Microfinance sector in Sri Lanka: Opportunities and growth strategies

Abstract:

Financial inclusion for low-income households in the developing world has the power to propel the economic and social development of the country as well as alleviate the ill effects of poverty. Microfinance institutions play a key role in ensuring access to formal financial services especially for the low-income population. Sri Lanka, an island nation located in the Indian Ocean is one of the fastest growing economies in South Asia, and is classified as a lower middle income country. The country has a significant low-income population segment whose financial needs are served by many existing MFIs in the country. However, there is limited industry data and monitoring mechanisms for the microfinance sector in the country leading to lack of clarity on the market structure, market potential and avenues of growth for the existing players. This paper is an attempt to bridge this information gap and present a high level understanding of the Sri Lankan microfinance landscape as well as highlight a few market opportunities and growth strategies. The authors of this paper are associated with the microfinance sector for nearly a decade, and have closely studied the Sri Lankan microfinance sector in the last two years. They have worked with a few leading practitioners, and interacted with policy makers and capital providers to gather insights into the Sri Lankan market.

The financial services landscape in Sri Lanka

Sri Lanka with a population close to 20 million people and per capita GDP of USD 3,280 is positioned as the country in the lower middle-income level.[1] Sri Lanka has witnessed a high GDP growth of nearly 7% year over year[2] and the country is performing well on various human development indicators. The financial system of Sri Lanka is quite diverse consisting of 20 commercial banks, 47 licensed finance companies (LFCs), nine specialized leasing companies (SLCs), many primary dealers, pension/ provident funds and credit co-operative societies. Commercial banks dominate the financial system and account for nearly 60% of the total asset value (nearly LKR 7000 Billion or USD 65 Billion).[3] With a sizable proportion of population availing basic financial products such as savings accounts coupled with the relatively high coverage of credit bureau (Figure 1) and a good mix of diverse financial institutions, Sri Lanka has the building blocks for strong financial services growth.

Figure 1: Financial development indicators for Sri Lanka in comparison to South Asia

Source: World Bank Global FINDEX Indicators 2014 data. All population figures include age 15+ years only

The number of LFCs and SLCs in Sri Lanka grew at a rapid pace in the last decade, largely backed by high growth momentum and credit demand in the economy. In the last 4-5 years, however, many of these institutions grappled with operational and governance problems impacting asset quality and profitability of the financial services sector in Sri Lanka. In order to improve the state of financial health of these FIs, in 2013-14, the Central Bank of Sri Lanka rolled out the blueprint for consolidation in the LFC and SLC segment to strengthen the balance sheets of the beleaguered FIs. However there has been little analysis on the benefits and challenges faced during this consolidation process.

[1] World Bank data 2013
[2] Central Bank of Sri Lanka, socio-economic data
[3] Central Bank of Sri Lanka statistics, as on end December 2014

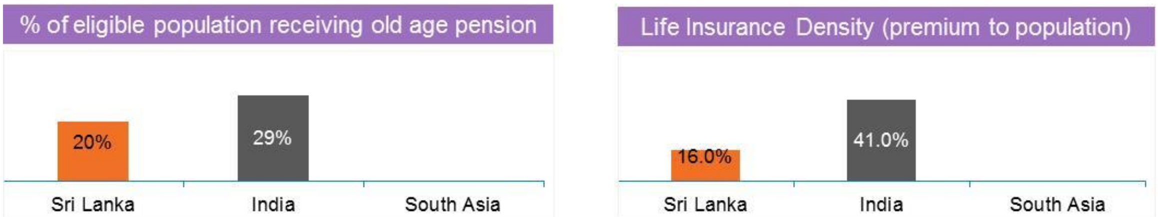
Microfinance sector landscape in Sri Lanka

Despite high penetration of basic financial services, Sri Lanka lags in financial inclusion parameters such as credit penetration, life insurance penetration, pension coverage as well as credit access for small businesses and farm-based activities when compared to India and South Asia (see Figure 2 and Figure 3). Reaching out to customers, especially from low-income groups, and providing them diverse financial and credit services is arguably the key objective for a microfinance institution (MFI) and Sri Lanka could potentially be a good base for developing robust business models and innovative products to serve this customer segment. Moreover, a good percentage of the population in Sri Lanka (nearly 30%) falls in the 45+age bracket[4], and they have limited avenues to access various credit and financial products. MFIs could target this age group with specific financial products such as insurance and pension, and expand their offerings in Sri Lanka.

Figure 2: Indicators on Credit penetration for Sri Lanka in comparison to South Asia

Source: World Bank Global FINDEX Indicators 2014 data. All population figures include age 15+ years only

Figure 3: Insurance and pension penetration indictors for Sri Lanka



Source: ILO social protection indicators for 2012, IRDA for India insurance and IASL for Sri Lanka insurance data

Currently, there is no clear policy guideline from the central bank of Sri Lanka that recognizes the microfinance sector in Sri Lanka[5] though A Co-operative Rural Banks (CRBs), Regional Development Banks (RDBs), financial Non-Government Organizations (FINGOs) are active in the country for the past many years. Entry of the private companies (primarily from the LFC and SLC segment) providing dedicated microfinance services gained traction in the mid to late 2000s. As per estimates, nearly 14,000 financial institutions in the country directly or indirectly provide microcredit products. [6] However, a majority of these financial institutions are either FINGOs, not-for-profits or follow a local cooperative structure. For-profit formal sector microfinance institutions are few, and the market is dominated by the five to seven players that serve the majority of the low-income customer segments.[7]

[4] Department of statistics 2012 data
[5] There is a high possibility that a microfinance bill will be drafted by the central bank in early 2016 and put up for discussions
[6] Lanka Micro Finance Practitioners Association estimates for 2014
[7] Based on author’s discussions with key stakeholders

Regulatory landscape for microfinance in Sri Lanka

The relatively less developed regulatory infrastructure for microfinance in Sri Lanka allows some operational ease to existing players, but may lead to limited customer protection. Unregulated interest rates could particularly impact rural and marginal customers where awareness about credit or loan products is very low. The central bank is planning to propose the regulation of interest rates charged by Sri Lankan MFIs, and is awaiting a response from the Government. The impact of interest rate regulations has yielded positive results across various developing countries such as market consolidation, sustainable portfolio growth and stronger customer protection. Some of these cases have been presented in Box 1.

Box 1: Interest regulations in other emerging economies: examples from Bolivia and India

Bolivia: 11% interest rate cap on 60% of loan portfolios of all regulated financial institutions; the other 40% remain uncapped. Forced many small MFIs to sell to larger groups and hence market consolidation was achieved

India: An initial cap on MFI interest rates at 26% led to reduced borrowing and de-growth. New regulations follow a flexible rate: cost of funds (at market rates) plus 10% for existing MFIs and plus 12% for new MFIs. Sector has rebounded after a slowdown and is growing at more than 35 % since 2014 (GLP terms)

Adapted from: Interest Rate Debate, Koch, 2015

Key characteristics of the Sri Lankan MFI market

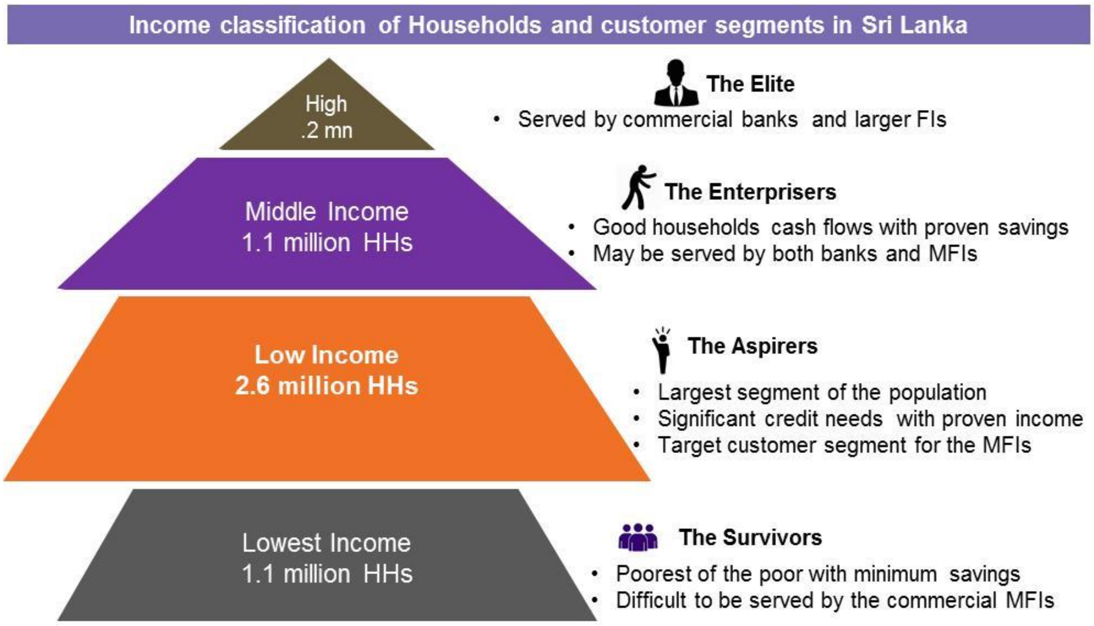
Significant target customer segment of nearly 2.6 million households: Among South Asian countries, Sri Lanka is unique in terms of population distribution by income, with a majority of the households in the low-income and middle-income segments rather than lowest (or poorest) segment (Figure 4). As per our assessment, gained from experience across assignments in Sri Lanka, these 2.6 million low-income households (or the aspirers as shown in figure 4) represent the target customer segment for MFIs in Sri Lanka. While market penetration data for the existing MFIs/ NBFCs in Sri Lanka is not readily available, the total number of customers served by the 5 largest MFIs/NBFCs in Sri Lanka is estimated to be around 1.4 million customers[8] while industry association LMFPA estimates the total number of customers served by 24 smaller MFIs in the country to be nearly 0.3 million.[9] In addition, hundreds of credit cooperative societies and small FINGOs are also active in the Sri Lankan market. A reasonable estimate that excludes multiple lending pegs the unique number of MFI customers in the country ranging from 1 to1.2 million representing 45%-50% of the target market. In addition, some independent market studies indicate that penetration of MFIs / NBFCs providing microcredit in Sri Lanka is 'medium to high' (indicating penetration of more than 45%). A few leading MFI practitioners also share the view that the microcredit group loan segment in Sri Lanka has become 'highly' saturated (typically more than 60%) in the last 3-4 years and there is a need to diversify into segments such as individual housing or business loans. Sri Lankan MFIs/ NBFCs interested in growing/consolidating their market share have to adapt different growth strategies and tap into new opportunities for deeply penetrated segments compared to those segments with significant potential for expansion. A few of these opportunities have been discussed in the subsequent sections.

'There is a significant gap between access to credit and access to savings in Sri Lanka with very few people from low-income background having credit access. MFIs could play a key role in bridging this gap and offer credit products and loans to the low-income and the MSME segment in the country.'

Kumudhini Saravanamuttu, Policy Review & Monitoring, Central Bank of Sri Lanka

[8] Intellecap analysis based on the annual reports of the top 5-6 MFIs/NBFCs in Sri Lanka
[9] Lanka Micro Finance Practitioners Association estimates for 2015

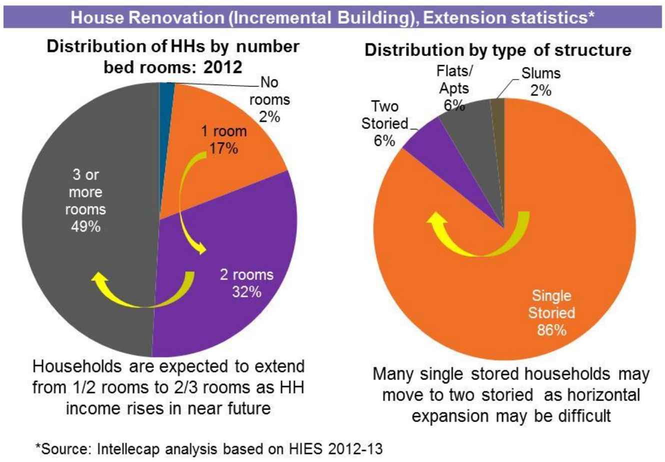
Figure 4: Household income pyramid patterns in Sri Lanka



Source: Intellecap analysis based on IFC Consumption database 2013 and HIES 2012-13
*Lowest refers to per capita income of less than US$2.97. Equivalent to monthly HH income of LKR 19,000 (2014 PPP basis)
*Low refers to per capita income between US$2.97 and $8.44. Equivalent to monthly HH income of LKR 53,000 (2014 PPP)
*Middle refers to per capita income between US$8.44 and $23. Equivalent to monthly HH income of LKR 145,000 (2014 PPP)
*High income refers to per capita income of more than US$23

Affordable housing finance products for house renovation/repair: Owning a house is a cultural and social norm in Sri Lanka with nearly 83% of the houses owned by a household member, while only 10% of the population lives in rented accommodation.[10] For many low-income families in the country, building, renovating and upgrading their homes is a continuous investment. With economic growth and increasing household incomes, there will be a significant demand for up-gradation, repair or renovation of existing housing units (Figure 5). Credit needs of low-income households are likely to be small. Further, the operational processes of mainstream financial services companies such as underwriting, legal proceedings and turnaround time may not be aligned to the expections of the low-income households.MFIs can tap into this opportunity to expand their service portfolio.

Figure 5: Housing renovation/extension needs in Sri Lanka



Micro-credit providers, however, should be cognizant of the approach they take for estimating the credit worthiness of potential housing loan borrowers as these are different from the traditional micro-loans given in the group lending model. Adjusting all household finances and cash flows analysis, instead of only considering the

Intellecap has developed customized training modules and toolkits for its MFI clients across operations management, risk management, branch management and MIS. Our deep expertise in training key executives/ managers on measurement frameworks and reporting system and formats assist the clients for operational process improvement and achieve growth in line with strategic objectives

[10] Population census data for housing 2012, Department of Census and Statistics, Ministry of Finance and Planning, Sri Lanka

individual borrower's funds flow, is a key step to effective underwriting for such loans. Moreover, mortgage based housing loans are likely to involve significant legal costs and technical / legal understanding. MFIs venturing into this space will need to build capacities of their credit officers, who are more likely to be familiar with group lending processes. Specifically, they will need to invest in training in credit underwriting for such loans.

Focus on micro entrepreneurs and the emerging micro, small and medium enterprise (MSME) financing segment: The problem of 'missing middle' in MSME financing is well acknowledged in emerging markets. Sri Lanka's private MSME sector suffers from inadequate access to reliable and sustainable sources of financing. Despite a high credit/deposit ratio of nearly 90%, domestic credit to private sector as a percentage of GDP is only 28% in Sri Lanka, which is much lower than the South Asia average of 46%[11]. This indicates that domestic credit is not adequately available to the private sector enterprises, particularly MSMEs. The total credit gap for MSMEs in Sri Lanka was estimated at USD $3.5 billion in 2010[12] or around 7% of the country's GDP. MFIs and NBFCs could play a key role in meeting the capital requirements for the MSME sector given their understating of the self-employed "micro entrepreneurs" with short-term cash flows and their financing needs on periodic business cycles. Their experience in providing microcredit enables them to establish the correlation of the periodic demand for capital and subsequent cash flows of the customer. Many MFIs and NBFCs in Sri Lanka have introduced individual business loans to meet the potential demand of capital by MSMEs, but seem to lack the requisite processes to make these loans accessible with short loan approval time leading to higher loan processing time.
MFIs / NBFCs focusing on MSME financing in Sri Lanka should be cognizant of key challenges in extending credit to the MSME sector such as weakness and transparency of the financial statements and accounting methods of MSMEs, inadequate credit history and information, and default risks.

Strategies for market growth in Sri Lankan micro credit / microfinance market

Given the market characteristics and positioning of the microfinance sector in Sri Lanka, the growth strategy pivots for practitioners could be based on specific pivots (see figure 6)

Figure 6: Proposed pivots for growth in the Sri Lankan microfinance market

Demand: Tap in the existing demand for microfinance and capture existing client base from smaller players

Digitization: Utilize digital finance to enhance operational efficiency and improve profitability

Innovation : Design innovative products to meet lifecycle or business cycle needs for various client categories

Savings: Tap into savings products to reduce the cost of funds as well as minimize currency fluctuation risks

Tap into the demand potential of significantly high penetrated markets with innovative products:

MFI players in Sri Lanka should explore strategies for market and prouct differentiation due to comparatively higher penetration levels of microcredit in the low-income population. Existing players in the sector thus need to focus on deepening financial inclusion by serving unmet needs, for instance, government payments such as pension, insurance, and lifecycle microcredit products for the target customer segment.

> 'Given relatively high penetration of micro-credit and group loan products in Sri Lanka, product expansion and diversification into housing finance, SME financing etc. is likely to drive the growth for MFIs in near future.'
>
> Leading Microfinance practitioner, Sri Lanka

[11] World Bank Development indicators 2014
[12] IFC SME finance Gap for Sri Lanka 2011-12

Innovation in product design is a good strategy to attract more customers in a penetrated market where differentiation in terms of loan size, duration or interest rates is difficult to achieve. Geographic and economic position related products could be designed to attract more customers. Some examples include value chain financing products for agriculture in the Northern Province, tourism in the Western Province and aquaculture in the Southern Province. MFIs could also offer value added non-financial technical services to selected clusters of customers (see Box 2) after conducting market research and diagnostic studies to inform the development of such products. Current data on market penetration will allow the practitioners to further test qualitative, macro and institutional factors in innovative product design.

Box 2: Innovation in product design- brief case of Sembrar Sartawi
Sembrar Sartawi founded in 1990 offers a wide range of financial services such as microcredit and insurance, primarily targeting small farmers in Bolivia. It combines Technical Assistance (TA) with its microcredit products to transfer best practices with credit support for market access. TA is provided to increase yields and reduce risks; financial services create access to capital while market access contributes to better returns, making agriculture more profitable and qualifying small-holder farmers for further loans.

Drive behavioral change for use of digital finance technology: Technology and digital financial services have the potential to improve access to financial services in a cost effective way. Several examples such as bKash in Bangladesh, Saldazo in Mexico and M-Pesa in Kenya have shown the power of technology for enhancing financial inclusion. In Sri Lanka, focus on technology for enhancing financial inclusion emerged with the 2012 regulatory framework for categorizing mobile money.[13] However despite having higher access to mobile networks and the internet; use of technology for financial transactions seems to be low (Figure 7). While a detailed research on the low uptake of digital finance technology is required, preliminary research indicates that the current low uptake of digital finance in the country is linked to cultural and behavioral aspects of the low-income population. The low-income segment seems to prefer cash for all financial transactions and prefer traveling to a brick mortar branch to withdraw money.

Figure 7: Technology usage indicators of financial services for South Asia and Sri Lanka

Source: World Bank Global FINDEX Indicators 2014 data.

Investment to encourage behavior change among low-income customers would allow MFIs and NBFCs to achieve scale and operational efficiency. Moreover, microfinance processing tasks, such as credit analysis, recording disbursements, payments, and monitoring can be carried out more efficiently through the use of technology. Box 3 indicates on how a microfinance company was able to increase the uptake digital financial services in its customers and reach scale.

Box 3: bKash digital financial inclusion
bKash is a mobile money system in Bangladesh and a subsidiary of BRAC Bank that aims to serve users at the BoP. The service focused on behavior change of low-income users to adopt electronic money as a genuine alternative to physical money. Campaigns around users to keep money in a safe digital system, secure transfers, and pay low fees and to recognize the importance of being part of financial inclusivity brought in a behavior change amongst the customers. bKash was also able to lower the 'perception of technology' in the users mind as something less sophiscated and easy to use.
Launched in 2011, bKash now has 2.2 million registered customers with good use frequency

[13] Enabling Mobile Money Policies in Sri Lanka, Simone di Castri, 2013

Promote saving products to reduce external dependence on capital and reduce currency fluctuation shocks: Keeping the 'cost of funds' low is a key metric for improving the profitability of MFIs and NBFCs. The cost of funds for Sri Lankan MFIs and NBFCs was seen to vary in a significant way depending on their access and exposure to the foreign investors and funds as well as relationships with larger domestic banks. However in the last few months of 2016, Sri Lanka seems to be grappling with weak public finances, depleting foreign reserves and high foreign debt share leading to Fitch downgrading country's long-term foreign- and local-currency issuer default ratings (IDRs) to 'B+' from 'BB-' i.e. from 'stable' to 'negative'[14] indicating a significantly weak credit risk. This may indicate that the MFIs and NBFCs in the country may find it difficult to source low-cost foreign funds in near future, and hence, may have a higher dependency on domestic sources of capital.

A comparative higher cost of domestic funds, MFIs/NBFCs in Sri Lanka may require a financial strategy to source low-cost funds or look towards promoting saving products among its clientele to lower the cost of capital. For many of these low-income customers, it is important to continuously reiterate the benefits of a formal savings product along with microcredit account. This is not only expected to improve the customer's relationship and stickiness with the MFI/NBFC but also reduce the harmful impact of tunneling and risks for loan default. Inculcating savings habit among the low-income population is however, a difficult task. A specific strategy adopted by a microfinance bank to promote savings has been briefly presented in Box 4

Box 4: ADOPEM strategy to promote savings

ADOPEM is financial institution focusing on providing microcredit and savings products to women in Dominican Republic. Till 2010, ADOPEM was expanding its client base and credit portfolio, however promoting savings to low-income clients remained a major challenge. Many savings accounts were inactive or maintained very low deposit balances.

In order to overcome this challenge, APODEM focused on two key intervention areas: (i) core marketing strategy and targeted campaigns and (ii) forging partnerships with foundations and other institutions. The campaigns assisted ADOPEM to create awareness in the customers whereas the partnerships enabled launching of a series of innovative products for the low-income population groups.

Adapted from: APODEM Bank strategy, Suzanne A, 2010

Setting up self-regulatory bodies for policy advocacy and setting up guidelines for safe business practices: The microfinance sector in Sri Lanka is less developed in terms of regulatory ecosystem especially on interest rate regulations and clarity of customer acquisition and protection norms as compared to other South Asian countries. Less regulatory clarity and customer protection could potentially seed future turmoil in the industry. The market is also characterized by low barriers to entry and expansion, and at times, imperfect competition between MFIs and NBFCs. A self-regulatory body (SRO) could play an important role in policy advocacy, set up guidelines for safe business practices and customer practices, and promote market development for microfinance sector in Sri Lanka. A SRO for MFIs in Sri Lanka would work towards standards promotion, knowledge sharing, and development of transparent business environments while protecting the customers. The SRO could also play a key role in attracting commercial capital to the MFI sector, as well as advise policymakers on promoting financial inclusion initiatives in Sri Lanka. MFIN and Sa-Dhan from India are good examples of self-regulatory bodies of regulatory and policy advocacy that could be further investigated.[15]

[14] Fitch Downgrades Sri Lanka to 'B+' , Reuters, Feb 2016, http://www.reuters.com/article/idUSFit950402

[15] Intellecap played a key role in the conceptualization and formation of a Self-Regulatory Organization: MFIN for leading the Indian microfinance Non-Banking Financial Corporations (NBFCs).For this Intellecap engaged with microfinance industry stakeholders, including CEOs of MFIs, investors, bankers, donors, networks, rating agencies, etc. to determine the contours of risk in the Indian microfinance space and mitigation strategies

Way Forward

These market opportunities and growth strategies can provide a starting vintage point for relevant stakeholders to further study and closely monitor Sri Lanka's microfinance sector. The industry is expected to reach maturity in the next few years, so market penetration growth strategies such as product differentiation and market diversification will shape the growth of successful players. It will be interesting to see the impact of the new Microfinance Bill that was passed in Parliament in May 2016 to cater to the licensing, regulation and supervision of the country's microfinance players. Moreover, there are talks about new laws that could enable foreign capital to further boost the sector's growth. However, deeper diagnostic study of the Sri Lankan microfinance sector is needed to identify the quantifiable market potential of various players, and to highlight key intervention areas for regulators, development financial institutions, and multilateral organizations. There is also a need for a detailed study on the present market penetration levels of microcredit products, in order to design policies for customer protection on multiple lending, as well as to promote healthy competition among the various players. There is much to be analyzed, documented and discussed to set the future course for the microfinance sector in Sri Lanka, and to maximize its potential to change the lives of the country's low-income population.

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About Intellecap

Since 2002, Intellecap Advisory Services Private Limited (Intellecap) has been committed to economic and social development through market-based solutions that help build and scale innovative businesses for social change. Founded in 2002, Intellecap has grown into a Group with more than 600 employees and 300 engagements across 23 countries around the world.

Intellecap has more than a decade of experience in working with multiple MFIs in India, Sri Lanka, Bangladesh, Indonesia and many countries in Sub-Saharan Africa. During this period, we have worked with more than 50 MFIs working in diverse domains ranging from community-based Microfinance Institutions to Housing Microfinance Institutions. We supported many MFIs in areas like strategic planning, market landscaping, designing and developing microfinance operational procedures including defining credit underwriting policies, facilitate in raising capital and market linkages, facilitated in identifying appropriate MIS. Our investment banking team has facilitated growth capital for many MFIs across India and South Asia assisting them to expand their business operations across new geographies as well as introduce new products. Our annual "Inverting the Pyramid" series on the microfinance sector in India can be viewed here.

For more details on our service offerings in the microfinance and financial inclusion segment please visit our website: www.intellecap.com or write to vasu.kangovi@intellecap.net for any specific queries.