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A Commercial Bank's Microfinance Program

The Case of Hatton National Bank in Sri Lanka

Joselito S. Gallardo
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Foreword

The global experience of successful microfinance programs and institutions which provide financial services to the poor on a sustainable basis reveals the wide range of channels that can play a role in this market. The continuum of rural/microenterprise finance intermediaries is diverse, ranging from formal institutions to semi-informal institutions and informal channels. Although commercial banks play a dominant role in the financial sector they have generally had limited involvement in microfinance. However, as the microfinance industry matures a small number of commercial banks have recognized the potential for developing specialized financial services geared to the requirements of clients operating microenterprises and small-scale businesses.

This paper reviews the experience of a commercial bank which has initiated a program offering financial services to the poor while continuing its traditional business operations. The Hatton National Bank Limited (HNB) in Sri Lanka is one of a handful of commercial banks which is an exception to the lack of involvement of such formal institutions in microfinance. The paper addresses how a commercially profitable microfinance program is carried out by HNB within the operating structure of a private commercial bank.

The Financial Sector Development Department has prepared this paper as part of its activities in rural/microenterprise finance to disseminate best practice in providing financial services to the poor. As the Bank is in the midst of increasing its support to microfinance, we hope that this paper will assist Bank staff in involving commercial banks as institutional partners where appropriate.

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Abstract

A financial systems approach to microfinance is aimed at developing the capability of a range of institutions to provide financial services to the poor on a sustainable basis. As channels for microfinance, commercial banks have advantages because of access to liquidity from various sources and existing infrastructure through branch offices. However, commercial banks' involvement in microfinance remains limited because of relatively high operational costs and specialized human resource requirements of microfinance programs. This paper reports on the microfinance program of Hatton National Bank Limited (HNB), the largest private commercial bank in Sri Lanka.

Launched in October 1989, HNB's *Gami Pubuduwa* (GP) or "village reawakening" program provides banking services to households in rural and semi-urban areas in Sri Lanka through GP units operating in 20 administrative districts through HNB's branch network. Between 1989 and 1995, the program has reached 12,654 borrowers with an average loan size of US$ 360 and US$ 4.6 million in total loans approved. It has mobilized 44,500 deposit accounts with average balances of US$ 145 and total deposits of US$ 8.05 million.

Principal lessons gleaned from HNB's microfinance experience are summarized below.

▪ A clear objective and basis for motivation are core elements of successful microfinance programs. HNB's main objective is to use the GP program as a platform to promote in rural areas the banking services available from its branches and accumulate information on nonfarm microenterprises and small-scale business projects suitable for financing support.

▪ Management has carefully selected and trained experienced staff from mainstream banking operations to carry out the program and established a clear career development path. As an integral part of regular banking operations, HNB has taken advantage of external economies, e.g. communications facilities, operating systems and office support available from its existing network of bank branches without significant incremental capital expenditure outlays.

▪ Deposit products are designed to conform to income and employment characteristics of the rural villages served. Loans are structured to fit revenue/cash-flow generation patterns of microfinance borrowers. Collateral requirements and loan application procedures have been modified to facilitate access to the program by microfinance borrowers. Since the mostly unsecured GP loans are subject to the same standards and procedures used by HNB in loan administration and provisioning for possible loan losses, the GP program is subject to prudent regulatory standards.

▪ The transfer price mechanism used for "purchasing" excess deposits from GP units is the same as that used for HNB's regular branches. This transfer price is adjusted from time to time according to market conditions to signal shifts in program orientation to loans vis-à-vis deposits.

The HNB experience shows that institutional commitment, operating autonomy and a management environment that encourages responsive procedures enhance program sustainability. A clearer understanding of how microfinance is carried out within the operating structure of a commercial bank would be useful for institutional development of microfinance NGOs transforming into formal banks, as well as for other commercial banks that may be considering involvement in microfinance.

Chapter I. Introduction

Objectives of the report

A financial systems approach to microfinance is geared to developing the capability of a range of institutions to provide financial services to the poor on a sustainable basis. As channels for microfinance, commercial banks have advantages because of access to liquidity from various sources and existing infrastructure through branch offices. However, commercial banks' involvement in microfinance remains limited because of relatively high operational costs and specialized human resource requirements of microfinance programs.

This paper reviews the microfinance initiative of Hatton National Bank Limited (HNB), the largest private commercial bank in Sri Lanka. Its experience through its *Gami Pubuduwa* (GP) or "village reawakening" program shows how microfinance can be viable within a commercial bank's regular operations. The report addresses four issues pertaining to HNB's microfinance operations:

- What motivated HNB to undertake a microfinance program?
- Can a privately-owned commercial bank successfully downscale part of its operations for microfinance?
- What adjustments in regular banking operations are needed to build a profitable microfinance program ?
- Is a microfinance operation consistent with a privately-owned bank's profit-maximizing objective?

Framework of the report

With a view to exploring the issues listed above, the report reviews financial intermediation methodologies developed by HNB to provide financial services to the poor in rural and semi-urban areas in Sri Lanka. The institutional aspects and operating results of the GP program, which is fully integrated into HNB's regular commercial banking operations, are compared with microfinance programs of NGOs, village banking societies, savings and credit cooperatives and rural development finance institutions in Sri Lanka. Data used for the analysis in this study are derived from HNB's internal management reports on the GP program supplemented by information provided by and gathered from HNB staff at head office, branches and GP operating units, GP program clients and staff of other microfinance institutions in Sri Lanka. While HNB's financial statements are examined and audited by external auditors in accordance with Sri Lanka Auditing Standards, separately audited records of GP microfinance operations are not maintained.

A clearer understanding of how a commercially profitable microfinance program is carried out within the operating structure of a full-service commercial bank can be useful for institutional development of microfinance NGOs transforming into full-fledged formal banks in an **upscaling** strategy. The exposition of HNB's GP experience also demonstrates an alternative **downscaling** approach to microfinance operations that other formal banking and financial institutions considering possible involvement in microfinance can consider.

Chapter II. Models of Microfinance Development

Microfinance programs are based on the proposition that the structure of the financial system in most developing countries, characterized by market distortions and financial repression,[1] is the main reason why poor and small borrowers do not have access to financial services. The core elements of microfinance are:

- strengthening financial institutions which have the capacity and motivation to focus operations on targeted poor households is crucial for poverty alleviation;
- microfinance operations need to be market-driven because full coverage of costs is necessary for continued business and intermediation benefits to clients; and
- a financial systems approach promotes functional specialization and market coverage among different microfinance institutions and enhances their integration into a country's formal financial markets. [2]

The institutional development model that is widely covered in recent studies is one of **upscaling**. The institution building and transformation process involves a financially-oriented NGO expanding the scope and scale of its business to achieve operational self-sufficiency over a five-year period. It then transforms by establishing a subsidiary formal bank or regulated institution to specialize in financial intermediation, while the NGO parent continues to focus on developmental services. The better known models are PRODEM/BancoSol[3] in Bolivia; CorpoSol/FinanSol in Colombia; and Kenya Rural Enterprise Programme (K-REP) and Tulay Sa Pag-Unlad Inc. (TSPI) in the Philippines which have applied for banking licenses from their respective central banking regulatory authorities.

In contrast, a **downscaling** strategy requires formal-sector financial institutions with the willingness to acquire the know-how -- in terms of appropriate lending technology and new organizational structures -- to provide banking services to microenterprises. The most prominent model is Bank Rakyat Indonesia (BRI), a state-owned commercial bank, and its network of *unit desas* or village banks. International agencies which have promoted downscaling programs are the InterAmerican Development Bank (IDB) and the European Bank for Reconstruction and Development (EBRD).[4] In these downscaling programs, selected private commercial banks have been given access to funds for onlending and additional equity, in the case of EBRD's program.

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[1] Edward S. Shaw, Financial Deepening in Economic Development, New York: Oxford University Press, 1973; and Ronald I. McKinnon, Money and Capital in Economic Development, Washington, DC: Brookings Institution, 1973.

[2] Maria Otero and Elisabeth Rhyne (eds.), The New World of Microenterprise Finance - Building Healthy Financial Institutions for the Poor, West Hartford, CN: Kumarian Press, 1994.

[3] Fundacion para la Promocion y Desarrollo de la Microempresa (PRODEM) and Banco Solidario, S.A. (BancoSol).

[4] Reinhard H. Schmidt and C.-P. Zeitinger, "Critical Issues in Small and Microbusiness Finance", Interdisziplinare Projekt Consult GmbH, Frankfurt am Main, September 1994.

HNB's microfinance program differs from these downscaling models because it has been developed and implemented solely on private initiative, without reliance on government or international donor subsidies. HNB's experience underscores an important reason why commercial banks' participation in microfinance is desirable. Commercial banks like HNB have the ability to access liquidity through various sources and to mobilize deposits, which minimizes the need to access funds available from government onlending programs.[5]

[5] Other commercial banks with microfinance experience such as Bank Dagang Bali in Indonesia which started with specialized microfinance operations before expanding into regular commercial banking operations bear out this observation.

Chapter III. Poverty Alleviation Programs

Dimensions of poverty in Sri Lanka

Sri Lanka remains a low-income economy, with a per capita GNP of US$ 540 in 1992. Although its long-term growth compares favorably with most of the developing world, it falls well short of the growth rate achieved in the last three decades by the high-performing East Asian economies such as Korea, Malaysia, Thailand and Indonesia. According to the recent Poverty Assessment Report of the World Bank the incidence of poverty is higher in rural than in urban areas (24% and 18% respectively in 1990-91) and is the same in all regions of the country, except for the Western region where the incidence of poverty is significantly lower. Key characteristics of poverty in Sri Lanka can be summarized as follows[6]:

- Households are likely to be poor if their members are employed in agriculture and other primary production activities, construction, or as casual laborers.
- Poverty is about the same among female-headed and male-headed households.
- While poor households have more members who are likely to be less educated than those of non-poor households, the differences are slight.
- Members of poor households have lower labor force participation rates, partly explained by the higher proportion of children (age 10+) in them.
- The poor devote a very large proportion of consumption expenditure to food (rice alone accounts for fully 25% of total consumption expenditure).

Government-sponsored poverty alleviation programs

Poverty alleviation programs in Sri Lanka consist of employment-generating credit schemes, income transfers and social safety nets. Income transfer and subsidy programs include food stamps, mid-day meals, flour and fertilizer subsidies, free school uniforms and direct public assistance to the destitute poor and people displaced by civil strife. Social safety nets are supplemented by income transfer programs designed to provide selected poor households fixed monthly cash grants for two years, considered to be a sufficient period to exit poverty by finding employment or developing a microenterprise. These poverty programs entail substantial public expenditures -- about 3.5 % of 1995 GDP[7] -- and face targeting and efficiency problems. The Government of Sri Lanka is taking steps to consolidate some of the income-transfer schemes into a better-targeted new system, the *Samurdhi Programme.*

The National Development Trust Fund (NDTF) [8] was set up in May 1991 to implement the Poverty Alleviation Project sponsored by the World Bank with the collaboration of

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[6] Sri Lanka Poverty Assessment, Report No. 13431-CE, The World Bank, Washington, DC, January 11, 1995.

[7] For a detailed discussion of these transfer and subsidy programs, see "Chapter IV - Transfers, Safety Nets and NGOs", Sri Lanka Poverty Assessment, Report No. 13431-CE, The World Bank, Washington, DC, January 11,1995.

[8] NDTF was formerly called Janasaviya Trust Fund.

UNDP, KfW and the Government of Sri Lanka. The program has four components: credit and microenterprise; women and child nutrition and health; community facilities; and human resources development projects.[9] The credit and microenterprise development (CMED) component was planned to expand the income-earning capability of the target poor households by developing credit and other support services to promote self-employment and microenterprise. Full disbursement was not achieved in the CMED component due to several factors, including the fact that a number of participating financial institutions have the ability to mobilize resources from the communities in which they operate.

Private sector initiatives

Private sector organizations have also carried out a significant number of income-generating and job-creating programs, funded mostly by financial resources generated on their own initiative and/or supplemented by international donor agencies. The most prominent examples are the Sarvodaya movement with its network of village societies, the SANASA Thrift and Credit Cooperative Societies, Women's Development Federation of Hambantota District and its Janashakthi Bank Societies, People's Rural Development Association and HNB's GP program.

With their established outreach and experience, these private sector institutions have also been important channels for government-funded rural and microfinance programs. Government-directed microfinance programs such as NDTF increase access to funds for on-lending funds. However, most of these institutions continue to rely on self-generated resources and other resources rather than risk uncertainties associated with the continued availability of government funding, especially in an environment of privatization, deregulation and devolution. Some private and public sector institutions accumulate sufficient resources to support their microfinance operations, leading to a lack of demand for NDTF funds.

[9] For a full discussion and treatment, see Midterm Project Implementation Review, Poverty Alleviation Project (CR. 2231-CE), Annex 1: Credit and Microenterprise Development Component, April 23 - May 13, 1995, The World Bank, Washington, DC.

Chapter IV. Hatton National Bank Limited

Corporate structure

A privately-owned company incorporated under the Companies' Ordinance No. 51 (1938) of Sri Lanka, HNB is licensed by the Central Bank to carry out general banking business authorized under the Banking Act. It traces its origins to 1888 when Hatton Bank commenced operations in the hill town of Hatton, which was flourishing in the tea industry of colonial Ceylon. Brown & Co. Ltd., a leading company in the engineering business took over ownership and control of the bank 60 years later in 1948. In 1970, the branches of National and Grindlays Bank were acquired and merged to form Hatton National Bank, with subsequent acquisitions of Mercantile Bank and the Colombo branch of Emirates International Bank UAE. As of the end of 1995, the 12 million issued common shares (Rs. 10 par value) which are publicly listed and traded on the Colombo Stock Exchange were held by 2,335 individuals and 156 institutions.

HNB is the largest privately owned Sri Lanka commercial bank. It was ranked number 431 (in terms of asset size)[10] among all banks in Asia and ahead of two other Sri Lanka private banks included in *Asiaweek Magazine's* top 500 – Seylan Bank (457) and The Commercial Bank of Ceylon (472). These two other banks have comparatively limited, indirect participation in microfinance. HNB is smaller than the two state-owned banks, which also have limited participation in microfinance programs: it is one-fourth the asset size of the Bank of Ceylon, and a third of the asset size of People's Bank. Both state-owned banks had suffered from inadequate capital reserves for loan losses, until government funds were infused in 1993 for restructuring and recapitalization. Table 1 below puts in perspective HNB's standing among Sri Lanka commercial banks.

Table 1. Financial Profile of HNB and Selected Banks in Sri Lanka (1994)

US $ Millions	Hatton Nat'l Bank	Seylan Bank	Commercial Bank	Bank of Ceylon	People's Bank
Asiaweek Rank	431	457	472	344	364
Ownership	Private	Private	Private	Government	Government
Branches	54	79	34	337	323
Assets	458	412	352	2,080	1,596
Deposits	348	327	245	1,363	1,165
Loans	225	205	215	953	896
Net Profit	8.9	3.8	2.8	42.7	13.1
Equity	34.4	13.8	32.3	150.2	74.1
Operating Ratios					
Equity : Assets	7.5 %	3.4 %	9.2 %	7.2 %	4.6 %
Profits : Equity	25.8 %	27.5 %	8.7 %	28.4 %	17.7 %
Profits : Assets	1.9 %	0.9 %	0.8 %	2.1 %	0.8 %
Loans : Deposits	64.6 %	62.7 %	87.7 %	69.9 %	77.0 %

Source: Asiaweek, September 15, 1995.

[10] Information is based on Asiaweek rankings for 1994 as reported in Asiaweek, September 1995.

Banking and financial intermediation services

HNB's principal business consists of commercial banking, development finance, international banking, trusts and investment, mortgage loans and lease financing, with an active program of investment banking services. Corporate finance focuses on loan syndication, equity financing, underwriting, corporate restructuring and rehabilitation. A separate insurance department offers a full range of insurance services to its clients. Investment advisors are fielded at branch offices to assist customers in selecting, buying and selling listed shares and providing margin trading facilities as part of the bank's share-broking operations and services.

Local currency loans comprised 81% of Rs. 16,251 million in total loans and advances as of end-1995. On a 5-year average, income from loans and advances grew 35% per year, accounting for 77% of total income generated which increased at 31% per year. Some 54% of total revenue covered interest expense which grew 33% per year. On a 5-year average, retained earnings were equivalent to 11% of revenues; staff salaries and expenses absorbed 14% and other operating/administrative expenses consumed another 15% of average revenues for the period 1991-1995. At end-1995, the commercial sector accounted for 58% of total loans outstanding, the industrial sector 15% and agriculture 3%. In terms of type of security, 34% of total loans were unsecured or backed by third-party guarantees, twice the proportion of loans secured by cash, quoted shares and other readily realizable assets. Microfinance loans which are mostly unsecured or subject to third-party guarantees are equivalent to about 2% of HNB's total unsecured loans outstanding. This provides useful perspective on the size of HNB's microfinance program relative to overall bank-wide operations.

Performance profile

Return on average net worth was 25% in 1995, slightly lower than the 29% average for 1990-1995. The ratio of after tax profits to average assets at 1.8% was more than double the ratio for other private commercial banks and slightly higher than its 1990-1995 average of 1.7%. After-tax profits have grown at an average rate of 40% per year. Performance ratios for 1990-1995 are presented in Table 2 below.

Table 2. Performance Ratios (Bank-wide, 1990-1995)

	1990	1992	1995
Ave. Loans : Ave. Deposits	84.8 %	82.1 %	69.2 %
Ave. Loans : Ave. Assets	44.2 %	52.7 %	51.9 %
Liquid Assets : Liabilities	31.0 %	29.0 %	23.0 %
Assets : Net Worth Leverage (times)	17	22	14
Non-interest cost : Total Revenues	33.5 %	29.7 %	32.1 %
Net after-tax profits : Average Assets	1.6 %	1.2 %	1.8 %
Net after-tax profits : Ave. Net Worth	27.0 %	25.0 %	32.1 %
Gross Revenues/Employee, Rs. 000	531	838	1,326
Total Assets per Employee, Rs. 000	4,290	7.272	11,184

Source: Computed from HNB Financial Statements in Annual Reports. See Annex Table 2.

Highlights of HNB's operating and financial results during the 5-year period 1990-1995 are summarized below and presented in Annex Table 2.[11]

- Average assets grew 29.6% per year, average loans 33.6% , average deposits 36.5% and net worth 37.5%. Loans comprised 51% of average assets. The ratio of average loans to average deposits for the 5-year period was 78% as the orientation of HNB's banking operations traditionally has been deposit-based, rather than that of a money-center bank. Access to refinancing facilities supported 12% of lending operations.

- Raw data show a gearing ratio averaging 16.5 times. Banks in Sri Lanka are required to maintain a minimum total risk-weighted capital ratio of 8%, where Tier 1 capital must be at least 50% of minimum capital requirements. In 1995, HNB had total Tier 1 and Tier 2 capital equal to 10.40% of weight-adjusted risk assets including off-balance sheet exposure. Average net worth has grown at 37.5% yearly, or 27% faster than the annual growth of average assets.

- Gross revenues per employee which grew at 23.3% per year from 1990 to 1995 stood at Rs. 1,326,000 at the end of 1995 – 33% more than the 5-year average. Assets per employee increased 16% per year, and reached a level of Rs. 11,184,000 at the end of 1995 – 37% higher than the 5-year average.

[11] The financial figures used for bank-wide operations are from the audited financial statements of HNB, as presented in its Annual Reports. Separately audited reports for the GP program are not prepared and thus not available. HNB's accounts are audited and certified by KPMG Ford, Rhodes, Thornton & Co. in accordance with Sri Lanka Auditing Standards. In 1995 Sri Lanka passed a government decree adopting the International Accounting Standards (IAS). The Securities and Exchange Commission has not yet gazetted and enforced the new standards (through the Sri Lanka Institute of Chartered Accountants) pending completion and approval of official translation of the standards into the three legally-accepted languages in Sri Lanka.

Chapter V. The Gami Pubuduwa Program

HNB's motivation for the program

HNB's early operations were oriented to servicing the financial needs of the plantation industry for development of tea cultivation and related activities. Its historical exposure to rural finance through banking services to small farmers, dairy operators, fisheries developers and agricultural-product processors complemented its participation in government-promoted small- and medium-scale industry financing schemes. With its operational roots and the profitable experience in programs for smaller-sized loans, HNB visualized the GP program as the opportunity to develop a competitive platform to promote the bank's products and services in the rural sector and strengthen its strategy for market penetration.[12]

HNB has been a major participating onlending institution in a series of World Bank-sponsored Small and Medium Scale Industry (SMI) loan programs in the late 1980s to the early 1990s. The Bank's SMI programs in Sri Lanka were relatively successful because of three main factors:[13]

- an upper limit of US$ 200,000 for loan approvals, which provided autonomy in loan approval decisions by participating financial institutions;
- use of the same financial intermediaries that participated in four preceding SMI loan projects, which took advantage of their familiarity with criteria, procedures and processes of the program; and
- the fact that 80% of enterprises in Sri Lanka are small which served to ensure the existence of a market for SME loans. The fairly large size of the SME sector might possibly be related to the stage of agro-industrial development of Sri Lanka, an observation which is indirectly supported by data from Pakistan and Bangladesh concerning the extent of the contribution of small-scale business and microenterprises to total value added.[14]

Participation in the SMI loan program provided additional experience and insights on the operations, origins and developmental evolution of micro- and small-scale enterprises which have extensive linkages to larger-size businesses. Most importantly, it provided direct knowledge about these enterprises' financing requirements and loan

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[12] HNB internal management report, "Gami Pubuduwa Scheme, Review and Report for the period ended 30 June 1995."

[13] Leila M. Webster, Randall Riopelle and Anne-Marie Chidzero, World Bank Lending for Small Enterprises 1989-1993. Washington, DC: The World Bank, Private Sector Development Department, 1995.

[14] See "Staff Appraisal Report, Islamic Republic of Pakistan - Microenterprise Project", Report No. 9070 - PAK, The World Bank, November 30, 1990; and Reazul Islam, J. D. von Pische, and J. M. de Waard (eds.), Small Firms Informally Financed - Studies from Bangladesh, Washington, DC: The World Bank, Discussion Paper No. 253, 1994.

collateral availability, the closely intertwined relationships between revenue/cash flow generation and loan repayment and knowledge of the microentrepreneur's operations[15].

This successful SMI experience served to reinforce HNB's decision to develop banking services geared to microenterprises and nonfarm businesses in rural areas. In mid-1989, HNB formally inaugurated its ***Gami Pubuduwa*** program by opening 13 GP units at village locations to service the Kurunegala, Anuradhapura, Galle, Colombo, Vavuniya, Gampaha and Kandy districts through its existing branch offices with Gami Pubuduwa Upadeshakas ***(GPUs)*** -- "barefoot bankers" or village banking advisers. The initial task set for the GPUs was two-fold: to promote in rural areas the banking services available from HNB's branches and to accumulate information on non-farm microenterprises and small-scale business projects suitable for HNB financing support.

HNB institutional relationships with the ***Sarvodaya*** village-based organization, the SANASA federation of thrift and credit cooperatives and other NGOs through the UNDP-CARE network of microfinance institutions in Sri Lanka have provided for improvements in the GP program. In addition, HNB and other rural finance institutions have benefited from contact with the Bangladesh Rural Advancement Committee, whose program has served as a model for microfinance in Sri Lanka, as well as with the Australia-based Opportunity International's banking with the poor program.

Structure of the program

The internally-funded program has provided access to banking services to support income and risk diversification for marginalized households in the predominantly agricultural economy of Sri Lanka. The program provides working capital and equipment-financing requirements of households diversifying income by engaging in financially viable income-generating or job-creating microenterprises, and its microfinance services adapted to the needs of the target clientele[16]. The GP program completed six and a half years of operations in December 1995, operating from 45 bank-branches and 33 village-based units as shown in Annex Chart 1. The program continues to be expanded to new villages, using existing HNB branches as regional bases.

Poverty is neither homogeneous nor uniform, as it has different gradations. The poverty pyramid concept separates the poor into five strata.[17] At the bottom layer are

[15] HNB's experience parallels that of Orient Leasing Pakistan Limited which, in gaining knowledge of the microenterprise sector through its business experience with small-scale enterprises, identified promising microenterprises and decided to set a corporate objective and formulated a business plan to expand into this market niche. (See Report No. 9070, "Staff Appraisal Report, Islamic Republic of Pakistan - Microenterprise Project", The World Bank, November 30, 1990 which also has an extensive discussion of sub-contracting linkages between microenterprises vis-à-vis larger industrial firms in the urban areas as well as the agricultural sector in rural villages).

[16] The importance, both for households and providers of financial services, of diversification of risks and of sources of income and the issue of crafting financial services to conform to the needs of target clients are discussed extensively in Orlando J. Sacay and Bikki K. Randhawa, World Bank Discussion Paper No. 293, 1995. Design Issues in Rural Finance, Washington, DC.

[17] Joe Remenyi. Where Credit is Due. Boulder, CO: Westview Press, 1991.

the *ultra poor* who depend on the earnings of others. The next layer consists of the *laboring poor* who are employed full-time in unskilled labor positions. The upper three strata consist of the *self-employed poor* who work for their own account and also employ others, the *entrepreneurial poor* whose enterprises employ five or more people, and the *near poor* at the top of the pyramid, who have stable wage employment characterized by low earning power.

The government's income transfer and social safety net programs target those in the ultra poor and laboring poor categories -- households earning less than Rs. 1,500 (US$ 30) monthly. Other microfinance institutions (mostly NGOs) such as Sarvodaya SEEDS-REP, SANASA TCCSs and the Janashakhti village bank societies, address the laboring poor and self-employed poor categories where microenterprises have differing scales of operation and income generation. The GP program has been positioned to focus on the upper three layers of the poverty pyramid -- the self-employed, the entrepreneurial and the near poor. In addition, HNB addresses the banking requirements of small and medium scale business entrepreneurs beyond the top of the poverty pyramid through other operations including its participation in the World Bank SMI loan project.

The GP program has attracted microfinance borrowers, many of whom have track records in microenterprise operations for about a year and whose successful operations lead to repeat or larger loans. The financing of a start-up microenterprise comprises about one-third of the number of new loans approved. GPUs are encouraged to identify viable start-up projects for microfinance support under the program.

Since late 1995, the GP program has begun to venture into group-lending methodologies. Management has perceived that group or solidarity lending schemes can build upon *"shramadana"* or the community-based sharing tradition of villages to reach larger numbers of households. In this regard, the experience of the Sarvodaya SEEDS-REP has provided a useful roadmap for the GP program. A solidarity group lending approach has been launched by the Ambalantota GPU in Hambantota district -- where the Women's Development Federation and its Janashakhti village bank societies has successfully used the group-based technology for lending to women.

The GPUs who have been selected to implement the program are experienced banking officers from HNB's mainstream operations who have participated in training programs in microenterprise finance and project development. HNB senior management has provided continuing support for the GP program and has established a clear career path development for GPUs within the bank.[18] A number of senior GPUs who were among the first batch of officers when the program was launched in 1989 have moved up to the position of Cluster Leaders overseeing other GP units.

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18 The practice of HNB management contrasts with the case cited in Schmidt and Zeitinger, where the most mediocre officers (and least likely to be attracted to risky projects and activities) are given the microfinance assignments which results in limited success of a downscaling strategy. See Reinhard H. Schmidt and C.-P. Zeitinger, "Critical Issues in Small and Microbusiness Finance", Interdisziplinare Projekt Consult GmbH: Frankfurt am Main, September 1994.

The GPU plays an integral role in the village community, participating in social, religious, cultural and various other activities with the view of carrying out the GP business as one driven by relationship development. As the primary means for delivery of banking services to microfinance clients, GPUs are critical to the effectiveness and viability of the program for the following reasons:

- As most GPUs are from the same geographical areas of the villages in which they work they have familiarity with and can identify with the villages' culture, lifestyle and traditions.
- By attaining a closer understanding of the business of the GP client, the GPU becomes a more proficient banking officer in developing and designing banking services that properly address the clients' requirements. It is indispensable for the GPU to develop an information base about asset turnover cycles and seasonality factors, absorption of financing and transaction costs, risks, and collection patterns for the microenterprises in the villages covered. This is particularly important because most GP loans are not collateral based.
- As the GP program is integrated into HNB's regular commercial banking operations, GPUs have the ability to bring to the attention of head office the products of microenterprises which can be showcased at market and trade fairs and in some cases linked to export marketing organizations.
- Perhaps the most important contribution of GPUs is the accumulation of information capital which is indispensable to sound banking operations. This is generated through repeated screening and monitoring of borrowers, accumulated over time through durable banking relationships. It is indispensable in any effort to manage and control costs and achieve high loan repayment rates in microfinance operations.[19]

Banking services and market areas covered

The GP program has progressed into a comprehensive program targeting the rural sector for the banking services that HNB offers to its traditional markets. Credit facilities extended under the program consist of loans whose repayment profiles follow the production-marketing-cash collection cycle of enterprises financed. Loans of one year or less are generally for working capital; these comprise about 23% of loans approved. However, some credit facilities extended to support working capital have been granted for repayment periods of up to three years. Loans granted for periods in excess of one year, particularly loans with two to three year repayment terms are generally for additional equipment, machinery and shop improvements related to microenterprise expansion. Almost half of the number of GP loans provided, equivalent to 63% of the value of GP loans approved are for maturities of more than 24 months. This is in sharp contrast to the experience of most other microfinance institutions in other countries, where microfinance loan maturities are for one year or less. The

[19] The importance of information capital on the operations of rural finance institutions is discussed in Claudio Gonzalez-Vega and Douglas H. Graham, "State-Owned Agricultural Development Banks: Lessons and Opportunities for Microfinance", Ohio State University, Economics and Sociology Occasional Paper No. 2245, June 1995.

primary factors explaining the GP loan portfolio maturity profile are the types of microenterprises and loan purposes (expansion and diversification) financed. Table 3 below shows the term profile of GP loans as of December 31, 1995.

Table 3. Term Profile of Gami Pubuduwa Loans Granted (through December 1995)

Term of Loan	Value Rs. 000	% Distribution	Number of Loans	% Distribution
< 6 months	26,517	11.08 %	1,540	12.16 %
7-12 months	7,247	3.03 %	917	11.08 %
13-24 months	54,745	22.88 %	4,050	32.01 %
> 24 months	150,743	63.01 %	6,147	48.58 %
Totals	239,253	100.0 %	12,654	100.0 %

Source: Data provided by Hatton National Bank.

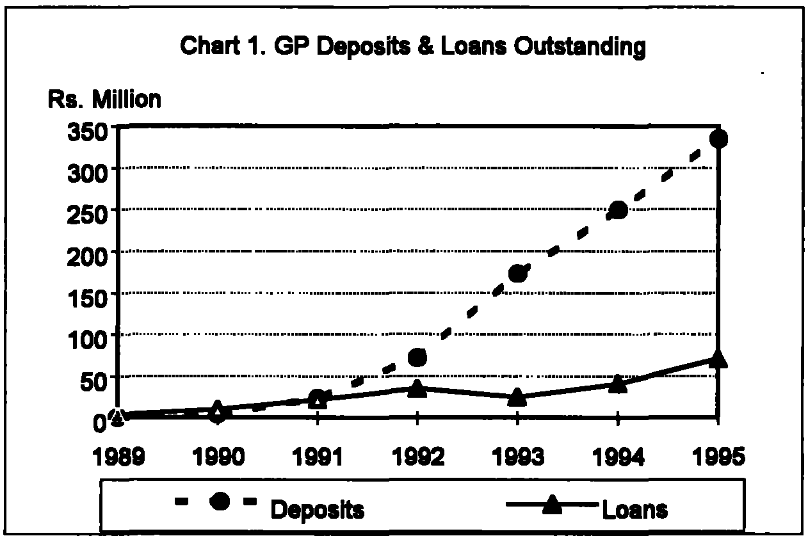
The collateral requirements and procedures for GP loans have been adapted to facilitate access by microfinance borrowers. For loans up to Rs. 100,000 (≅ US$ 2,000) the guarantees of two other existing clients of HNB generally suffice, with the turn-around time between application, evaluation and approval at 48 - 72 hours. Timely repayment, together with successful business operations monitored by the GP officer during regular visits, are important for access to progressively larger repeat loan amounts. About 33 % of loan accounts in the GP program are to repeat customers. This has enhanced the accumulation of information capital on such repeat clients.

The program also caters to start-up microenterprises, where the loan amount is generally below Rs. 25,000 (≅ US$ 480) and often granted on an unsecured basis. Thus, GPUs' inputs in project identification and evaluation are critical for HNB's program. One third of the outstanding portfolio consists of loans to support start-up enterprises, while the majority (two-thirds) of loans for expansion and diversification of on-going microenterprises of existing or new clients. This is not the conventional practice in other microfinance programs (e.g. BancoSol in Bolivia, Alexandria Business Association in Egypt and ADEMI in the Dominican Republic) which focus on providing credit services to microenterprises which are in operation, i.e. with at least a six months to one year operating track record and which require larger average loan amounts.

Nominal interest rates on GP loans are 19% - 25% p.a. with an average of 21.8% p.a. These rates are not much higher than interest rates charged on HNB's regular commercial bank loans with an average of 21.2% p.a. Thus, there is a question as to whether GP loans fully reflect transaction and credit administration costs which, by convention, are expected to be higher for more numerous smaller-sized loans such as those in the GP program. This raises the issue of cross-subsidy for the GP program from HNB's other operations. However, HNB management has set its pricing policy and is apparently satisfied that GP operating and administrative costs (including provisions for possible loan losses) are adequately covered by total revenues derived by HNB from the program, particularly as the GP program has generated deposit levels which are much higher than loans outstanding.

Deposit products have been adapted in the sizes of minimum balances, modalities of collection, recording and reporting to account-holders, to conform to the needs and demographic characteristics of the clients. Primarily, the market-driven modifications are smaller amounts to open accounts; smaller balances to be maintained to earn interest; and flexibility in deposit collection modes to provide convenience to depositors. The average cost of GP deposits is 10.5%, compared to an average of 9.34% interest expense on deposits bankwide. This differential is partially explained by the fact that non-interest bearing demand deposits are a small component of GP deposits compared to the rest of the bank.

The full range of HNB's financial services is promoted and marketed in the rural areas covered by GPUs: savings accounts, fixed deposits, savings certificates, children's savings accounts and the savings lottery campaign. The focus of the GP program is on total banking services for households in the rural areas. GPUs have mobilized total deposits of Rs. 402 million from 44,500 accounts. As of September 30, 1995 the value of savings was 205% of total GP loans granted (Rs. 196 million), and 5.7 times GP loans outstanding (Rs. 70 million). Chart 1 below illustrates GP deposit mobilization and loan generation by year from 1989 to 1995.

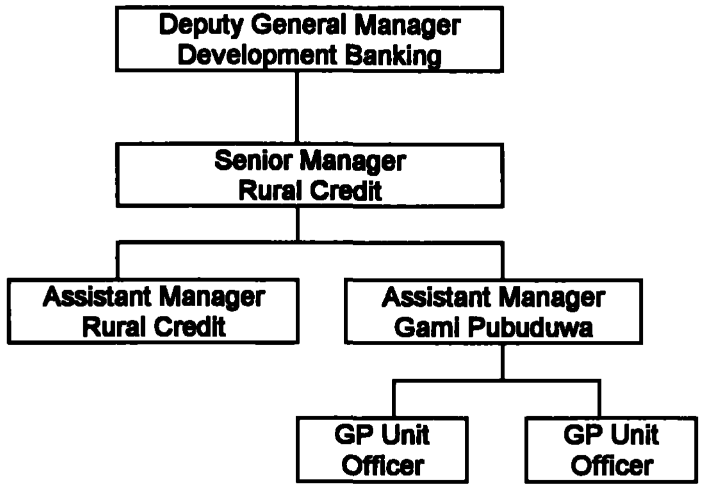


Source: Computed from data provided by Hatton National Bank.

Organizational structure

The 78 GPUs and program assistants are integral components of the bank's branches from which the GP programs are operated under the administrative jurisdiction of the branch manager. At head office, the GP program is the principal responsibility of the Project Finance Division, headed by a senior executive, a Deputy General Manager. Chart 2 shows the organizational structure for the GP program.

Chart 2: Organizational Structure
of GP Operations at Head Office



Source: Information provided by Hatton National Bank

The key aspects of operational procedures and administrative arrangements which have been simplified to keep the GP program responsive to the relatively less complex banking requirements of the GP client base and to facilitate account management by the GPUs are summarized as follows:

- Separate ledgers are maintained at the branch for GP program borrowers and depositors. This facilitates tracking, monitoring and reporting of status of accounts; performance of GPUs; progress of the program against budget goals. Operational reports on the GP program and business are consolidated at head office on a regular basis at the end of each month, to form part of operating management's report to the directors.
- Loan amounts are well within delegated loan approval and commitment limits of branch management. Clearly defined procedures, criteria and limits -- together with the high proportion of repeat loans and the close working relationship between the GPU and the microfinance borrower-- allow for simplified loan processing and two-day turn-around time for loan application, evaluation and documentation.
- GPUs manage an average of 125 accounts in a service area defined by a 20-kilometer radius from the branch, visiting about 10-15 clients and prospects a day. Clients are visited every two weeks. Meetings with depositors in rural areas are scheduled at village centers such as schools, temples and in the course of a GPU's business calls.

The village-based units in the GP program have offices which rural and microfinance clients can visit to discuss their business with the GPU. On the other hand, branch-based GP units do not take up much space and do not require separate supporting staff in the bank branch. Therefore, GP units are able to take advantage of external economies. The marginal cost to a particular branch for the physical space occupied by a GPU is negligible. Any incremental cost for part-time administrative staff support that may be required is more than adequately covered from GP program operating revenues generated from loans and transfer pricing on excess deposits sold to head office under well defined fund transfer pricing guidelines and internal accounting procedures. The head office intermediates funds from surplus deposit units to those where loans exceed deposits. Surplus units are compensated and deficit units pay for funds use.

Financial and operating results [20]

Sectoral distribution of loans granted

The GP program has provided financial support and linkages to other businesses for GP clients in a wide variety of income-generating and job-creating microenterprise activities in rural and semi-urban areas. These include agricultural cultivation and processing, fisheries and aquaculture, animal husbandry, trading and distribution, handicrafts, garments and batik cloth printing, carpentry and furniture making, pottery, brickmaking and light construction materials, welding and light engineering, equipment repair and servicing and food preparation. Sectoral distribution of loans approved is detailed in Table 4 below.

Table 4. Sectoral Distribution of Value of Loans Granted (through December 1995)

Values in Rs. 000	Loans Granted	% Distribution
Agriculture cultivation	11,895	4.97
Animal Husbandry	21,189	8.86
Fisheries & aquaculture	27,156	11.35
Agro-based industries	9,090	3.80
Non agro-based industries	56,528	23.63
Construction materials	17,140	7.16
Welding & light engineering	1,405	0.59
Garments	21,482	8.98
Handicrafts & batik cloth processing	2,484	1.04
Trading & distribution	53,999	22.57
Others	16,882	7.06
Total	239,253	100.00

Source: Data provided by Hatton National Bank Limited

The GP program has substantial exposure to agricultural cultivation activities and to fisheries and aquaculture – about 16.3% of loans approved as of end-1995 were destined for this sector. Enterprises in animal husbandry and agro-based industries comprised another 12.7% of total loans approved. These support the hypothesis that rural households make an effort to diversify their income sources to lessen risk of over-dependence on a narrow income base.[21] As GP loans conform to operating cycles of the

20 The financial values and operating results used for the study are derived from internal management reports on the *Gami Pubuduwa* program, since separately audited records of the program are not maintained by HNB and thus not available.

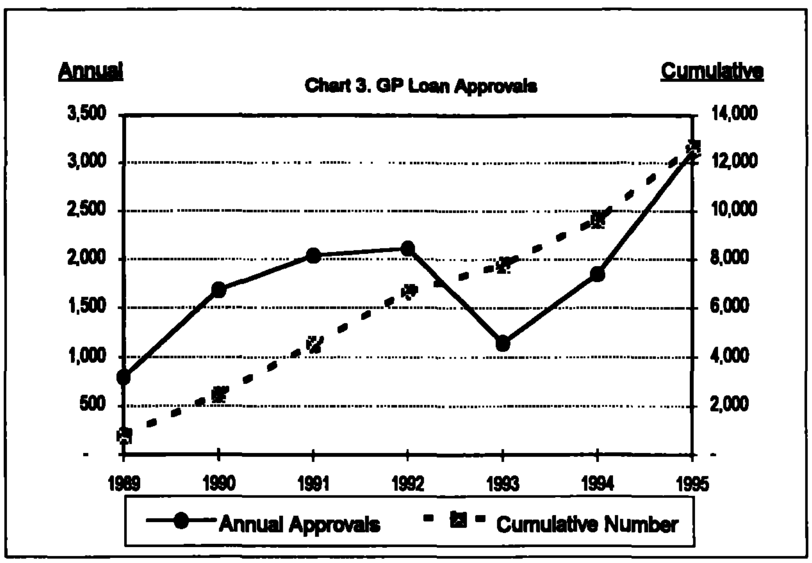
21 The principle of rural households diversifying their income sources through microenterprise activities, in order to manage and reduce risk of overdependence on a household income base that is narrow and subject to seasonal and climatic factors is discussed in Orlando J. Sacay and Bikki K. Randhawa, World Bank Discussion Paper No. 293, 1995. Design Issues in Rural Finance, Washington, DC.

businesses financed, 63% of loans approved are for 24 months or more, with another 23% of loans approved having a term of 13 - 24 months (as seen earlier in Table 3).

About two-thirds of total loan approvals are concentrated in 5 administrative districts: Gampaha, Puttalam, Colombo, Anuradhapura and Kandy. Rather than being a case of market-segment concentration and geographical resource transfer, the pattern is due to several operating factors. The number of years of operation of GP units determine the size of the loan portfolio i.e., older units have more loan approvals and repeat loans than newly opened units. The skewed distribution is also affected by the size of loans approved. For example, the GP units in Puttalam are newer than those in Anuradhapura and Gampaha, but the average size of loans to support prawn farming enterprises in Puttalam is considerably larger.

Outreach

Since 1989, a total of 12,650 microenterprises (yearly average of 2,100 borrowers) have been financed with total loan approvals amounting to Rs. 239.2 million. The more significant statistic for outreach is the number and value of loans outstanding -- 4,400 accounts and Rs. 78.5 million respectively as of the end of 1995. The numbers of GP loan approvals on a yearly and cumulative basis are shown in Chart 3 below.



Source: Computed from data provided by Hatton National Bank.

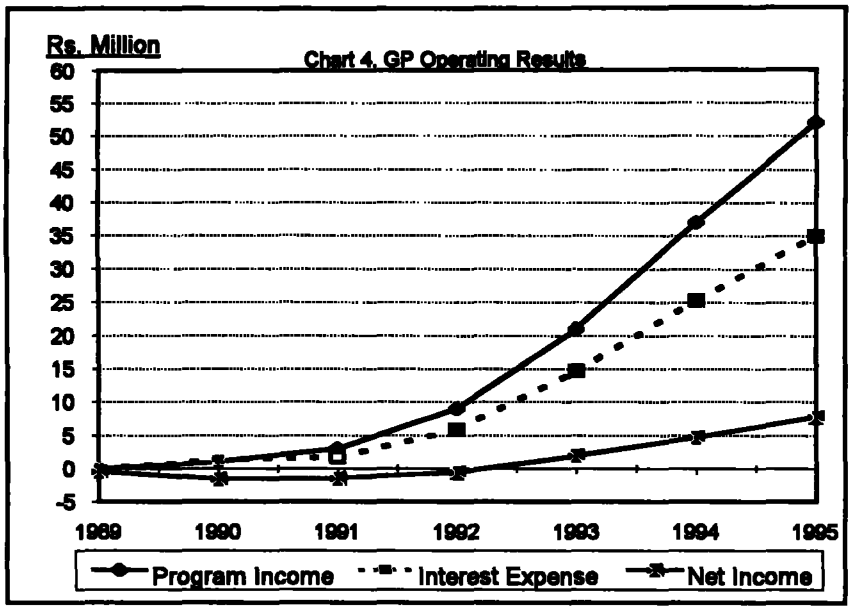
While separate statistical data have not been maintained by HNB on gender distribution of the program's client base, field visits at four GP units and discussions with GPUs indicated that about one-third of the borrowing clients in these units consisted of women. On a program-wide basis, management estimates that at least 20% of the GP borrowers are women who are involved in self-employment enterprises. Examples of these enterprises are hand-loomed bedsheets, dress-making, embroidery, sub-contracting work on children's garments, coconut-coir mat-making, plants and flowers nursery, packaging and distribution of salt and food preparation. A new banking product launched in August 1995 is the ***Pragathi Kantha*** account, specifically for women engaged in self-employment enterprises.

HNB maintains statistics on the age distribution of clients in the GP program. For both the number of borrowers and amount of loans approved, 70% has been to microentrepreneurs in the 18 - 25 (16%) and 26 - 40 (54%) age groups, while the 41 - 55 age group acounted for 27%. With respect to size distribution, 78.5% of the value of loans approved is for amounts below Rs. 50,000 (≅US $950). The average loan amount is Rs. 18,900 (≅US$ 360) for this group which comprises some 90% of the total number of borrowers. Loans for up to Rs. 10,000 constitute 22.7% of the total number but only 6.8% of the value of loans approved, averaging Rs. 5,678 (≅US$ 110) per loan. In contrast, the number of loans for Rs. 50,000 or more constitute 9.8% of total number of loans but account for 21.5% of total value of loans approved, an average of Rs. 24,340 (≅US$ 470) per loan.

Performance indicators

Operating results for the GP program expressed as standard ratios of balance sheet and income statement items are somewhat higher than those for the bank as a whole which absorbs more indirect costs of supporting infrastructure for transport equipment, communications and data automation facilities, branch offices and statutory reserve requirements. Program net income of Rs. 7.7 million as of September 1995 translates to a 2.64% return on program asset base (deposit balances were used as a proxy instead of the more conventional loan balances outstanding, in the absence of a separate GP balance sheet), versus 2.1% for HNB as a whole. Assets per employee bankwide were Rs. 9,112 K compared to Rs. 6,450 K per GP officer. Gross revenues were Rs. 945 K per GP officer, as against Rs. 1,100 K per employee bankwide.

The direct non-interest operating expense for the GP program was 17.5% of gross revenues compared to 30% bankwide. This may be an indication of the extent of cross-subsidy for indirect operating expenses (especially for head office support services) of the GP program. Direct administrative expenses for salaries, allowances and traveling expenses of GP officers averaged 10% - 12% of GP loans outstanding over the past 3 years. When provisions for possible loan losses are added to administrative expenses as the basis for transaction costs, the program showed an average transaction cost of Rs. 0.16 for every Rupee of loans outstanding. Operating results for the program from 1989 through September 1995 are shown graphically in Chart 4 below.



Source: Computed from data provided by Hatton National Bank.

Credit administration

Loans granted under the GP program are subject to portfolio management standards and procedures similar to HNB's regular loans. GP loans with overdue installments as of June 1995 amounted to Rs. 817,900 (Rs. 1,006 K in December 1995) from 524 accounts. There were 270 loan accounts classified as past due, bad or doubtful, amounting to Rs. 2,693 K or 3.8% of the June 1995 GP loan portfolio outstanding. The cumulative recovery rate was 97% as of December 1995.

The successful loan recovery rate is due in no small measure to the personal relationship that the GP officer builds with his customer. HNB's approach emphasizes establishing dialogue with the depositors, borrowers and other villagers. This includes participation in village social events, close monitoring of projects identified for financing, careful disbursement of loan proceeds and structuring the loan to fit the clients' business operations and providing business and financial advice to clients in their business operations.

As noted earlier, the GP officer is selected from HNB's experienced permanent staff. Most of the GPUs are from the same geographical areas as the villages they work in. This selection criteria ensures that the GPUs understand the particular customs, traditions, economic activities and community leadership hierarchies in the areas they are assigned to. The GP officers' approach to their banking responsibilities is no different from that needed in successful account management of regular bank clients.

Operational self-sufficiency

The GP program was operationally self-sufficient after three years in 1992, a pattern that GP units' operations seem to follow. GP units that have been in operation for 5 years have generally built up microenterprise loan portfolios of Rs. 3.0 million or more.

The units that have been in operation for at least three years generally have loan portfolios of Rs. 2.0 million. There were 28 new units formed during 1995; six have generated deposit balances in excess of Rs. 1.0 million and another three have mobilized deposits of Rs. 2.0 million or more. Excluding these new GP units, 25 offices have deposit balances greater than loans approved; 15 have loans granted in excess of deposits mobilized; while 10 have loans granted that are about equal to deposits mobilized. As an illustration, the operating income and cost profile for the three-year old Ambalantota GP unit as of September 1995 is shown below:

Table 5. Revenue & Cost Profile – Ambalantota GP Unit, 1995

1. GP deposit balances outstanding	3,500,000
2. Cost, @ 10.5 % p.a. average interest expense	367,500
3. GP loans outstanding	875,000
4. Revenue, @ 21.8 % p.a. average interest	190.750
5. GP operating surplus (deficit)	(176,750)
6. Surplus deposits bought by HO	2,625,000
7. GP revenue on surplus deposits, @ 17% p.a.	446,250
8. GP operating profit (#7 + #5)	269,500
9. Operating cost, GP unit	184,000
10. Net Operating surplus, Ambalantota GP unit	85,500

Source: Computed from data provided by Ambalantota GPU and branch manager.

The net operating surplus differs among GP units in accordance with their volumes of loans and deposits. HNB management has put in place a transfer pricing mechanism that does not penalize deposit generation nor dampen the incentive to identify viable loan projects. Otherwise, GP units that generate more deposits than loans would always show an operating deficit, such as the Ambalantota GP unit illustrated above. Internal intermediation among funds surplus and deficit GP units is performed by Treasury Operations at head office. The intermediation function and administration, with the transfer pricing policy and mechanism could serve as useful operating models for apex-type banking structures contemplated for the banking operations planned by SANASA, Sarvodaya SEEDS-REP, or possible pilot provincial banks for cooperative rural banks.

Comparative analysis

Compared with other microfinance programs in Sri Lanka, the GP program's outreach of 12,654 borrowers is smaller than those of Sarvodaya SEEDS-REP (170,717), SANASA (713,700 members), the Janasakthi bank societies (61,887 loans granted to 26,955 members) and the Cooperative Rural Banks (3,924,000 accounts in 1,216 branch units). These membership-based organizations mobilize deposits from members and access onlending funds from donors, the NDTF or commercial sources. Another difference is that the self-sufficient and profitable GP program is an integral part of regular commercial banking operations. Successful microenterprise clients graduate to HNB's small and medium industry financing program, providing continuity in banking relationships which is important to clients. Comparative highlights of Sri Lanka microfinance programs are shown in Table 6 below.

Table 6. Comparative Highlights of Microfinance Programs - Sri Lanka (1994-1995)

	Hatton Gami Pubuduwa	SEEDS-REP SSSs	WDF-Janashakhti Bank Societies	SANASA TCCSs
Type of Institution	Commercial Bank	NGO	NGO	Credit Coop
Ownership	Private investors	Village residents	Women's groups	Members
Funding sources	Own capital, rural deposits	Grants, members' share capital, deposits, borrowed funds	Grants, members' share capital, deposits, borrowed funds	Members' share capital, deposits, borrowed funds
Branches/Units	78	1,652	67	7,681
Year Started	1989	1987	1989	1978
Area of Operation	Rural	Rural	Rural	Rural
Client Outreach				
Loans $	$ 4,601 K	$ 2,800 K	$ 3,075 K	$ 25,408 K
No. of Borrowers	12,654	170,717	61,887	not available
Ave. Loan Amount	$ 360	$ 55	$ 55	not available
Interest Rate per year	21 - 25 %	18% - 21%	36 %	18% - 23%
Loan Recovery	97 %	87 %	97 %	88 %
Credit Technology	Individual	Individual; Group	Group loans	Individual
Deposit Balances	$ 6,442 K	$ 1,730 K	$ 633 K	$ 34,712 K
No. of Accounts	44,480	228,692	25,794	713,692
Ave. Deposit Balance	$ 145	$ 7.50	$ 24.55	$ 48
Sustainability				
Operating Efficiency	117.5 %	62 %	103 %	not available
Deposits / Loans	4.27 X	61 %	56 %	1.36 X%
Adm. Exp. / Assets	13.0 %	40 %	not available	not available

Source: Computed from basic data provided by HNB, SEEDS-REP, Women's Development Federation of Hambantota, and SANASA. Figures are for operations as of the end of 1994 except for HNB (1995).

Annex Table 1 summarizes comparative highlights of HNB's GP program relative to other microfinance programs in Sri Lanka and in other country settings, to provide a wider perspective on the program. The principal points in the comparisons are summarized below:

- the GP program's outreach is smaller than those of specialized microfinance banks and institutions such as BancoSol in Bolivia (63,000 clients), the BRI Unit Desa System in Indonesia (2,000,000 clients) but larger than Kenya Rural Enterprise Programme (5,303 borrowers), and Davao Cooperative Bank in the Philippines (7,625 borrowers);
- the average size of loans outstanding for the GP program is US$ 360 per loan, compared to $535 for BancoSol, $625 for BRI, $225 for Davao Cooperative Bank, $217 for K-REP and $55 for both of Sarvodaya SEEDS-REP village societies and Janashakhti Bank Societies;
- the GP program has built up 44,480 deposit accounts with an average balance of $145 per account, lower than the average balance for BancoSol's 27,000 deposit accounts and the average $164 per account among BRI's 12,000,000 depositors. The GP program is more similar in its base of village depositors to BRI's Unit Desa system where the deposits are from individual village residents.

- **the operating efficiency indicator for HNB's GP program (118 %) is higher than the similar ratio for BancoSol (107%), BRI Unit Desa (113%), Davao Cooperative Bank (115 %), K-REP (106%) and Sarvodaya SEEDS-REP (66%). The 97% loan recovery rate is comparable to that for BRI (97%), Davao CoopBank (95%) and K-REP (97%). It is slightly lower than BancoSol (99%) and higher than Sarvodaya SEEDS-REP (87%).**

Chapter VI. Summary and Conclusions

Since it began operations in October 1989 the GP program has provided HNB an effective platform to promote the bank's products and services in the rural sector and improve its market penetration. The GP program brings commercial banking services to rural households through 78 GP offices in 20 administrative districts of Sri Lanka, where 73% of the total population live in rural areas and about 50% live below the poverty line. The review focused on four issues, reprised below.

HNB's experience shows that a privately-owned commercial bank can successfully downscale its operations for a sustainable microfinance program.

HNB's GP program demonstrates how a privately-owned commercial bank has downscaled part of its regular operations into a sustainable microfinance program. In contrast to other downscaling models that require subsidies, technical assistance grants and working capital funding for participation in programs to bring financial services to rural areas HNB's GP initiative is a rare example of a microfinance program undertaken and carried out by a private commercial bank without reliance on government funding or incentives. As the GP program is integrated with regular branch operations and HNB takes advantage of external economies from existing infrastructure in its branch offices, a cross-subsidy from other bank operations may exist. However, the extent of surplus deposits (compared to GP loans outstanding) mobilized under the GP program from rural villages has generated incremental revenues for HNB, and has provided it a competitive market platform and penetration, for which direct and indirect benefits to the bank as a whole are difficult to estimate.

The GP program clearly does not address all five levels of the poverty pyramid. By choice, HNB has positioned its GP program to focus on the upper three layers of the poverty pyramid -- the self-employed poor, the entrepreneurial poor and the near poor. The banking requirements of small and medium scale business entrepreneurs beyond the poverty pyramid are addressed by HNB through its participation in the World Bank SMI loan project and other operations.

HNB made important adjustments in its GP operations -- in the selection and training of staff and adapting deposit products, credit services and collateral requirements to the program's target clientele -- to build a sustainable microfinance program.

HNB's management has carefully selected and trained experienced staff from its mainstream banking operations to carry out the program. The village-based officers, attached to HNB's regular banking branches and linked to the GP administrative section in head office, work in close proximity with households engaged in agricultural cultivation and in non-farm business activities. The functional and operational structure takes advantage of external economies available from existing infrastructure of established branch offices. HNB senior management has shown continuing commitment to its microfinance program and established a clear career-development path for the staff selected to carry out the program.

Savings and time deposit products have been adapted to conform to the characteristics of the rural villages served. The modifications feature smaller amounts to open accounts, smaller balances to be maintained to earn interest and flexibility in deposit collection modes to provide convenience to depositors.

Credit facilities are priced and structured to fit revenue and cash-flow generation patterns of microenterprise borrowers. Security and collateral requirements likewise have been modified to facilitate access for microfinance borrowers to the program. For loans up to Rs. 100,000, guarantees of two other existing clients of HNB generally suffice, with a turn-around time between application, evaluation and approval of about two to three days. Timely repayment and regular monitoring by the GP officer are important for access to progressively larger amounts.

GP clients have access to financial, quality control and marketing advice and support from HNB through referrals by the GP officer, similar to the account management service that regular banking clients receive. In addition, the experienced and knowledgeable "barefoot bankers" selected from mainstream operations have used their experience in seeking out bankable microfinance projects and assisting microentrepreneurs in preparing their projects for financing under the program.

To achieve outreach and profitability objectives, HNB has devised ways to efficiently manage costs, administer loans and establish pricing policies suitable for the program.

Interest rates on deposit products offered to GP clients are similar to the rates offered to other clients of HNB in its regular banking operations. Maturities on microfinance loans are within the same range as loans to the bank's regular clientele. However, interest rates on GP loans are not much higher than on regular loans. This GP loan pricing does not fully reflect the typically higher level of transaction costs in generating and administering microfinance loans and includes elements of cross-subsidy from other operations of HNB.

Loans extended under the GP program are subject to the same standards and procedures followed by the bank in monitoring and classifying its bank-wide loan portfolio and making provisions for possible loan losses. Microfinance loans under the GP program are therefore an integral part of mainstream banking operations and are within the scope of prudential banking regulations set by the Sri Lanka Central Bank.

The transfer pricing mechanism, designed for purchasing excess deposits from GP units, is the same system used for buying excess deposits of regular HNB branches. Therefore, there are no other income and cost indicators abnormally biased in favor of the GP program (relative to regular banking operations), or in favor of either deposit-oriented or lending-focused GP unit operations. The purchase price set for excess deposits is adjusted from time to time according to market conditions so that the transfer price does not become a disincentive to seek out more loans or a handicap for regular branches and GP units to mobilize more deposits. As the experience of the BRI village banks demonstrates, the transfer pricing mechanism is a powerful tool for signaling shifts in emphasis in deposit mobilization vis-à-vis loan generation.

Final observations

HNB's approach to expansion of its *Gami Pubuduwa* program has a horizontal orientation which is anchored on availability of knowledgeable mainstream bankers from regular operations and the ability to use the physical facilities and infrastructure of an HNB branch as the anchor for operations of GP units. The latter is based on exploiting external economies in operations and facilitatesin communications, reporting, accounting and internal control systems. Additional coverage of rural areas in a regular branch's market area has been achieved by opening more GP units attached to the branch. The major constraints to more rapid expansion of outreach will be posed by these two factors and HNB senior management's willingness to continue with the GP program. While the GP program is still only a small part of overall bank operations. the HNB experience provides useful lessons for a wide range of microfinance institutions pursuing a development path toward sustainability.

While GP loans are mostly unsecured, the delinquency and loan loss experience of HNB's microfinance program has been generally favorable with a 97% loan repayment ratio and a provisioning equivalent to 5% of the outstanding GP loan portfolio. Prudential banking regulations are generally biased against unsecured loans in terms of adverse risk classification. Thus far, this has not been a major deterrent to HNB in continuing its microfinance program, although the issue is an important one for making the GP program a major banking operation and is being raised with increasing frequency in other country settings.

Pricing of GP loans has not been significantly higher than that of regular commercial bank loans, notwithstanding the prevailing convention that transaction costs will be higher for generating and managing more numerous, smaller-sized, riskier credits. For example, the Janashakhti Bank Societies charge their member-clients a higher rate than does HNB on its GP clients. A distinctly differentiated pricing policy between loans for GP microfinance borrowers vis-à-vis other loans may be difficult to put in place because of a seamless progression of HNB clients from microfinance to SMI to regular-client categories. With its current pricing policy on banking services and products bankwide HNB management is apparently satisfied that GP operating and administrative costs (including provisions for possible loan losses) are adequately covered by total revenues that HNB generates from the GP program, particularly from the large amount of excess deposits and market penetration that the program provides.

Recovering costs associated with both deposit and loan transactions has always been important for profitable banking operations. The virtual lack of differentiation in the pricing of GP loans and deposits raises the issue of whether transactions costs are being adequately covered. Conceptually, recovery of transaction costs associated with deposits is attempted by either charging a transaction fee, or offering a lower interest rate on deposits, or adjusting minimum deposit balances to qualify for interest payment. This is not an easy issue to address especially when a microfinance program such as the GP program is not isolated from the rest of regular banking operations.

HNB's GP experience underscores the point that savings deposits from households in rural areas can be mobilized provided that appropriate techniques are applied for attracting resource surpluses into financial assets and instruments, rather than in non-financial form. Attracting deposits has generally been the conventional way for starting banking relationships. The techniques used by HNB's GP officers would be useful for other deposit-oriented microfinance institutions in other countries.

Given the significant number of repeat borrowers for progressively larger loan amounts who graduate to the small industry loan program, it would be interesting to study the impact that access to GP credit facilities has on income levels and employment creation of microentrepreneurs in this program. The impact assessment of microfinance programs is often a qualitative prognosis, in the absence of well-organized data on borrowings by microentrepreneurs. HNB's GP program could provide a good venue for an impact assessment study.

Finally, HNB's microfinance experience enderscores three important lessons. Firstly, there is no single model suitable for promoting the development of microfinance. In the case of Sri Lanka there are, in fact several different institutional channels for microfinance within the financial system. Secondly, a clear objective and well-defined basis for motivation are core elements of successful microfinance programs. Lastly, institutional commitment, operating autonomy and a management environment conducive to responsive business decisions is indispensable.

ANNEXES

Annex Table 1. Comparative Highlights of Selected Microfinance Institutions

	BancoSol ⊗	Davao Coop Bank θ	K-REP ⊗	A B A Ψ	BRI Unit Desa ⊗
Country	Bolivia	Philippines	Kenya	Egypt	Indonesia
Per Capita Income	US$ 680 *	US$ 838 #	US$ 310 *		US$ 670 *
Type of Institution	Commercial Bank	Coop Bank	NGO	NGO	Commercial Bank
Ownership	Private foundations & institutions	Primary coops	Non-profit organization	Non-profit organization	Government
Funding sources	Own capital, deposits, borrowed funds	Own capital, deposits, borrowed funds	Grants, retained earnings	Grants, earnings, borrowed funds	Capital, earnings, deposits
Branches/Units	21	7	6	8	3,267
Year Started	1991	1983	1990	1990	1984
Area of Operation	Urban	Rural	Rural / Urban	Urban	Rural / Urban
Client Outreach					
Loans	$ 33,214 K ⊗	$ 12,675 K	$ 4,000 K ⊗	$ 4,370 K ⊗	$ 1,006,000 K ⊗
No. of Borrowers	60,034 ⊗	5,682	15,023 ⊗	9,567 ⊗	2,204,838 ⊗
Ave. Loan Amount	$ 535	$ 225	$ 217	$ 865	$ 625 @
Interest Rate %	55 %	22 % - 26 %	38 %	28 %	31.5 % @
Loan Recovery %	99 %	95 %	97.7 %	98 %	93.5 %
Credit Technology	Group Loans	Individual	Group Loans	Individual loans	Individual & Group
Deposits	$ 4,900 K	$ 10,520 K	$ 430 K	not permitted	$ 1,852,300 K
No. of Accounts	27234	14,205	12,893	~	8,500,000 @
Ave. Deposit	$180	$ 740	$ 33	~	$ 150 @
Sustainability					
Operating Efficiency	107 %	115 %	106 %	105 %	113 %
Deposits / Loans	19.8 %	83 %	28.7 %	~	1.72 X @
Adm. Exp. / Assets	15.4 %	7.8 %	10.1 %	9.7 %	3.6 %
Assets / Net Worth	6.25 X	9.8 X	1.12 X	1.75 X	20 X

* - 1992; # - 1994
⊗ - December 1994. Source: MicroFinance Network member statistics (1995 Conference)
@ Rodrigo A. Chaves and Claudio Gonzalez-Vega, "The design of successful rural financial intermediaries: evidence from Indonesia", World Development, vol. 24, no. 1 (1996)
θ Annual reports and data provided by Davao Cooperative Bank.
⊗ Data from Robert Peck Christen, Elisabeth Rhyne, Robert C. Vogel and Cressida McKean, Maximizing the Outreach of Successful Microfinance Programs, USAID, Assessment Report No. 10, July 1995.
Ψ Data from Nabil A. El Shami, "The Small & Micro Enterprise Project of the Alexandria Business Association", 1995

Annex Table 2
Operating Results and Performance Ratios (Bank-wide, 1990-1995)

Values in Rs. Millions	1990	1991	1992	1993	1994	1995	Ave. Annual Growth Rate
Balance Sheet Items							
Assets, average #	7,428	8,718	12,793	18,623	21,678	26,486	29.6 %
Loans Outstanding, average #	3,282	4,510	6,737	9,140	10,587	13,760	33.6 %
Deposits, average #	4,275	6,118	9,454	12,943	15,790	19,898	36.5 %
Net Worth, average #	402	501	575	882	1,445	1928	37.5 %
Income Statement Items							
Interest Income	653	884	1,372	1,849	2,255	2,925	35.4 %
Interest Expense	467	674	1,053	1,343	1,445	1,859	32.8 %
Net Interest Income	186	210	319	506	811	1,066	28.7 %
Forex/other Income	275	348	432	639	532	642	- / -
Gross Revenues	928	1,232	1,803	2,489	2,788	3,567	27.9 %
Non-interest expense	311	383	539	714	839	1,144	36.3 %
Income taxes	41	38	52	71	60	80	- / -
Net Profits after taxes	109	138	158	362	443	483	9.0 %
Performance Ratios (% or times)							
Ave. Loans : Ave. Deposits	84.8 %	81.2 %	82.1 %	83.4 %	76.0 %	69.2 %	
Ave. Loans : Ave. Assets	44.2 %	51.7 %	52.7 %	49.1 %	48.8 %	51.9 %	
Liquid Assets : Liabilities	31.0 %	37.0 %	29.0 %	33.0 %	38.0 %	23.0 %	
Assets : Net Worth (times)	17	18	22	16	13	14	
Non-interest cost : Total Revenues	33.5 %	31.1 %	29.7 %	28.5 %	30.0 %	32.1 %	
Net after-tax profits : Average Assets	1.6 %	1.5 %	1.2 %	2,1 %	2.1 %	1.8 %	
Net after-tax profits : Ave. Net Worth	27.0 %	27.0 %	25.0 %	39.0 %	31.0 %	25.0 %	
Net Interest Margin : Average Asets	2.5 %	2.4 %	2.5 %	2.7 %	3.7 %	4.0 %	
Gross Revenues/Employee, Rs. 000	531	658	838	1,056	1,100	1,326	20.4 %
Total Assets per Employee, Rs. 000	4,290	5,302	7.272	8,056	9,112	11,184	21.6 %

Source : # Average values computed from audited financial statements in Hatton National Bank Annual Reports.

Annex Table 3
Percentage Distribution of Sources and Uses of Income Generated (1990-1995)

Values in %	1990	1991	1992	1993	1994	1995	5-Year Average
Sources of Income							
Interest earned on Loans & Advances	70.31	71,70	76.08	74.31	80.91	82.00	77.00
Commissions	6,78	6.87	6.76	6.03	6.73	6.95	6.67
Exchange earnings	9.68	11.24	9.46	9.30	5.93	4.77	8.14
Income from investments	0.33	0.98	1.68	4.21	1.43	0.70	1.80
Miscellaneous income	12.89	9.22	6.01	6.15	5.00	5.58	6.39
Total Income Generated	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Uses of Income							
Interest paid for funds used	50.29	54.69	58.42	53.95	51.83	52.13	54.20
Salaries and other staff expenses	16.02	14.76	14.86	12.98	13.40	15.10	14.22
Other operating expenses	16.21	15.22	13.92	15.02	15.97	16.02	15.23
Directors' and auditors' fees	0.03	0.02	0.01	0.01	0.02	0.01	0.01
Income, turnover, and defense levies	5.70	4.13	3.99	3.49	2.86	3.19	3.53
Dividends paid to shareholders	2.59	1.95	1.33	1.45	1.72	1.79	1.68
Retained earnings	9.15	9.21	7.45	13.08	14.18	11.76	11.13
Total Uses of Income	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Computed from financial statements in Hatton National Bank Annual Reports

Annex Table 4. Gami Pubuduwa Program Profile

Program Profile	1995*	1994	1993	1992	1991	1990	1989
No. of Gami Pubuduwa Units	65	43	38	34	26	23	13
No. of Administrative Districts	20	19	18	16	12	10	7
No. of Gami Pubuduwa officers/trainees	55	48	42	34	26	23	13
No. of Projects supported	2,280	1,979	1,042	1,999	1,962	1,392	802
No. of new jobs created	1,800	1,000	600	1,200	900	800	500
No. of jobs strengthened	2.100	1,900	800	1,850	1,500	1,100	750
No. of direct beneficiaries	2,500	2,200	1,300	2,200	2,200	1,800	950
No. of indirect beneficiaries	2,720	2,350	1,590	2,420	2,390	1,930	1,075

Profile of GP Loans

GP Loans	1995*	1994	1993	1992	1991	1990	1989
No. approved during the year	2,252	1,849	1,147	2,111	2,037	1,681	802
Amount of approvals, Rs. 000	62,000	52,000	21,000	38,000	24,000	13,000	5,000
Average amount per loan, Rs.	27,500	28,100	18,300	18,000	11,800	7,700	6,200
Loans Outstanding, year-end, Rs. 000	70,000	41,000	25,000	35,000	22,000	10,000	4,000
Cumulative No. of loans disbursed	11,100	9,171	7,192	6,155	4,156	2,194	802
Cumulative amounts disbursed, Rs. 000	196,000	137,000	93,000	74,000	39,000	16,000	5,000
No. of Loans Past Due	269	272	207	32	0	1	0
Amount of Loans Past Due, Rs. 000	2,700	2,600	1,900	100	0	negligible	0
Amount of Loans Collected, Rs. 000	123,000	93,000	66,000	39,000	17,000	6,000	1,000
Cumulative % Loan Recovery	96.8	97.2	96.0	97.0	98.0	99.0	100.0

* 10 months ending October 31, 1995 (period for which detailed data are available)
Source: Data and information provided by Hatton National Bank at field visit.

Profile of GP Deposit Accounts

GP Deposits	1995*	1994	1993	1992	1991	1990	1989
Total Deposits generated, Rs. 000	402,000	299,000	208,000	87,000	29,000	5,000	1,000
Number of Deposit accounts	44,479	36,074	32,014	18,837	8,118	3,667	1,270
Average amount per Deposit, Rs.	7,500	6,900	5,400	3,800	3,000	1,100	600
Year-end Deposit balances, Rs. 000	335,000	249,000	173,000	72,000	24,000	4,000	720

Financial Highlights of GP Operations

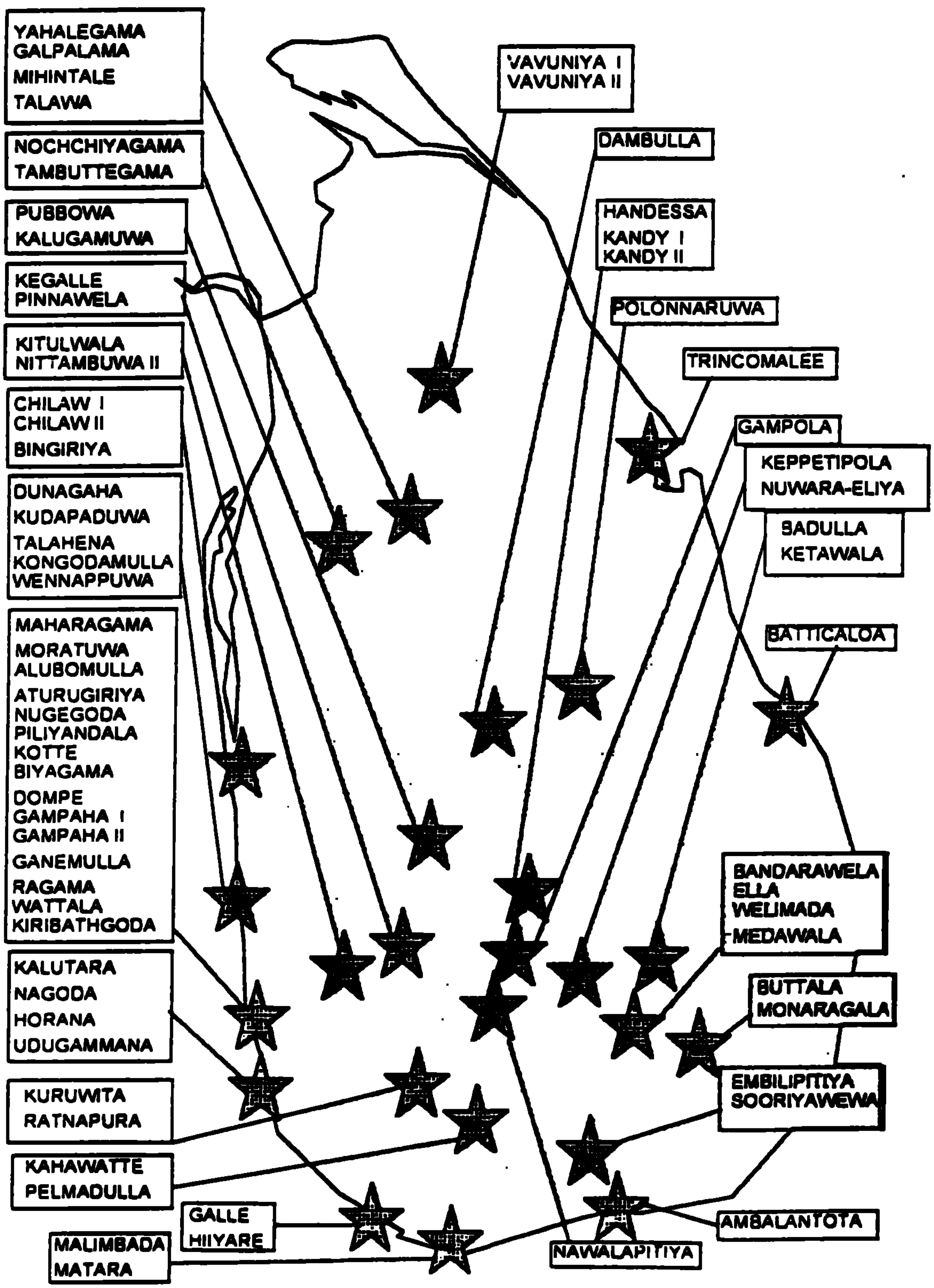
Financial Highlights	1995*	1994	1993	1992	1991	1990	1989
Loans outstanding, year end, Rs. 000	70,000	41,000	25,000	35,000	22,000	10,000	4,000
Deposit balances, year end, Rs. 000	335,000	249,000	173,000	72,000	24,000	4,000	720
Program Revenues							
Interest Income - Loans, Rs. 000	12,000	7,000	6,000	6,000	3,000	1,000	negligible
HO credits - Excess Deposits, Rs. 000	40,000	30,000	15,000	3,000	negligible	negligible	negligible
Total Program Revenues #	52,000	37,000	21,000	9,000	3,000	1,000	negligible
Program Expenses							
Interest Expense - Deposits, Rs. 000	35,000	25,300	14,700	5,800	1,700	1,300	negligible
Direct Admin. Expense, Rs. 000	5,600	4,400	3,500	2,200	1,800	1,300	400
Provision for Loan Losses, Rs. 000	3,500	2,050	1,250	1,750	1,100	500	200
Total Program Expense	44,100	31,750	19,450	9,750	4,600	3,100	600
Program Net Income #	7,700	4,700	1,900	(600)	(1,500)	(1,600)	(500)

Details do not add up to totals because of rounding.

* 10 months ending October 31, 1995 (period for which detailed data are available)
Source: Data and information provided by Hatton National Bank at field visit.

Annex Chart 1

GEOGRAPHICAL DISTRIBUTION OF UNITS



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