\$ a day standard (World Bank, 2002). There may be several reasons for difficulty to bring down poverty level and inequality: vast spending on the civil war making it difficult of spending in the development projects, government's progressive involvement in the economy and particularly lack of access to finance by the poor. High cost and lower access to financial services according to joint study by the World Bank and Asian Development Bank have been found as major barriers for the country's economic growth. This is especially true in case of the poor who lack the access to formal financial institutions such as banks and other formal institutions in Sri Lanka, although there is very few micro credit programs operated by banks, private and government commercial banks and development banks in the country.

Micro credit in Sri Lanka

Although the concept of micro credit started in 1970s in various forms of models such as Grameen Bank Model, Sri Lanka has an experience of this “mechanism” of micro finance since 1900s. Credits through cooperative societies are one of the oldest forms of micro finance type program in the country (Colombage, 2004). Later, various forms of government initiative projects such as *Janasaviya* program starting from 1989 and *Samurdi* program are few to name. Commercial banks, licensed specialized banks, registered finance companies, thrift and corporative societies, community based organizations such *Janashakthi* Banking Society in Hambanthota, and SEEDS are main categories that provide micro credit services in Sri Lanka, according to a GTZ study.

Regulatory environment for micro credit

There are no special regulations concerning micro credit activities in Sri Lanka and no interest rate caps exist in the country. However, government initiated subsidized micro credits programs are crowding out micro credit by other providers, for instance, 30% micro credit market is entertained by the government initiated Samurdi program. Under-developed institutional capacity increases the transactional cost : basically lack of "legal entity concept", reporting, auditing, supervision, regulatory problems, enforcement problems for both sides, difficulty obtain financial resources, for instance, go for market based funds, and lack of transparency prevent investors coming in to the sector.

3.2. The Sarvodaya Economic Enterprise Development Services (Grantee Limited)

Background

The Sarvodaya Economic Enterprise Development Services (Grantee Limited), SEEDS, has been established as a separate legal entity under the Sri Lanka Companies Act of 1982 in 1998 and is in operation since then as the economic arm of Sarvodaya Movement (<http://www.seeds.lk/>, 13.12.2006). Until 1998, before this was established under the Companies Act of 1982, micro finance activities were carried out as a Sarvodaya Development Program under Sarvodaya Shramadana Societies at village levels to promote social development process and poverty alleviation of the rural community.

The objectives and targets groups

The main objective of SEEDS is to eradicate poverty among the poor through economic empowerment for a sustainable livelihood. The target groups are both members and non- members of Sarvodaya Development Program and also both poorest of the poor and better off, however, main target group of customers is considered as economically active poor above the national poverty line of LKR 3, 000 per month. The general criterion for determining eligibility for a loan is based on household's monthly income. SEEDS categorizes the poor under three groups based on their house hold income as below LKR 3,000 per, between LKR 3,000 and 5,000 and over LKR 5,000 per month and classifies them as poorest of the poor, moderate poor, and the poor respectively. This sum has to be approved by the government agent of respective area "Gramasevaka Niladari".

Organizational structure

SEEDS's head office is located in Colombo and has three divisions: Enterprise Services Division (ESD), Training Division (TD), and Banking Division (BD). This office engages in decision making activities and is also responsible for approving large sums of loans. SEEDS employs two different channels in approaching to grass root level, client's level, in villages and this approach depends on the type of the prospective clients, on members or non-members of Sarvodaya Development Program Chart 1 (Appendix D ,the chart shown as How does SEEDS accesses Grass Root?). If the prospective client is a member of a Sarvodaya Society, the member access to SEEDS financial programs through village societies. However, a non- member does not need to follow this routine, accessing credit programs through village level societies instead they can directly access to district level offices. District managers are responsible for loan approval with the help of field officers who closely work with the non-member clients.

ESD is primarily responsible for technology transfers and creation of opportunities and it is also accountable for, in addition to the above main functions, technical skills development, sales & marketing linkages, technology product developments, information dissemination, business counseling services, and preparation of business plans. Training Division involves in capacity building activities. BD carries out savings and credits activities. There are twenty six district offices in operation and three thousand five hundred twenty six, 3527, societies by the end of 2006.

Operation of SEEDS credit program

Both credit and savings facilities are provided by the banking division at SEEDS and the division presently offers three different type of micro credit facilities: "A", "B" ,and "C" type loans Figure 1 (Appendix D, Figure shown as The Banking Divisions Micro Finance Canvas). Loan type "A" is considered as "income generating" loans provided for lowest income group for self- employment activities and the minimum amount of credit is LKR 10, 000. And this loan is increased up to LKR 50, 000 for expanding those self -employment activities to small scale businesses subjected to the borrower has successfully completed minimum of three cycles of loans and has received training in Enterprise Development and Business Management. Type B loans is provided to improve the quality of life and granted for housing, utilities, transport, consumer durables, children's education, and other special needs such as weddings. The maximum amount of the loan size is LKR 40,000 and provided only to

society members. There is also medium term loan aimed for special projects- Alternative Energy Loans- under loan type “B” ,and is granted to both member and no- members maximum up to 4 years starting from LKR 40,000 to maximum of LKR 77,000, depending on the client’s need. Type “C” loans are for employment creating opportunities by expanding successful rural business enterprises and target both members and non- members. This type of loan is granted up to a maximum amount of LKR 1,000,000 and need to be collateralized by a personal guarantee and /or other fixed assets such as land, buildings and machinery.

3.3. Hatton National Bank and *Gami Pubuduwa* “Village Awakening”

Background

Hatton National Bank is considered to be the largest private commercial bank in Sri Lanka and has been in banking business over more than a century. Presently, bank has more than 103 branches throughout the country, 79 branch based units and 24 village units. In 1989, for the first time, the bank initiated its micro credit program called *Gami Pubuwuwa-Village Awakening*- as a commitment to the economic and social development of the country. This program mainly aims at alleviating poverty among rural community and provides small scale loans. In addition to the provision of micro loans it also engages in skill development, training and community organization activities (USAID, 2005). Operation of GP is a successful example of down scaling commercial bank activities to micro finance operation.

The objectives and targets groups

The main objective of the program is to take part in the country’s social and economic development process by targeting the poor section of the population. Main activity of the program is to provide credit facilities, but clients are also facilitated with savings opportunities. The target group is both rural and semi-urban poor, but not the poorest of the poor and individual borrowers. However, GP is supplying micro finance services to a *small scale niche program* servicing approximately 16,000 clients by the end of 2006, compared to SEEDS, the largest private micro finance program in Sri Lanka.

Organizational structure of the development banking unit

Gami Pubuduwa operates as an integrated product line to HNB's main operational activities and is being considered as an additional product line offered by the bank. Thus, this program does not operate under a separate banking division; instead it operates under the Development Bank Unit and ultimately reports to the Personal Banking Division. The staff of the Development Banking Unit is responsible both for GP operation and also for rural credits, but rural credits are separated from GP credits. The Development Banking unit manages only one third of the total portfolio. GP does not account for a considerable amount of the total loan portfolio managed by the Development Banking Unit, and currently it is only a one percent of the total loan portfolio of the bank.

As we can see in Chart 2 (Appendix D) in the organizational structure, there are unit managers reporting to Development Banking unit and also supervising field officers. Field officers are the bottom line mediators with clients in villages and are either attached directly to branches, or to rural village based units. They report directly to branch managers and also sell other banking products; most important product is savings which is considered as one of the primary responsibilities of these officers.

Operation of Gami Pubuduwa credit program

These loans are granted for income-generating projects: animal husbandry, agricultural/export oriented crops, collection and distribution of farming equipment, sewing and patchwork, furniture/ handicraft/ toys/ ornament fish plants/ fishing equipment/ manufacture of bricks, repairing of bicycles and motor vehicles, repairing of radio and television. GP does not employ "Garmeen Model" group lending method, group members consisting of five people, although in times members are encouraged to form a group of three people who will cross guarantee each other's loan. The loans range from LKR 25,000 to LKR 750,000, depending on the customer requirements; there is also possibility to obtain loans over LKR 750, 000 to qualified clients by the bank. The approval of loans is mainly done by the respective branch managers; however, the head office staff gets involved in the approval process if the amount of the loan is a large sum. HNB employs field officers and few numbers of agricultural officers who have direct contact with clients in villages.

Categorization of loan portfolio

Loan portfolio is divided under four categories: current, sub standard, doubtful, and loss loans on the basis of success of repayments. Under the category of “current loans” includes all the loans that have been paid without any arrears, arrears up to three months and arrears up to six months while “sub-standard” category comprise loans with arrears for 6 months to 12. Loans with period of arrears between 12 to 18 months come under the “doubtful category” whereas loans unpaid more than 18 months are considered as “loan of loss”.

Estimation of profitability of the program has not separately been done until 2003, the year Development Banking Unit was established. However, profitability records are kept only by branch manager for internal management purposes, and are submitted to the respective units at the head office, however, these records are not prepared for publication purposes. One explanation by the officials at the bank, head office, is that loan portfolio of GP is not considerably large enough to prepare separate report for publication purposes. The other is that it is difficult to exact specific figures for GP products and they program is treated as only another product line of the bank. However, the committee of the USAID has emphasized the requirement of separate records for GP and presently bank has is developing a structure for separate recording of result of GP program.

Chapter 4

Analysis of Performance of SEEDS and GP at HNB

4.1. SEEDS

4. 1.1.Operational sustainability

Table 2 Operational Self sufficiency SEEDS

Period	2001	2002	2003	2004	2005
Operational Self -Sufficiency	69.76%	77.30%	92.73%	104.71%	111.81%

Source: Annual Report 2005/2006, SEEDS Ltd, Sri Lanka

Sarvodaya Development Bank shows an improving trend in operational sustainability indicator during last five years from 2001 to 2005. The operational self sufficiency indicator has nearly been doubled from 69.76% in 2001 to 111.81% in 2005. Several factors have contributed to this improvement: an attempt to build employees' capacities at lower levels, results oriented (profit oriented) employees' evaluation system, and improved emphasis on improved management information system.

However, the growth of the indicator cannot be considered as significant and the company has only a narrow interest rate spread of one point nine three percent, 1.93%, according to the most recent calculations as of 31.3.2006. This stingy margin has been caused by higher total cost of funds costs such as administration, finance, and loan loss provision expenses. The latest total cost of funds ratio, including above three main expense categories, is 18.07%, as at 31.3.2006. The average lending rate is twenty percent, 20% and is not higher enough rate to cover the total cost of funds.

Higher operational cost at SEEDS is a consequence of higher administrative expenses, and higher proportion of financial costs; the respective amounts are 8.37% and 7.95% of the total operational cost as of 31.03.2006. It also maintain higher rate of interest for savings deposits between 8-12% per annum as a strategy to attract deposits, whereas the average rate of interest maintained by the financial system on deposit is approximately 5% per annum.

SEEDS faces difficulty of keeping enough gap between on - lending rate and the break even interest rate to generate considerable income differences. According to the most recent calculation as discussed above, SEEDS operational cost is 18.07% which then is the break even interest rate .This rate

comparing its on-lending rate of 20%, SEEDS has slightly been able to cover operational cost and ,then barely significantly been able to achieve financial self-sufficiency.

4.1.2. Outreach

Loan size

SEEDS being the largest private micro finance institution of Sri Lanka has a significant membership base and considerable number of active borrowers, roughly more than 170 000 borrowers. It has inherited this large membership base from Sarvodaya Movement which initially started late 50s to provide basic social welfare needs and primary education for the poor rural community and in this sense it has an obvious market to serve even in the future. Being at an advantage position in term of rich legacy, SEEDS has achieved considerable outreach in loan amounts and also in term of borrowers since its establishment in 1998. Loan size has been increased by five times form LKR 607Mn in 2001 to LKR 3 172Mn by the third quarter of 2006 Table D2 (Appendix D). The maximum loan size at SEEDS is usually LKR 500 000 (US\$5 000), but this is increased up to LKR 1Mn in special occasions considering the needs of the borrowers and their characteristics, according to bank the officials. Average loan size has been increased from LKR 30 621 to LKR 43 980, in my opinion, loan size, average loan are not very larger values that is because SEEDS provide the service to the typical target group of micro credit programs –the poorer.

Outreach in members and borrowers

The membership base at SEEDS has increased from 390 206 by the end of 2004 to 453 171members by the end of 2005 and these members can be considered as potential borrowers. A significant outreach in terms of borrowers has also been achieved and it provides credit facilities to 62 660 clients, both to members and non-members, by the end of 2005 this figure is 11% improvement from 2004, Table D 2(Appendix D).

Women participation

It seems that women empowerment, in economic activities, in Sri Lanka has actually being taken place. Women participation in banking activities at SEEDS is comparatively higher than that of men and this

has even improved from 56% in 2004 to 59% in 2005. This may be enforced by the fact that Sri Lanka has higher literacy rate, school enrollment rates even among women and positive signs of women liberation.

4.2. Hatton National Bank- Gami Pubuduwa

4.2.1. Operational Self sufficiency

Table 3 Operational Self sufficiency GP program

Period	2001	2002	2003	2004	2005
Operational Self Sufficiency	n.a	n.a	n.a	121%	n.a

Source: USAID report, 2005.

Operational self-sufficiency in 2004 is 121%, however, it has been difficult to compare the trend of operational self sufficiency indicator because HNB has not prepared separate financial reports for publication purposes. HNB has been able to cover its operational cost and should, therefore, be able to achieve financial self sufficiency. On lending rate for the program varies between 16% and 17%, and the break even interest rate is between 12% and 13.5%, according the bank officers and this has contributed to higher average operational self –sufficiency indicator.

GB does not have a difficulty of generating revolving fund for the program. The program maintains savings more than two third of loan portfolio and one of the main functions of the field officers working under this program is to promote savings among borrowers. Deposits and loan portfolio as at the end of 2006 were LKR 1200Mn and LKR 1600Mn respectively.

4.2.2. Outreach

Loan size

Gami Pubuduwa program at Hatton National Bank is considered as the most successful micro credit program operated by a private commercial bank in the country. This program is operated as an initiation of down scaling commercial bank’s activities to a small credit program. They regard the LKR 5000 as the “life- changing” loan, minimum loan size, and borrowers are allowed to exceed this amount

up to 750 000(US\$7500). Average borrowed amount is approximately LKR 100 000(US\$1000) Appendix D Table D3 (shown as outreach of Gami pubuduwa Program) Total loan portfolio of GP has been increased from LKR 921Mn as at the end of 2004 to LKR 1 600Mn as at the end of 2006 .The average amount of loan, in my view, is an indication of the income level of target groups. It seems that the program does not target the very poor instead aims at “economically active poor”, however the information regarding the income level of borrowers was inaccessible. The reasons for prioritization of “rather better off” section of the population will be that it is difficult to reach the very poor in a profit making environment and also lack of staff trained to do business with such groups. Bank estimates that it has been able to attract savings from GP clients amounts to LKR1200Mn and this amount is 75% of the total outstanding loan portfolio.

Number of and client outreach

The number of borrowers, outreach in terms of borrowers, compared to the total amount of loan portfolio is smaller and these numbers are 11 682 borrowers as at the end of 2004 and 16 000 borrowers as at the end of 2005. It is obvious that the bank caters only to “niche” market.

Women participation

Although Hatton National Bank has achieved recognition both at national and international level for its work, in my opinion, it still keeps the distance with the women borrowers and tries to constrain to the traditional banking clientele. Women borrowers are only 18.5% of the total borrowers compared to their counter part of 80.3%, and the rest comprises of joint borrowers as of December 2003(USAID Report, 2005)

4.3. Comparison of operation and outreach of SEED and GP at HNB

Operational Self-sufficiency

Commercial banks will operate micro finance activities competitively than other MFIs as they have access to wide range of funding sources and necessary infrastructures; however, high costs related to small amounts of transactions, lack of specially trained staff can be considered as barriers for smooth

operation of micro credit programs operated under commercial banks. HNB has been able to maintain higher level of operational efficiency compared to SEEDS. This may be the outcomes of several opportunities that HNB is having over SEEDS. It is an established commercial bank and has the experience of operating commercial banking activities. It also has a legacy of operating as profit making business and therefore may have higher efficiency of operation; for instance, it usually takes around three months for the whole process of loan approval for SEEDS, but it takes only few weeks for HNB. Limited practice of result oriented activities, for instance, profit maximization targets and lack of employee evaluation system seem to be other weaknesses at SEEDS for achieving sustainability targets.

However, there are certain constrains that SEEDS is facing, as a company registered under the Companies Act of Sri Lanka, does not have power to accept savings from non- members and this is a limiting factor compared to HNB. Therefore, SEEDS offers higher rate interest for deposits to attract savings resulting lower level of operational self sufficiency; HNB's average interest rate on savings varies between 4.5%-5% per annum and the same for SEEDS range from 8-12% per annum. HNB possess a synergetic effect, micro lending is only one product of its whole loan product line where as micro loan is the main product at SEEDS. Lack of proper regulatory environment, although there is a drafted Micro Finance Act which will be presented to the parliament, is another barrier for community based institutions' development compared to commercial banks whereas GP operates at a more formal environment.

Outreach

Duflos et al.(2006) conclude that Sri Lanka has higher number of service points -“oversupply in terms of institutions”-except the fact that many of them are unsuccessful. And they further find that this oversupply has made it difficult to achieve higher outreach and to operate at economics of scale for sustainable targets by a single institution.

A significant outreach has been achieved by SEEDS compared to GP. SEEDS has provided credit facilities 62 660 clients, both to members and non-members by the end of 2005; while GP provided credits 11 682 clients. Present figure for GP is approximately 16,000 clients as of the end of 2006, but this figure includes clients who are also serviced under the refinance project for tsunami affected

people by German Savings Bank Foundation for International Cooperation, SBFIC, therefore the actual figure solely out of the HNP funds is lower than 16,000 clients.

SEEDS mainly employs group-lending approach, a group comprising five members, to minimize the main problems of asymmetric information in the credit markets, but the main lending approach at HNB even with GP is individual based lending. Their approach does not minimize the room for the problems of asymmetric information and this will be an explanation for not reaching the poorer section and also limiting the outreach in terms of number of borrowers to have a strong customer relationship. Present repayment rate at the bank is 95%, according to bank officials, while SEEDS has succeeded to maintain the repayment rate at 88%.

SEEDS's comparatively larger credit provision is a result of several underline facts: its decentralized structure, local community based organizational structure, higher outreach of membership, and small groups and societies. SEEDS entertains an advantage position in relation to putting a group pressure to reduce default rates. Further, according to district manager *Kurunegala*, a town in the North Western province, there are volunteers at village level societies who work for their groups, sometimes at their own expenses, which is an asset for SEEDS and helps success of its micro credit program.

Gender differences

Studies show that there are better results with female borrowers than male. Women have been the main target group by micro credit organizations, since they tend to invest in less risk and provide better social benefits. However, HNB's gender base is not consistent with that explanation where women borrowers consist only around 20% while 80% of the borrowers are men, but SEEDS has a 56% of women borrowers.

Thus the experience of these two institutions show those programs with appropriate designs, human resources, pertinent products, and profit oriented can achieve the most important aspects of micro credit- self-sustainability and outreach by being responsive to clients.

4.4. Factors affecting the development of micro credit institutions in Sri Lanka

Inflation rate:

When setting interest rates for credits, micro credit institutions should not ignore the impact of inflation rate. Like in many developing countries the real interest rate in Sri Lanka is lower than the nominal rate. This makes it difficult micro credit programs to maintain positive interest rate income. Overall, more stable macroeconomic environment is called for to achieve significant development of micro credit institutions in Sri Lanka.

Lack of strong legal environment

A bill, The Microfinance Act of Sri Lanka, has presently being prepared for approval by the parliament. This bill mainly aims to improve the effective and efficient operation of micro finance institutions, under the this act, it will be able to set up an agency which shall monitor the activities of microfinance institutions, however, to be monitored under the agency microfinance institution must at least have LKR 5 000 000 (US\$50 000) as its equity. This will be a discourager for small scale institutions. Nonetheless, a proper legal framework for better operation of these institutions is postulated, as discussed above one of the reasons for GP's favorable performance is its formal legal framework.

Inadequate investment in rural agricultural development

Approximately 75% of the total population resides agricultural based environment in the country and growth in this sector obviously underpins rural financial development. However, the country is not making adequate investments in agricultural sector and this hinders the development of micro credit institutions.

Chapter 5

Summary and Conclusion

Provision of financial services to the poor is considered as one of most effective strategies to eradicate poverty in developing countries. The poor need finance services; they should be able to borrow money for consumption purposes, start a business, expand an enterprise and need to save in small amounts and send their child to school and all these opportunities open the door to increase quality of their lives. Access to financial services at all level of the economy makes substantial growth and development, and this is more consequential for poor.

However, traditional financial systems are reluctant to provide financial services to this poorer section of the population. Credit markets are typically characterized by problems of asymmetric information and these problems are even more complicated in developing credit markets than developed credit markets resulting higher cost, uncertainty and risk faced by credit markets. Consequently, poor people are for the most part excluded from the formal credit markets.

Adverse selection occurs when two parties- borrower and lender- to a credit transaction have un-equal access to information relevant to their decisions. This problem of adverse selection might leads to a reduction of loans causing too little investment in an economy.

Moral Hazard represents the problems of not being able to monitor the behaviors of borrowers after the lending. There is always a possibility that borrower to act the other way than would be preferable for lender. A borrower is likely to not to stick to planned projects and to follow his /her own plan therefore monitoring must be conducted to avoid such circumstances.

Collaterals, interest rate, and monitoring creditors are widely used mechanisms to mitigate the problems of asymmetric information. Nevertheless, these mechanisms cannot effectively be used in credit market with needy because they likely to have irregular income, lack access to assets or lack assets property rights of which may have weakly codified resulting lower or zero value for lenders, are less educated, are ill-health that increases the uncertainty of repayment abilities, and need small amount as loans that causes higher transaction costs.

Micro credit is recognized an effective endeavor started in this century as an alternative remedy to provide credit services to the destitute overcoming the typical problems that exists in the formal credit markets. There are various forms of micro credit programs operating all over the world, but they are

not without difficulties. The two of the most important long term goals of a micro credit program are achieving self- sustainability and outreach targets to provide financial needs for poor on a continual basis to reduce and to increase the quality of life.

Approximately one fourth of the population of Sri Lanka lives below the national poverty level and higher percentage of this group is considered as *un-bankable*. There are varieties of organizations providing micro credit in the country, but a few is in the process of achieving most important aspects of micro credit program-self sustainability and outreach.

Servodaya Economic Enterprise Development Services Ltd, SEEDS, and Gami Pubuduwa at Hatton National Bank are main micro credit providers in Sri Lanka. The former is a registered company under the Companies Act of 1982 of Sri Lanka and considered to the largest private micro finance provider in the country while the latter is a micro credit program operated by Hatton National Bank of Sri Lanka.

The study found that these two programs are hopefully reaching their targets. More specifically the findings are:

1. Operational sustainability of SEEDS is improving year on year basis and Gami Pubuduwa shows similar indications, although the necessary data for GP to carry out a trend analysis is not available.
2. Both the programs are achieving positive outreach alike and SEEDS has a significant membership base compared to GP.
3. Women participation is higher at SEEDS in comparison to GP.
4. There are several challenges that needed to be overcome for the development of micro credit organizations in Sri Lanka: macroeconomic stability- inflation rate stability, sound legal framework, and adequate development in the agricultural sector.

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Appendix A

Interviews

Mr.Hiranthan Unit Manager,HNB.

Ms.Samanthika Project Manager, SEEDS.

Mr.Vishwanatha Gunawardana,Senior Manager Development Banking, HNB.

Mr.Uve,Consultant to SEEDS & HNB, German Savings Bank Foundation for International Cooperation.

Mr.Frank Muller,Consultant to HNB, German Savings Bank Foundation for International Cooperation.

Mr.Thushita, Manager, Product Development & Project Finance, SEEDS.

Mr.Dayasiri Karunaratna, District Manager, SEEDS, Kurunegala District.

Mr.Gaminiyapa, Consultant to SEEDS,SEEDS.

Appendix B

Questionnaire

1. Institutional and Financial Sustainability

- 1.1 Do you possess competence staff that can carry out all the functions within the organization?
- 1.2 Where do you get funds for operation?
- 1.3 How do you cover the expenses?
- 1.4 Do you have any difficulties you are facing when providing credit?
- 1.5 Do you think that the existing regulatory and monitoring, and enforcement frame work is enough for program's development?

2. Outreach

- 2.1 How is the client dispersion in the area, for instance, per kilometer?
- 2.2 Have you reach the full potential?
- 2.3 Does your loan portfolio depend on narrow income base, for instance, income a few sources of borrows?
- 2.4 Are all clients permanently staying here? If not, which percentage is staying temporary, for instance, may be due to civil conflict in the country?
- 2.5 Do you have reached outreach targets in terms of number of clients?

3. Client Assessment methodologies

- 3.1 What is the minimum income of your target clients?
- 3.2 What is your main target group poor or better off?
- 3.3 Which group is more credit worthier according to your experience?
- 3.4 Which group is improving faster, when do you compare in relation to deposits, frequency of loans taken?
- 3.5 What is your perception about client assessment?
- 3.6 If you do such an assessment, what is you purpose of doing so, is it to avoid risky customers, or to provide a better service according to their demand?

3.1 Do you think that the assessment makes a difference for your decision to lend?

3.2 Have you found that the assessment is cost effective instead of defaults?

4. Loans

4.1 What is the frequency of loans obtained by a borrower on average?

4.2 Has the size of the loan increased gradually?

4.3 Do you follow up how the credit is being used?

4.4 What happens in the case of a default?

4.5 Do you feel that there is any potential for local savings?

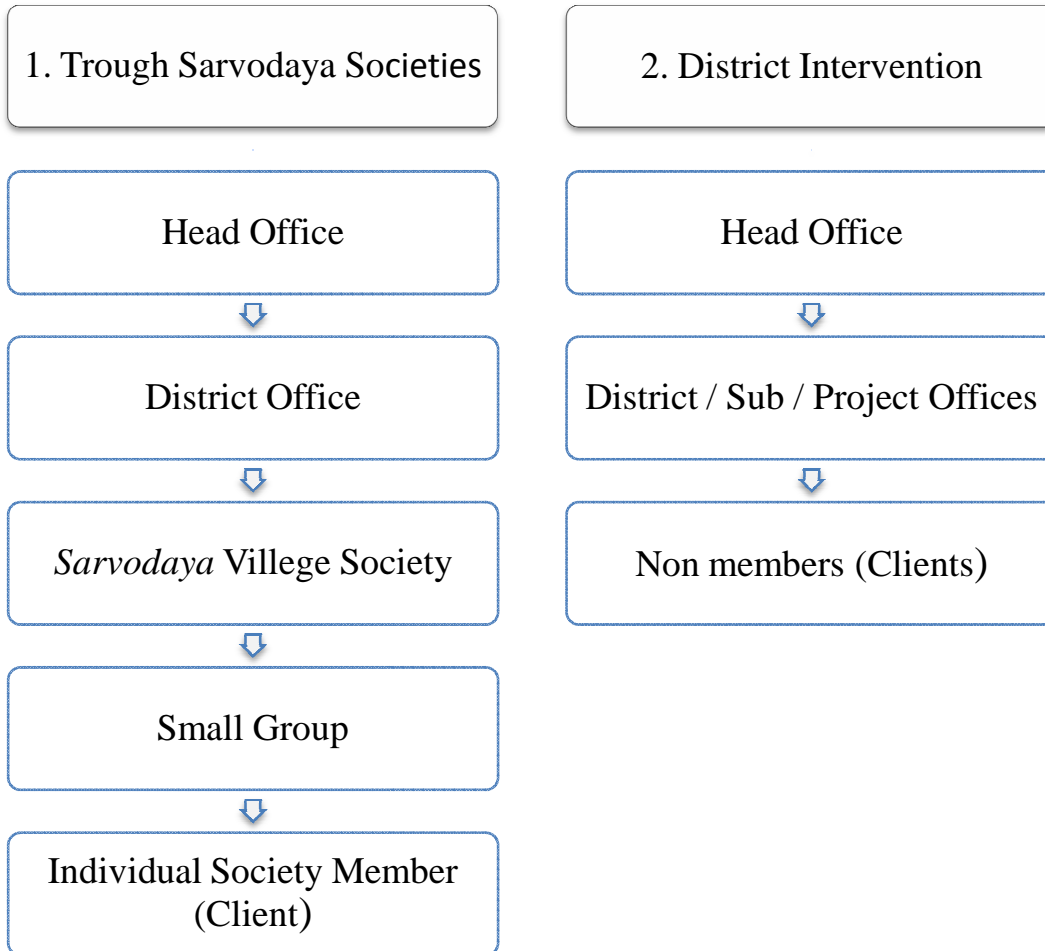
4.6 What are the aims, problems and /or benefits with the program?

4.7 Do you have anything to add?

Appendix D

Chart D 1

How does SEEDS access grassroots?



Source: Annual Report 2004, SEEDS Ltd, Sri Lanka.

Chart D 2

Operation of Gami Pubuduwa Program

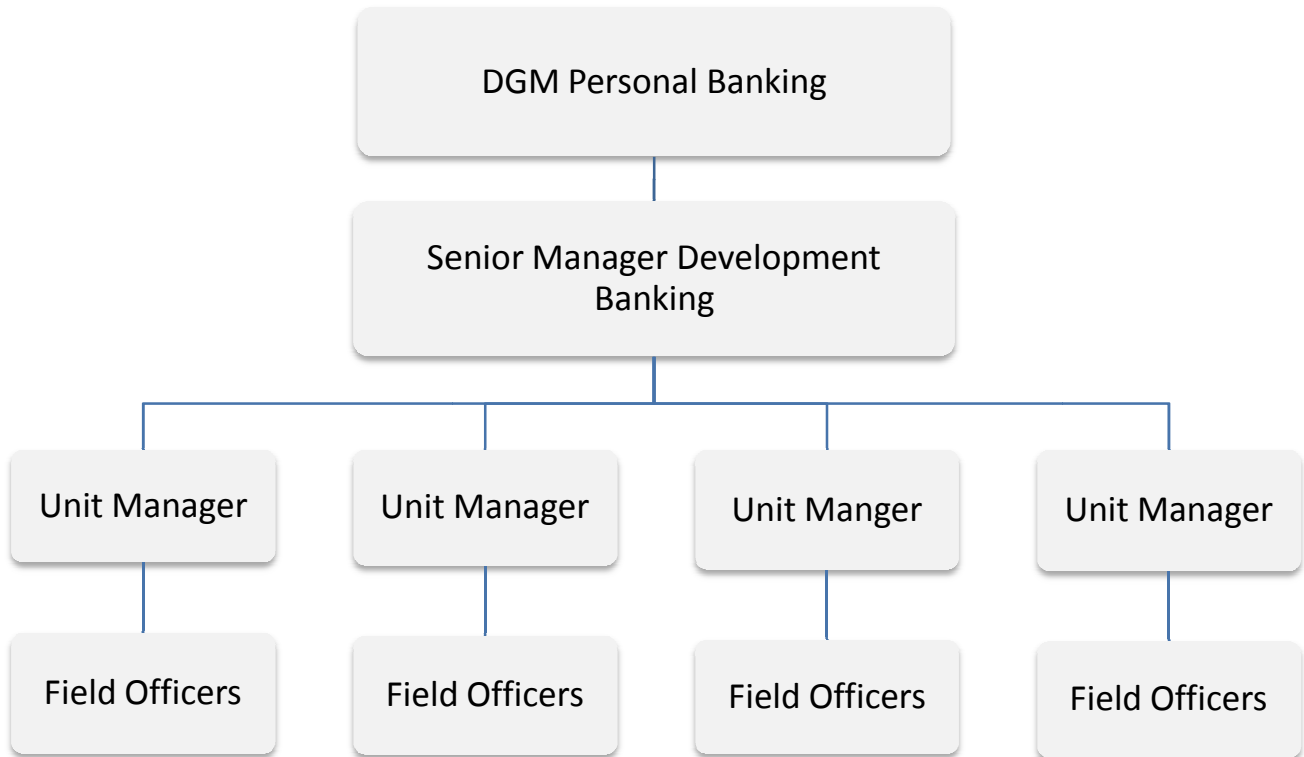


Figure D 1

The Banking Division's Micro Finance Canvas

Loan	Product	Target Groups	Collateral Repayments
A	Loan for income generation	<ul style="list-style-type: none"> Poorest of the poor & other low-income households. (Poverty threshold - below Rs.3000 per month. To capitalize their income generating projects. 	<ul style="list-style-type: none"> Groups guarantee. 10% for Loan Security Fund, and 2.5% for Loan Risk Fund.
B (Non Solar)	Loans to improve living standards	<ul style="list-style-type: none"> Moderate poor (income between LKR 3 000 to LKR5 000 per month) To meet basic and life cycle need and thereby improve the quality of life. 	<ul style="list-style-type: none"> Two guarantors. 10% for Loan Security Fund, and 2.5% for Loan Risk Fund.
B (Solar)	Alternative Energy Loans	<ul style="list-style-type: none"> Low and middle-income earners not limited to Sarvodaya Society members. To enable those living in remote rural areas to access renewable energy system such as solar and village hydro schemes. 	<ul style="list-style-type: none"> Transfer of ownership of SHS panels after full repayment. Group guarantee from Village Electricity Consumers Societies.
C	Saubhagya & Dasuna loans	<ul style="list-style-type: none"> Entrepreneurial poor - Savodaya members and non-members. To enable such clients to start or develop their enterprises and thereby create new employment opportunities in the village. 	<ul style="list-style-type: none"> Mortgage over Assets (vehicles, machinery, land & building.
Society	Consumption	<ul style="list-style-type: none"> Sarvodaya Society Members. Towards consumption smoothening and to meet urgent, personal or life-cycle needs. 	<ul style="list-style-type: none"> Member Savings Deposits.

Source: Annual Report 2004, SEEDS Ltd, Sri Lanka.

Table D 1

SEEDS' Calculation of Cost of Funds – As at 31.03.2006

Cost Items	Amount Rs.	% of Gross Average Loan Outstanding
Cost of Administration	232 720 208	8.37
Cost of Finance	221 094 792	7.95
Cost of Loan Loss	48 557 401	1.75
Total Cost of Funds	502 392 400	18.07
Average Lending Rate		20
Interest Spread		1.93
Operational Self Sufficiency		109.64
Financial Self Sufficiency		78.45
Loan Outstanding (as at 31.03.2005)	2 500 634 261	
Loan Outstanding (as at 31.03.2006)	3 059 312 537	
Average Gross Portfolio Outstanding 2005/06	2 779 973 399	

Source: Quarterly Report 2006, SEEDS Ltd, Sri Lanka.

Table D 2

SEEDS Outreach (Period year 2001-2006)

	2001	2002	2003	2004	2005	2006Sep
Total outstanding balance LKR Mn	607	867	1 220	1 733	2 754	3 172*
Number of active borrowers	na	na	na	56 521	62 620	na
Loans growth in						
- LKR Mn		260	353	513	841	418
- Percentage		42.8	40.7	42	48.52	15.2
Loan size LKR Mn						
- Minimum				10 000	10 000	10 000
- Maximum				500 000	500 000	500 000
- Average				30 621	43 980	
Average term of a loan						
Minimal interest rate %					20	20
Average disbursed loan as a percentage of GNP				30	36.74	

Source: Based on Annual Reports 2003-2005, SEEDS Ltd, Sri Lanka

Average loan size = Value of loan/Borrowers

*Figure is only for three quarters.

Table D 3

Outreach: Gami Pubuwa Program (period 2001-2006)

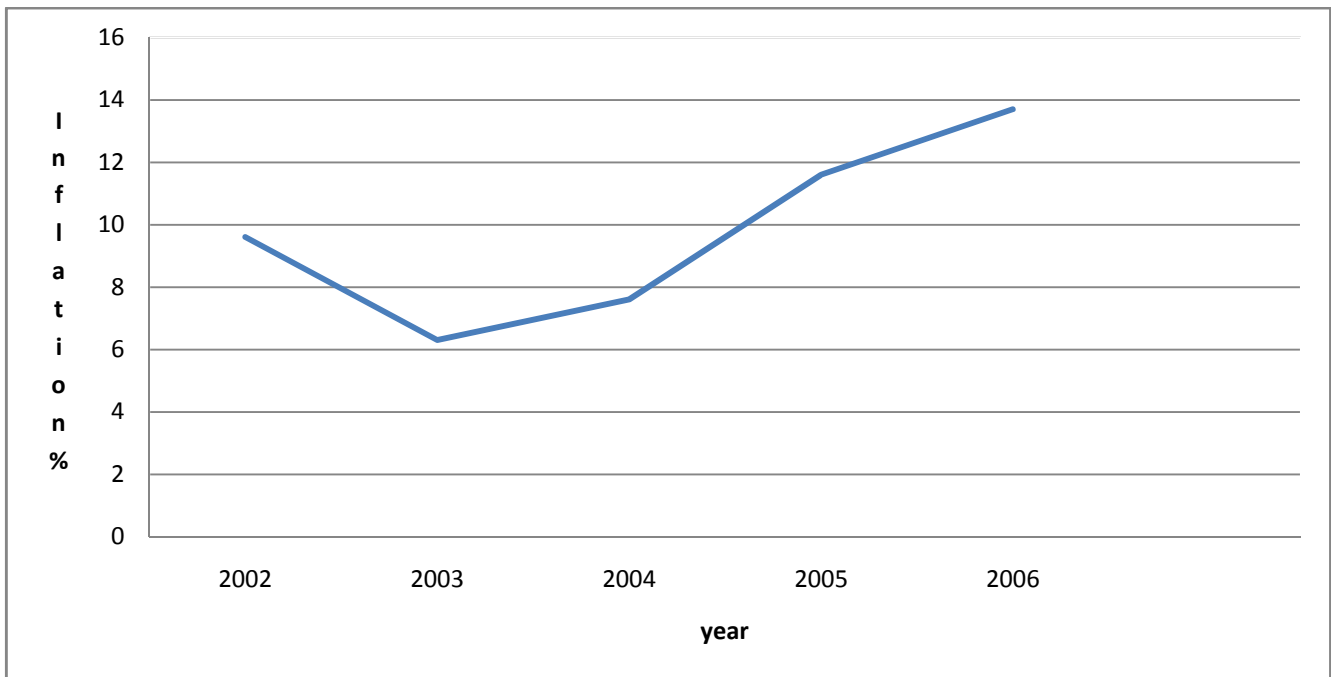
	2001	2002	2003	2004	2005	2006
Total outstanding balance Mn.						
- Rural credit				1 445		2 500*
- GP				921		1 600*
Number of currently active						
Borrowers				8 496	11 682	16 000*
Loans growth in						
- Mn.				n.a.	n.a.	n.a.
- Percentage						
Loan size in Rs.						
- Minimum	5 000	5 000	5 000	5 000	5 000	5 000
- Maximum	500 000	500 000	500 000	750 000	750 000	750 000
- Average				108 403		100 000
Average term of loan (Months)				36		
Nominal interest rate %						
- HNB						17 -19
- Refinancing						12 -41
Average disbursed loan as a percentage of GNP				104.87		71.2

Source: USAID report, 2005, & self reported figures

*Self reported figures, including the loans disbursed under refinance project by The German Savings bank Foundation for International Cooperation started from 2005.

Graph D 1

Inflation rate



Source: Annual Report 2006, Central Bank of Sri Lanka.

Table D 4

Per capita Gross National Production (GNP)

	2002	2003	2004	2005	2006
LKR	82 062	90 472	103 370	119 688	140 302
US\$	858	937	1 024	1 191	1 350

Source: Annual Report 2006, Central Bank of Sri Lanka

