

Microfinance and Commercial Banking

Abstract

This paper examines the link between microfinance and commercial banks. At the initial stage of evolving microfinance, commercial banks were not much interested in financing for the poor of developing countries, allowing other microfinance institutions to explore their work in this sector. Higher risk, higher transaction cost and socio-economic issues were the main reasons for lesser attention on microfinance activities. However, with increased competition in traditional market, commercial banks are gradually expanding their banking operations to the microfinance market, and this has supported to link formal and informal financial markets of developing countries.

Introduction

Microfinance refers to the provision of financial services to poor and low-income households. These financial services include loans, deposits, payment services, money transfers and insurance to people who are unable to access commercial banks and lacking of banking practices.

According to Mosley (2000), as quoted by Chandradasa (Dec 2004/ Jan 2005), the definition of microfinance often includes both financial and social intermediation. Some scholars, therefore, name these programs as "credit plus" approaches. According to Chandradasa (undated), the microfinance is not simply banking, but

a "development tool", because it includes;

- i. Small loans (micro-credit), typically working capital,
- ii. Informal appraisal of borrowers and investments,
- iii. Collateral substitutes, such as group guarantees or compulsory savings,
- iv. Access to repeat and larger loans, based on repayment performance streamlined loan disbursement and monitoring, and
- v. Secure saving products.

In developing countries, three types of sources, namely, formal, semi-formal and informal institutions provide micro-finance services for poor or low-income households. Rural banks and cooperatives are the major players of microfinance in the formal sector. However, with commercialisation of microfinance activities, development banks and commercial banks in the formal sector have been increasingly involved in microfinance of developing economies. Second source includes semiformal institutions, such as non-government organisations (NGOs) which are offering financial services for the poor of developing economies. Informal sources include money lenders and shopkeepers, traders, etc.

Significance of Microfinance

The provision of credit and generation of savings have long been recognised as essential

H.M.S.P. Herath¹

Head, Department of Banking and Finance Faculty of Business Studies and Finance, Wayamba University of Sri Lanka, Kuliyaipittya.

elements in any rural development strategy. The credit can play a crucial role in the modernisation of agriculture, but its role in the fight against rural poverty has seldom been recognised. Especially when addressing the issue of lack of capital for promoting agricultural enterprises and for up-lifting the social capital of the rural economy, the role of formal financial institutions, i.e., state or privately-owned commercial banking system is very much important. Those institutions can fulfil financial needs of the rural poor even by a way of granting credit facilities to improve their harvest or their businesses concerned. But, there is an allegation that even though those institutions are mobilising more and more rural savings, the provision of credit facilities to rural sector is very low. The rural poor men and women, landless, agricultural labourers and small fishermen have almost been excluded from these financial services either because they were not available (collateral and procedural requirements rendered to them inaccessible) or simply because they were not considered creditworthy. According to Karmakar (1999), the erroneous view is that the poor do not have any resources, do not save, that they cannot invest in view of immediate

consumption needs, and that they are ignorant of the basic principles of sound money management. In the competition for a small quantum of financial resources, the poor naturally lost out in the institutional markets and were constrained to resort to exploitative informal sources of financing such as money lenders and traders. Further, rural financial services have mostly been controlled by rich farmers, who are able to use their large endowment base and influence within the local power structure to secure loans at very advantageous terms. As a result, this informal financial sector was playing a crucial role in meeting the credit needs of the rural poor than the formal sector institutions. This informal financial sector was able to respond quickly and with great flexibility to press demands, and exploit the poor and further compound their poverty since the credit was provided at exorbitantly high rates of interest. According to Qureshi *et al.* (1996) as quoted by Karunanayake (2003), the importance of this money lending has tended to decline in countries of South Asia in the wake of post-independence development initiatives.

As a result of suffering from both formal and informal unfair treatments by these rural poor, many national rural development programs in the form of integrated efforts or cooperatives have endeavoured to increase the availability of financial services, reduce collateral or other requirements, and adapt lenient procedures to rural clients. Even though such credit cooperatives are widespread in South-Asian countries, the principle of open

membership caused most of the cooperatives to come under the control of well-to-do powerful farmers and have failed to make any contribution in the alleviation of poverty in the rural sector. Therefore, the benefits of these cooperative institutions have frequently been diverted to serve the interests of a selected few. From the world experience, since the rural economy was not properly served by formal financial institutions, at the beginning of the 1950s, many development projects began to introduce subsidised credit programs targeting at specific communities to fulfil the un-served financial needs of the rural poor. These subsidised schemes were rarely successful. Also, some institutions that have been specially established under these programs such as Rural Development Banks suffered massive erosion of their capital base due to subsidised lending rates and poor repayment discipline of the rural people. At the same time, the devoted funds did not always reach the intended beneficiaries, and instead, often ended up in the hands of better-off farmers (CGAP, 2003).

As a result, in the 1970s, experimental programs in Bangladesh, Brazil and a few other countries extended tiny loans (micro-loans/credit) to groups of poor women to invest in micro businesses through some NGOs. Because, during that time, the markets and governments failed to provide financial services to the poor, and later, it was widely accepted to select NGOs to accomplish this task. This type of

micro-enterprise based credit was disbursed as solidarity group lending system in which every member of a group guaranteed the repayment of all members. Here, there are several factors, which have led to increased interest in micro-credit in promoting growth with greater equity. There has been a growth in the recognition of the importance of empowering all people, by increasing their access to all factors of production, including credit. This enabled them to accumulate assets and raise household income and welfare. As a result, the value of the role of NGOs in development was received more attention. During the 1990s, many of these institutions transformed themselves into formal financial institutions to access and on-lend client savings, thus enhancing their outreach. Later, these institutions were given a specific name called Microfinance Institutions (MFIs).

Microfinance Institutions (MFIs)

A microfinance institution (MFI) is an organisation that provides financial services to the poor. This, a very broad definition, includes a wide range of providers that vary in their legal structure, mission, methodology, and sustainability. However, all share the common characteristic of providing financial services to clientele who are poor and more vulnerable than traditional bank's clients. Historical context can help explain how specialised MFIs developed over the last few decades. According to CGAP (2003), it is estimated that there are about three thousand MFIs in developing countries. These institutions also help create deeper and more widespread

financial markets in those countries. These MFIs can be formal, semi-formal or informal service providers.

Formal providers are those that are subjected, not only to general laws, but also to specific banking regulation and supervision (e.g., development banks, savings and postal banks, commercial banks, and non-bank financial intermediaries). Formal providers may also be any registered legal organisations offering any kind of financial service. Semi-formal providers are registered entities subjected to general and commercial laws, but are not usually under bank regulation and supervision (e.g., Financial NGOs, Credit Unions and Cooperatives). Informal providers are non-registered groups such as rotating savings and credit associations and self-help groups.

According to ownership structure, MFIs can be government-owned, like the rural credit cooperatives in China; member-owned, like the credit unions in West Africa; socially minded shareholders, like many transformed NGOs in Latin America; and profit-maximising shareholders, like the micro-finance banks in Eastern Europe.

The focus of some providers is exclusively on financial services to the poor. Others are focused on financial services in general, offering a wide range of financial services for different markets. Organisations providing financial services to the poor may also provide non-financial services. These services can include business-development services, like training and technical assistance, or social services, like health and empowerment training.

Poor people need and demand the same types of financial services as everyone else. The most well-known service is non-collateralised "micro-loans," delivered through a range of group-based and individual methodologies. The menu of services offered also includes those adapted to specific needs of the poor, such as savings, insurance, and remittances. The types of services offered are limited by what is allowed by the legal structure of the provider, i.e., non-regulated institutions are not generally allowed to provide savings or insurance.

The biggest challenges for MFIs are ensuring the financial services to the poorest segment of the households and their enterprises (i.e., loan amount less than per capita income) and financial viability of MFI itself for their survival and sustainable growth. According to Harper (2003), the following measures are used to evaluate MFIs to measure the impact of microfinance on beneficiaries:

- i. Profitability of the MFI
- ii. Loans disbursed
- iii. Savings Mobilised
- iv. Loan repayment rate
- v. Average loan size
- vi. No. of borrowers
- vii. No. of Savers
- viii. Staff productivity (Volume of loans/savings per employee)
- ix. No. of repeat borrowers
- x. Proportion of women clients

xi. No. of clients who know they belong to groups which are poor, such as people who are living in a particular areas, or belong to particular tribes

xii. Regularity of attendance at group meetings

xiii Changes in clients' assets

xiv. Changes in clients' income

xv. Improvements in clients' family nutrition

xvi. Improvements in education and school attendance and,

xvii. Changes in client empowerment

Commercial Banks in Microfinance

Commercial banks offer an array of deposit accounts, including checkable deposits, savings deposits and time deposits. Also, banks provide range of loans products to their customers like, personal loans, housing loans, business loans, etc.

At the initial phase of evolving microfinance, commercial banks have not shown their interest on microfinance activities, as they have believed that microfinance as an unprofitable option. Microfinance experts have identified three basic reasons for the absence of microfinance activities in commercial banks in the past. Perception of high risk and high cost associated with microfinance transactions and socio-economic and cultural barriers were the main reasons for non-involvement of commercial banks in microfinance transactions. Traditional bankers perceived that micro-enterprises as bad credit risk. Non-availability and lack of

collateral to guarantee demand for borrowings of micro-entrepreneurs was a major reason which discouraged commercial bankers for not involving in microfinance activities. Also, they perceived that micro-enterprises of the poor as unstable and unfeasible business which may make disable repayment of low-income groups' borrowings.

Also high cost associated with small loans was another reason which discouraged commercial banks to involve in microfinance. Transaction cost associated with finance activities is assumed to be decreased with the increase of loan size of borrowers. However, as micro credits are in small amounts and their maturity periods are shorter, transaction costs in micro credits were relatively high as compared to traditional loans of commercial banks, and this was another major reason for these banks to deviate from microfinance activities.

In addition, socio-economic and cultural barriers were another factor to depart banks from microfinance activities. Lack of education is a common issue for people who are living in low-income countries. As a result, they do not possess business records that can show their business feasibility. Also, these poor people in developing countries have some cultural and language barriers to adapt to modern banking sector.

However, by today, the situation has considerably changed. Commercial banks have increasingly been involved in financial transactions with low-income people. With increased competition in banking sector,

commercial banks are now facing a major issue of decreasing their market share in financial transactions, thereby causing to decrease their profit margin. Therefore, the interest has been given on microfinance activities by commercial banks. For example, CGAP (Consultative Group to Assist Poor) has identified up to 3 billion potential clients in the microfinance market and over 225 commercial banks and other formal financial institutions engaged in microfinance activities in developing countries. Hence, participation of commercial banks in microfinance activities has been significantly increased during the last decade.

With high competitive advantage in microfinance activities, it has been identified that commercial banks use six approaches to enter the microfinance market (Isern and Porteous, undated) through either a microfinance service company (direct approach) or the existing microfinance providers (indirect approach).

In direct approach, commercial banks use three different ways to enter microfinance market. They include either opening an internal microfinance unit or a specialised financial institution or a microfinance service company.

Commercial banks use three different ways in indirect approach to microfinance market. They are outsourcing retail operations or providing either commercial loans or infrastructure and systems to MFIs.

Goodwin (1998) has identified the following factors for the success of

commercial banks involvement in microfinance activities:

- (i) Creating a small specialised bank or a separated microfinance unit within a large commercial bank
- (ii) Treating savings as equally important to lending
- (iii) Charging interest rates to cover all the costs of the lending products
- (iv) Ensuring excellent Management Information System (MIS) and portfolio management
- (v) Recruiting staff from outside the banks and/or give staff specialised training
- (vi) Finding a champion or visionary who will see the program through to success

Microfinance and Commercial Banking in Sri Lanka

In Sri Lanka, various microfinance practitioners have been engaged over the last few decades. Commercial banks, Development banks, Finance companies, Public welfare organisations, Co-operatives, Co-operative Rural Banks (CRBs) and NGO-MFIs have been the key-players in microfinance of Sri Lanka. People's Bank, Bank of Ceylon and Hatton National Bank which offer various microfinance loans for poor people are the well-known commercial banks involved in microfinance of the country. Among development banks, Regional Development Bank and Sanasa Development Bank have been playing a vital role in microfinance market to meet the demand for financial transactions of poor people.

Among commercial banks in the country, the People's Bank, a State-owned bank and the second largest bank in Sri Lanka, provides access to financial services for the rural and poor households. Currently, it offers different microfinance loan schemes for small and medium agricultural entrepreneurs, agro-based industries, self employment, cottage industry, trade and services for more than 25 percent of household in the country. The People's Bank grants micro finance loans for starting, improving or expanding business of the poor. When the maximum loans amounts are considered, it shows a clear indication of commercialising microfinance activities in the country. For example, the People's bank provides a maximum amount of Rs. 250,000 for micro enterprises with only two personnel guarantees. Also maximum loan amounts for small and medium entrepreneurs are Rs. 2 million and Rs. 20 million respectively. Also, Bank of Ceylon (BoC) and Hatton National Bank (HNB) are the other key commercial banks in the country which have been engaged in microfinance for a long period of time. They are granting microfinance loans for agriculture, fisheries, self-employment, etc. Those two banks also grant loans with a maximum loan size of 1 million for micro-enterprises to fulfil their financial requirements.

Conclusion

There are various types and a large number of institutions and programs to finance and help promote micro-enterprises among the poor people. Hence,

microfinance has become a vital tool in poverty alleviation of these low-income households. At the initial stage of evolution, commercial banks had perceived microfinance as a non-profit option. High cost of both credit risk and transactions was the main reasons that discouraged commercial banks to enter the market. However, with increased competition among formal financial institutions for the traditional market, commercial banks have shown an increased interest to enter the microfinance market using direct and indirect approaches to enter the microfinance market. In direct approach, commercial banks enter the market by starting a special unit or specialised institution. In addition to that, banks use indirect approach to enter the market by channelling funds via existing microfinance providers in the market. This has increased the number of commercial banks serving for financial needs of the poor people. Larger size of credits and supply of credit for the poor with an interest are some indicators which show commercialisation of microfinance activities. The involvement of commercial banks in microfinance activities has accelerated the amalgamation of formal and informal financial markets in developing countries.

References:

Chandradasa, A.J.M. (December 2004/ January 2005). *What is Microfinance?*, Economic Review, People's Bank, Colombo, Sri Lanka.

Consultative Group to Assist Poor (CGAP). (2003). *Frequently Asked Questions*, Retrieved on August 8th,

2005, Available from <http://www.cgap.org>.

Goodwin R. (1998). *The Role of Commercial Banks in Microfinance: Asia Pacific*

Harper, M. (2003). *Practical Microfinance: A Training Guide for South Asia*, Vistaar Publications, New Delhi.

Isern, J. and Porteous, P. *Commercial Banks and Microfinance: Evolving Models of Success*, Karmakar, K.G. (1999). *Rural Credit and Self-help Groups: Micro-finance Needs and Concepts in India*, Sage Publications, New Delhi.

Karunanayake, M.M. (Ed.). (2003). *Rural-Urban Interface in Sri Lanka, Studies in Regional Development*, Department of Geography, University of Sri Jayewardenepura, Sida/SAREC Research Cooperation Project, p. 15.

Mosley, Paul. (2001). Micro-finance and Poverty in Bolivia, *The Journal of Development Studies*, 37(4), London.

Querishi, S., Ilaz Nabi, & Rashid, Faruquee. (1996). *Rural Finance for Growth and Poverty Alleviation in Pakistan*, Agriculture and Natural Resources Division, World Bank, South Asia Region.

Wattegama, W.G.E.J. (2007). The Role of Micro-Finance Institutions in the Rural Development Strategy, *Accountancy Journal*, Department of Accountancy and Business Finance, Wayamba University of Sri Lanka, Kuliyaipitiya, Vol 5, ISSN 1800-2382.

Footnote:

¹ E-mail: shan@wyb.ac.lk