

BANKING FOR THE POOR

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I. Introduction

Banking for the poor should not become 'poor banking'. It has become considerably fashionable to discuss the need for banks to help the poor. Nearly everyone agrees that banks should help the poor. However, if banks are to play an effective role in helping the poor there must be a proper understanding of the nature, character and functions of banks.

Banks are not charitable institutions but custodians of deposits funds. Banks must conform to rules and regulations laid down by the Central Bank; they must conform strictly to a number of cash and credit ratios stipulated by the Central Bank and most banks require to make profits and have a balance sheet which is acceptable in the banking world. If a commercial bank transacts its business in such a manner as to have a poor record of its business, then the ability of such a bank to transact banking operations with other banks and particularly in trade and international transactions is jeopardised.

On the other hand banks must have an understanding of their developmental role and degree of social responsibility. In a country like Sri Lanka, banks must realise that a very large section of the community is poor and that meaningful economic development cannot take place unless this poorer proportion of population is assisted. Therefore, a certain amount of subsidization of the credit given to the poorer sections may be warranted. This could be either through cross subsidization between sectors or by the assistance of the Central Bank through refinance at lower interest rates to commercial banks.

In discussing banking for the poor, one should be concerned not about a small quantum of credit being given for a limited period but one of developing a sustainable credit system which serves the poor. To develop a sustainable credit system for the poor, banks have to operate credit schemes which are viable. In other words by and large the credit given by banks to the poor must cover the cost of funds, the cost of administering such loans and the risks undertaken by banks. If credit is given without consideration of the cost factors of banks, then either a bank could give only a limited amount of its funds or would sooner or later be unable to continue a fairly extensive credit scheme to the poor.

While banks must on their part try to adapt themselves to assist the poorer sections of the community by changing their procedures and making themselves more acceptable to the less sophisticated poor, it must be appreciated that there are limits to their adaptation and costs in serving large number of small borrowers. It is for this reason that some of the experiments to serve the poor

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have consisted of developing semi-banking institutions which are more suited to the poor and smaller borrowers and less costly to operate than a full fledged commercial bank. It is also for this same reason that banks have attempted to reach the poor through intermediaries and in some countries separate banks have been established to serve the poor.

Therefore one must be realistic to acknowledge that however much one is interested in serving the poor there are certain limits to banks' ability to serve small borrowers.

This paper is organised so as to describe in the next section the efforts made by Sri Lankan banks to reach the poor and the several institutional innovations that have been devised. Despite these many innovations it is felt that only a small proportion of poor people receive credit. In the third section of the paper the lessons of the experience of banks are summarised. The paper concludes with suggestions to enable an expansion of bank lending to the poor borrowers.

II. Banking Efforts to Reach the Poor

There have been many efforts to increase lending to the poorer sections of the community. Over 1000 Cooperative Rural Banks and 11 Regional Rural Development Banks with over 80 branches are expected to serve the poor. The two State Banks in particular have implemented through their 600 branches a number of special credit schemes to reach the poor and hitherto unserved sectors, craftsmen and self-employed enterprises. More recently there have been several attempts to link the formal and informal markets by lending to the poor through non-government organizations and informal intermediaries.

These are in addition to the expansion of the branch banking network to provide a bank for every 22,000 of the population and concessionary credit for agricultural crops for over two decades.

Despite all these efforts the poor are ineffectively reached and informal sources meet most needs of small borrowers whether they be self-employed entrepreneurs, petty traders, farmers or craftsmen. The reasons for this are manifold. Poor customers find it difficult

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to complete the necessary forms, get guarantors, provide documentary evidence and convince the banks of the viability of their projects. Past experience of high rates of default discourage managers to lend to small borrowers. The workload of lending to a large number of small borrowers is greater than in lending to a fewer larger borrowers and the supervision of lent funds is difficult. Managers take a risk of having a large rate of default in their loan portfolio. Since the performance of a branch is judged by its profits, these factors discourage managers from increasing their lending to poor customers. It is easier to lend to bigger customers who may also reciprocate the assistance they have received with gifts and other favours. To be effective in this type of lending bank staff would require to be specially committed to this type of lending.

banks, whose impressive structures and procedures intimidate them. They are a device for extending limited banking facilities to areas where economic conditions do not justify the establishment of a branch bank. The limited facilities of accepting savings deposits, pawn broking and lending for specified purposes, could be adequate and even preferable to fuller banking services through sophisticated and less familiar institutions. CRBs also operate at times more convenient to the local clientele and could be more flexible in the provision of credit owing to their familiarity and knowledge of credit worthiness of borrowers.

After the first five years of CRBs operations their deposits exceeded advances and in most years since then there have been substantial surpluses. At the end of September 1989, CRBs

It is likely that the limitation in lending was due to excessive prudence with depositor's funds by the co-operative staff. The popularity of pawning perhaps vindicates this hypothesis. Lending based on the viability of projects would have been difficult as most staff would not have had the capability to appraise projects. Therefore, CRBs have turned out to be a limited source of funds for poor borrowers. This is not entirely due to deficiencies of these banks themselves, but also due to the local communities not having viable economic enterprises which require various skills and marketing possibilities. The greater flexibility in the lending procedures have not led to easy access to credit.

Regional Rural Development Banks (RRDBs)

The other more recent institutional innovation is the Regional Rural Development Banks (RRDBs). The first RRDB was inaugurated in 1985. Since the commencement of the scheme, 11 RRDBs were established with 89 branches (including their head offices). The security situation has hampered the expansion of the scheme to 14 other districts as well as reduced the pace of branch expansion within each district.

These unit banks are expected to meet the gap in credit which other commercial banks do not provide. In order to perform this function RRDBs were given guidelines that they should not compete with the existing financial institutions but supplement them by providing credit to small farmers, rural artisans, petty traders, small entrepreneurs and for personal needs which are not adequately serviced by banks. RRDBs were expected to be a new species of banks which would bring about a new culture in banking. The area of operation of each bank was also limited to make these objectives effective.

RRDBs had mobilised Rs. 172 million in savings at the end of 1989. During 1985-89, RRDBs had lent Rs. 433 million. In 1989 itself they had lent Rs. 155 million.

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The recognition that institutional lending has many limitations resulted in several efforts to service the poor borrowers through institutional innovations. These included semi-banking institutions called Co-operative Rural Banks and a system of unit banks called Regional Rural Development Banks. Banks have also devised methods of lending to the poor through intermediaries, most notably the Praja Naya Niyamakas. These are discussed here.

Co-operative Rural Banks (CRBs)

The foremost experiment has been the establishment of Co-operative Rural Banks (CRBs) in 1964 under the auspices of the People's Bank. CRBs are not banks but departments of co-operatives which mobilize savings and lend funds for limited purposes. They are small in size, less impressive than bank branches and established within the co-operatives which are a familiar institution in the village. Unsophisticated village clientele find it more comfortable to transact business with their village co-operative society rather than fully fledged

had a surplus of Rs. 12 billion with deposits being over twice the quantum of advances. In the 25 years of their operation nearly one thousand CRBs and special branches of the People's Bank, which were again an innovation to perform the same functions as CRBs, were established.

While the expansion of CRBs, their distribution in the country and the amount of savings mobilized by them could be considered a success, their lending has been limited. The surplus of deposits over total advances (including pawning) implies that they have been mobilizing rural resources for transmission to other areas rather than been a provider of funds for rural and poor borrowers. The funds lent have been for limited purposes. More than one half of short term loans has been for housing, electrification and water supply and about 20% for agricultural production and cottage industry. Credit obtained by pawning, which constituted as much as 30%, is likely to have been used for a variety of purposes including productive employment.

try, 23 per cent for trade and business and 7 per cent for Fisheries and Live-stock. There is evidence that they have lent for a wide variety of purposes and that many micro-enterprises have obtained funds from them.

RRDBs have a high cost structure owing to the tendency for the staff being paid fairly high salaries, the staff, numbers, being high for the small turnover in branches and costs of servicing large numbers of small loans. There is no data on the rate of defaults. Although it was intended to transfer the ownership of these banks gradually to shareholders in the community itself this has not happened.

The Praja Naya Niyamakas (PNNs)

The Praja Naya Niyamaka (PNN) scheme inaugurated by the two state banks in October 1988 is an attempt to link informal credit sources to the institutional banking system. The basic features of the schemes are that the two state banks lend funds to persons of proven credit worthiness, often on the basis of collateral, at an interest rate of 1 1/2 per cent per month (18% per annum) and expect the PNNs to lend at an interest rate not exceeding 2 1/2 per cent per month (30% per annum). The banks give the PNNs guidelines on how to lend but do not require them to provide documentation and other proof of their lending. Since this scheme is meant to assist the small borrower, loans are not expected to exceed Rs. 5,000.

Under this scheme the financial resources of the banks are expected to supplement the resources of the informal sector to meet the small borrower's credit needs. The flexibility and convenience in lending, which the banks as institutions could never provide, could be provided by the PNNs with the resources of the banks. The increased supply of funds from the PNNs and the consequent increased competition among informal lenders are expected to bring down the cost of borrowing, make credit more readily available for the needs of the small borrower and improve the conditions of borrowing. Since the two banks are expected to appoint about 14,000 PNNs throughout the country on

the basis of 2 PNNs for each village, the competition among them and with other informal sources is expected to bring down informal interest rates. By increasing the supply of funds and the availability of options to the small borrower, the interest rates in the rural financial market are expected to come down.

The success of the scheme would partly depend on the choice of the PNNs. Therefore, the banks are making an effort to choose persons who are not motivated by profit alone, but also have a social purpose and view the implementation of the scheme as one having a significant impact in improving the productive capacity of the economy, alleviating poverty and increasing incomes.

The two state banks have appointed over 7000 PNNs and lent over 200 mil-

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lion to them. PNNs have lent for a wide spectrum of purposes, including very small loans for self-employment, petty trade and various services. However, some of the PNNs have tended to concentrate on larger lending and not lent to very small enterprises as required under the scheme. There are instances of PNNs not lending the funds or lending only to their close relations.

Among the difficulties PNNs have themselves highlighted is that the upper limit of credit given by the banks (Rs. 200,000) or the limit imposed within this maximum on the basis of their credit worthiness was inadequate. They contend that they are unable to explain to borrowers that they have exhausted their resources when they are appointed as "agents" by the banks. Many PNNs have said that the margin of 1% per month was inadequate as they bore the entire credit risk and the maximum income that could be derived by on-lending Rs. 100,000 per month. The maximum loan limit of Rs 5000 was also considered inadequate and PNNs have in fact often lent higher amounts.

The PNN scheme is undoubtedly a useful experiment in linking the informal lender to the institutional system. One of the difficulties in its successful implementation is the need for the banks to ensure that the informal lender continues to lend unfettered in an informal manner. The banks should lend to credit worthy PNNs and ensure recovery of funds lent to them and give PNNs freedom in the manner they on-lend. The linking with the banks should not result in the introduction of formal procedures. Since the PNN bears the risk and the money he lends is 'his' money, the PNN should be free to lend in any manner he likes. Banks should only use some 'moral persuasion' to achieve the objectives of the schemes.

Lending through NGOs

One model used by banks to reach the poor is that of lending to non-govern-

ment organizations (NGOs) which in turn lend to groups and individuals on their own terms. The NGO takes the responsibility for monitoring the loans and ensuring recovery. The two state banks have made special efforts to expand this model as part of the government's programme for poverty alleviation. Some NGOs borrow at market rates and lend at rates which give them a margin to cover risks and build up their own reserves. Bank borrowings are used for on-lending for agricultural inputs as well as for strengthening marketing. While the cost of the credit is higher than the direct borrowing rates from the bank, the NGO offers the borrower flexibility, immediate access to credit and a minimum of transactions costs. This model of granting credit has in effect reduced the costs of inputs and noticeably improved the prices fetched for the borrower's produce. The latter has been achieved in several ways.

Illustrative of the benefits of such lending is the case of a NGO which borrows from a bank and lends to its members. The informal lender often links credit to

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marketing. The grower who borrows from the NGO is not restricted to selling his produce to the bulk purchaser of the produce ("Commission Agent") and therefore able to obtain the market rate for his produce. The NGO itself has used funds borrowed to provide transport facilities and for some of its members to be employed in marketing. Further the NGO has linked up with outlets in the metropolis to sell the produce of its members and to participate in regular or weekend markets. New economic enterprises arising out of the possibility of marketing their produce has also been organised. Since the borrowers are themselves members of the NGO they have a sense of responsibility to repay the loans.

There has been an interesting development in the above model which has enabled its implementation in a more

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extensive manner. Foreign organizations have given default guarantees on the bank's lending to the NGOs. This has enabled the bank to be more flexible in the granting of the loan as the repayment of the loans are guaranteed. Further on the basis of this guarantee the bank is also in a position to lend more than the sum guaranteed on the basis of its own assessment of the recovery rate. It is useful to indicate that the guarantee is not publicised among the members so as to ensure their sense of responsibility in repaying loans.

The role of the NGO also varies in the above model. Members of the NGO borrow certain loans direct from the bank and the NGO gives its 'approval' to the bank, supervises the use of the funds and helps in the recovery, but the banks uses its own criteria as it takes the full risks of the lending. In other loans the Bank lends to the NGO, which in turn lends to its member and takes full responsibility for the sum borrowed. A third type is where the NGO provides a guarantee but the bank uses its criteria

in deciding to give the loan. The fact that the guarantee operates is not known to the borrower.

There are however several difficulties in expanding this model. Many NGOs receive grants from foreign sources for their activities and lend free of interest or at very low rates of interest. Consequently such NGO cannot simultaneously implement a programme at market interest rates. In fact many NGOs are not motivated to borrow at market interest rates even when banks are willing to lend at minimum market rates owing to their view that if banks are really interested in poverty alleviation that they should charge very low rates of interest-rates much below deposit rates.

The NYSCO Scheme

The state banks have also used a government organization - the National Youth Services Council (NYSCO) - to

lend for a number of small enterprises employing youth. NYSCO plays the roles of preparing the projects, assisting the youth to obtain skills and inputs, lends part of the needed funds, monitors the projects and helps resolve any difficulties the youth may have, assists in marketing the produce and in ensuring recovery of the funds. This has been one of the most successful schemes both in terms of the extent of the implementation and the recovery of funds. About 3500 small scale projects have been financed with bank lending of about Rs. 25 million. NYSCO has played its role as if it were a NGO. It must also be mentioned that NYSCO has a larger number of projects of their own without bank financing.

III. Lessons of the Experience

What are the lessons of these experiences? A lesson that can be learnt from the experience of institutions adapted to serve small borrowers is that they have proved more successful in mobilizing savings than lending to small enterprises.

Therefore institutions should have means by which they could reach as large a number of persons as possible so as to mobilize savings. Semi-formal institutions and agents should be commissioned to muster small savings. Banks can then use these savings through the linkages they adopt to lend to small enterprises.

It appears that while banks and semi-banking institutions have a strength in mobilizing savings, informal lenders are more adapted to lending to the small borrowers. Therefore the two strengths could be combined with resources of the informal lender being significantly supplemented with institutional finances.

It is also part of the experience that when institutions, particularly government sponsored or state institutions, attempt to lend to small farmers, small enterprises and the poor, they run the risk of high rates of default. This is largely due to an attitudinal problem of borrowers from such institutions thinking that they need not repay their loans from state institutions. Therefore attempts to provide institutional finance through grass roots level institutions sponsored by the government tend to attract high rates of defaults. It is therefore preferable for the on-lending to be by non-institutional sources and certainly non-governmental organizations.

The essence of informal finance is the complete flexibility the lender has in his decision making. He is responsible only to himself. Whatever conditions he lays down are requirements he considers necessary. None are mandatory. He can vary his interest rate and requirements of collateral depending on the nature of each risk. His is a personal relationship with the lender which itself ensures a minimum of wilful defaults. These and many others features of informal finance are inherent features of informal and personal sources of finance. In contrast, institutions by their very nature require internally consistent rules to their customers. Documentation is a necessary part of institutional lending even if such documentation is reduced and simplified. Complete discretion to bank officials is also not realistic, they would have to operate within laid down

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parameters. The rates of interest can only vary within certain margins. For instance a bank cannot give interest free loans nor charge 120-300 per cent interest per annum. Bank interest rates cannot reflect risk or administration costs of loans as informal loans do.

To sum up institutions like banks can adapt themselves to lend to the poor to some extent but cannot possibly be likely informal lenders. Banks could be more flexible in their criteria, simplify procedures, reduced from filling and motivate their officers to lend to the poor and small borrowers. Yet they will still retain procedures and require documentation. Since they are not allowed to charge interest rates which reflect the true cost of such lending they will not lend extensively to the poor. Since there are limits to the extent to which banks and institutional sources of finance could be like informal lenders, it is not realistic to expect banks, however adapted they may be, to perform the functions in a manner similar to informal lenders. Therefore it is suggested that one of several methods be adopted to meet the requirements of the poor.

IV. Suggested Strategies to Serve the Poor

One method is to use an intermediary, preferably NGOs, to perform some of the functions of the bank so as to assist the borrowers and the bank. The NGO

could help in formulating the projects, filling in the forms and negotiating on behalf of the borrower, supervising the projects and helping in making the investments a success. A second suggestion is for the banks to lend the NGOs which would perform the functions of on-lending in much the same way as informal lenders. The NGOs could price the credit on the basis of risks and the return to capital.

A third strategy is to lend funds to persons who will take the risks of on-lending to small borrowers. The PNN scheme discussed in this paper is such an attempt and provides an effective means of making available adequate finances and increasing competition among informal lenders. The objective of such a programme should be to increase the number of such lenders and amounts rather than control interest rates, purpose of lending or loan amounts. In fact conditions should not be laid down on how the funds should be lent.

A fourth strategy would be to establish banks specifically designed for lending to the poor. What must be realised in adopting this strategy is that such banks could be sustainable and viable only if they lend at interest rates which cover the financial cost of funds, administrative and transaction costs of lending and risk. If interest rates are controlled or regulated and do not reflect their costs,

such banks would run out of funds unless it is a total subsidy.

Let me conclude, as I began, on an unpopular note. In my view low interest rates for lending to the poor do considerable damage to the development of a sustained programme of credit for them. Low interest rates are responsible for the inadequate to cover their costs. The requirement of the poor is easy accessibility to credit rather than credit at low interest rates. The interest rates charged by banks should reflect the costs of funds, their transactions cost and the risks of lending to the poor. Unless the margins cover these, banks would be unable to lend on any extensive scale and only a small proportion of the poor will have access to institutional credit. Most of the poor will continue to depend on informal sources, some of whom charge exorbitant interest rates. In my view market interest rates could provide the basis for developing a system of bank credit to the poor, otherwise the poor would be starved of adequate resources even for self-employment and small enterprises.

If 'banking for the poor' becomes 'poor banking', then the 'poor become un-bankable'. Therefore it is important to realise that a viable system of sustained credit should be the objective, rather than small amounts of funds lent at concessional rates of interest to serve a very small minority of persons.