Financial Inclusion in Sri Lanka: Issues and Challenges

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APBSL Seminar, 09 September 2014

Contents

Inclusive Growth

- The idea that both the pace and pattern of growth are critical for achieving a high growth that is sustainable as well as contributing to reduce poverty is now recognized
- *Strategies for Sustained Growth and Inclusive Development* (Commission on Growth and Development, 2008): The commission notes that inclusiveness – a concept that encompasses equity, equality of opportunity, and protection in market and employment transitions – is an essential ingredient of any successful growth strategy. Here we emphasize the idea of equality of opportunity in terms of access to markets, resources, and unbiased regulatory environment for businesses and individuals
- Financial Inclusion is a major component of Inclusive Growth

Definition of Financial Inclusion

- CGAP (Consultative Group to Assist the Poor): “Financial Inclusion means that households and business have <u>access</u> and can <u>effectively use</u> appropriate financial services. Such services must be provided responsibly and suitably, in a well <u>regulated</u> environment”
- UN MDG Summit 2010: “Financial Inclusion means universal <u>access</u>, at a reasonable cost, to a wide range of financial services, provided by a variety of <u>sound and sustainable institutions</u>. The <u>range of financial services</u> include savings, short and long term credit, leasing and factoring, mortgages, insurance, pensions, payments, local money transfers and international remittances”

Financial Inclusion in the Post-2015 Agenda

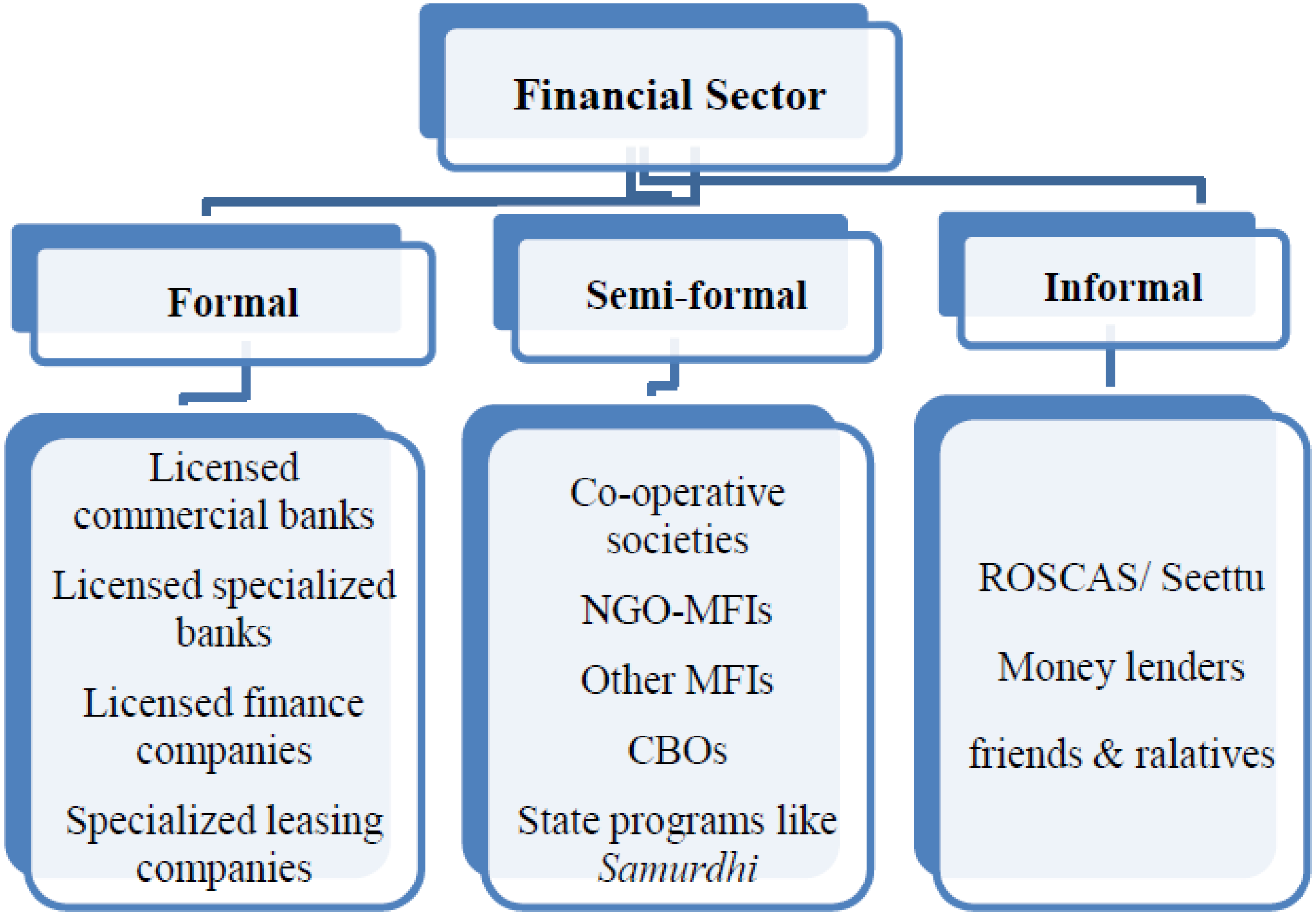
- Financial Inclusion is a part of the post-2015 Development Agenda
- Financial Inclusion is a critical enabler and accelerator of equitable economic growth, job creation, social and human development
- According to the Global Findex Survey 2012, 2.5 billion adults (more than 1/3rd of the global population) are excluded from formal financial institutions; 200 million SMEs in emerging markets lack adequate financing and financial services
- Universal access to financial services by 2030 is within reach (global target 90% usage of formal financial accounts) and remains the goal of the post 2015 agenda

Financial Landscape in Sri Lanka

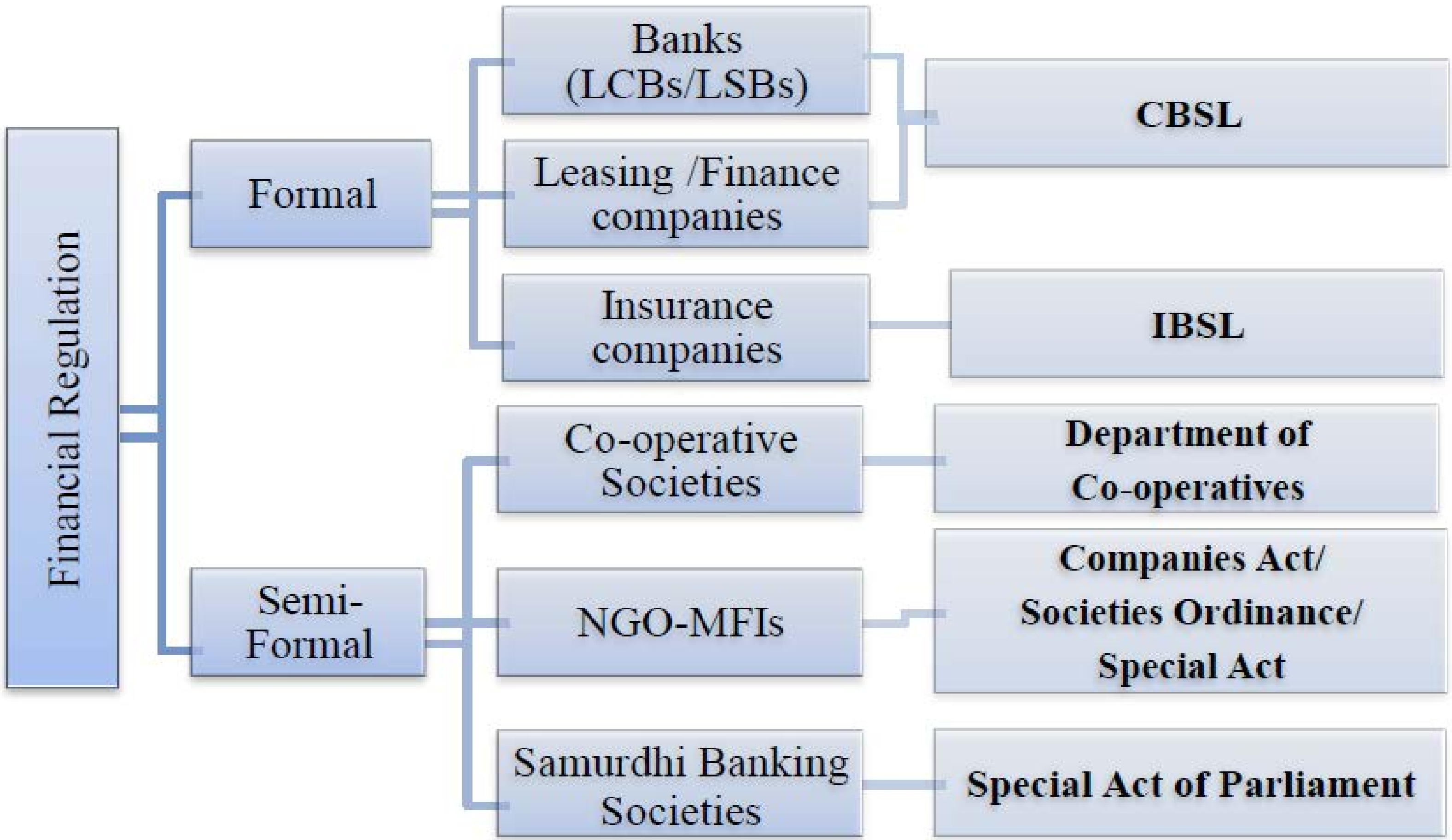
Financial Landscape of Sri Lanka

- Sri Lanka’s financial system consists of wide range of service providers
  - Formal financial institutions; commercial and specialized banks and finance companies
  - Semi-formal institutions like cooperatives, community based organizations (CBOs), Non-government micro-finance institutions (NGO-MFIs), Self-Help Groups (SHG), and government programmes like Samurdhi, Divineguma, etc.
  - Informal sources like money lenders and rotating savings and credit services (“seetu” – ROSCAS)

Financial Service Providers in Sri Lanka



Regulation of Financial Service Providers in Sri Lanka



Overview of the Microfinance (MF) Sector in Sri Lanka

- MF is considered as a key element in achieving Financial Inclusion as it cannot be a bank-led process
- History of MF in Sri Lanka dates back to early 20th century (TCCS, MPCS, etc)
- Growth of the MF sector since 1980s:
    - Several government initiatives (RDBs, NDTF)
    - Proliferation of NGOs
    - Entrance of commercial banks into MF
- Further growth of the MF sector due to influx of donor funds following Tsunami in 2004
- MFI's have extended to difficult areas by various means
- Wide range of institutions provide MF services: Co-operatives, NGOs, commercial banks (both govt. and pvt.) and special government programmes (Samurdhi)

Financial Institution Outreach in Sri Lanka: The Emerging Picture

Distribution of Commercial Bank Branches, ATMs, LFCs, SLCs, EFTPOS,….

Category	End 2011	End 2012
Total No. of Licensed Commercial Banks (LCBs)	24	24
Total no. of LCB branches and other outlets	5586	5667
Total no. of LCB ATMs	2235	2358
Total No. of Licensed Specialized Banks (LSBs)	9	9
Total no. of LSB branches and other outlets	812	820
Total no. of LSB ATMs	180	180
Total No. of Bank Branches and Other Outlets	6398	6487
Total No. of branches of LFC & SLCs	972	1060
Total No. of ATMs	2415	2538
Total No. of Electronic Fund Transfer Facilities at Point of Sale Machines (EFTPOS)	27689	27955
No. of Bank Branches per 100,000 Persons (excluding LFCs & SLCs)	16.5	16.8

Source: CBSL. Annual Report 2013.

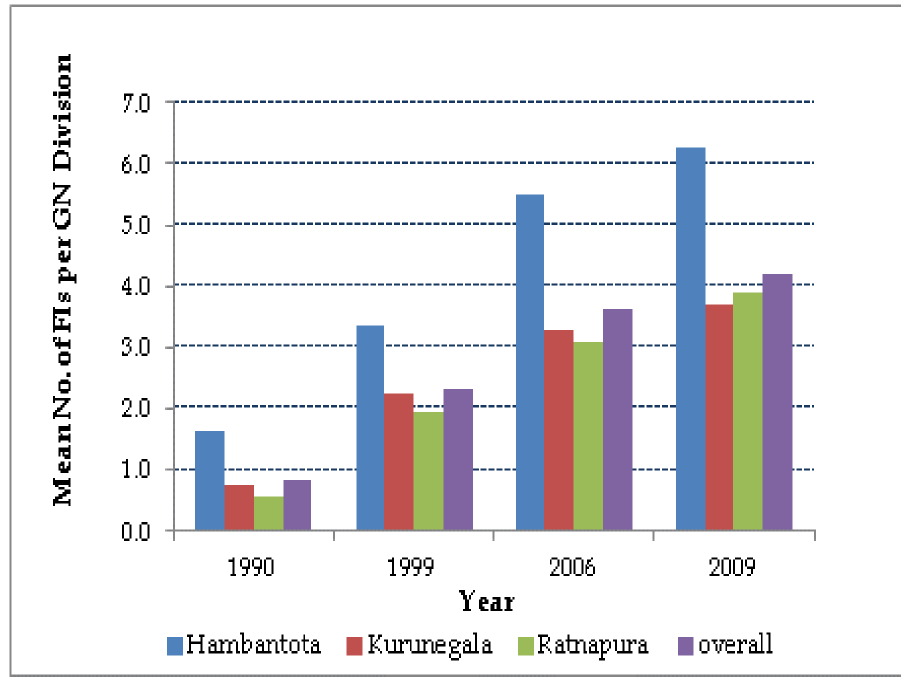
Microfinance Institutions (MFIs)

- **MFIs are defined** in this presentation to include the formal and semi-formal institutions that provide small scale lending or savings services to poor or low income groups, as their main activity, or at least as one of the major activities.
- These include formal institutions such as development banks (e.g. Regional Development Bank), semi-formal institutions such as co-operatives and NGOs, and special government microfinance programmes like Samurdhi, Divineguma, etc.
- Data is scarce and scattered for the MFIs and different sources provide different figures
- There are between 14,000 to 16,500 financial access points in MFIs where clients can deposit savings or withdraw loans
- MF borrower households as a percentage of total borrower households was 62% in 2006/7
- Some MFIs like have converted themselves to Finance Companies

Sri Lanka's Expanding Density of Financial Institutions (FIs) :1990-2009

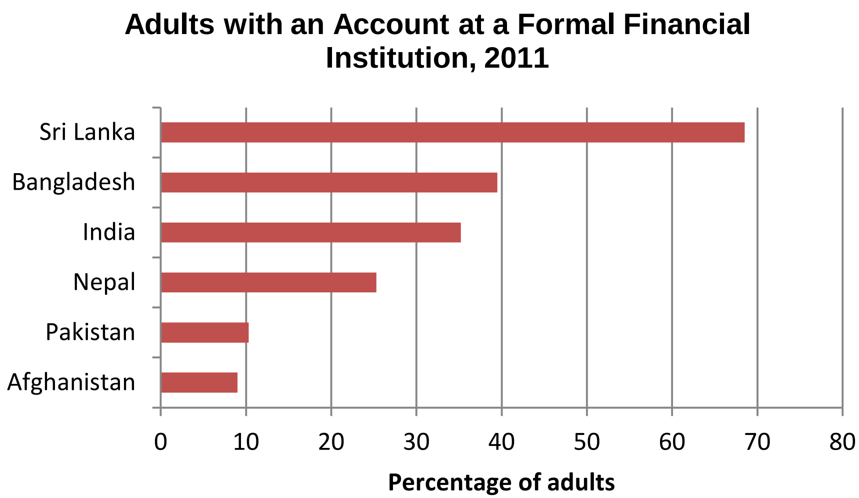
The term FIs in this slide refers to all institutional sources of finance, i.e., the sum of all the MFIs and CFIs. FIs cover both formal and semi-formal institutions such as commercial banks, development banks, finance and leasing companies, co-operative societies, NGOs, CBOs and special government programs like Samurdhi, **but exclude informal sources** of finance such as money lenders, employers, friends, relatives

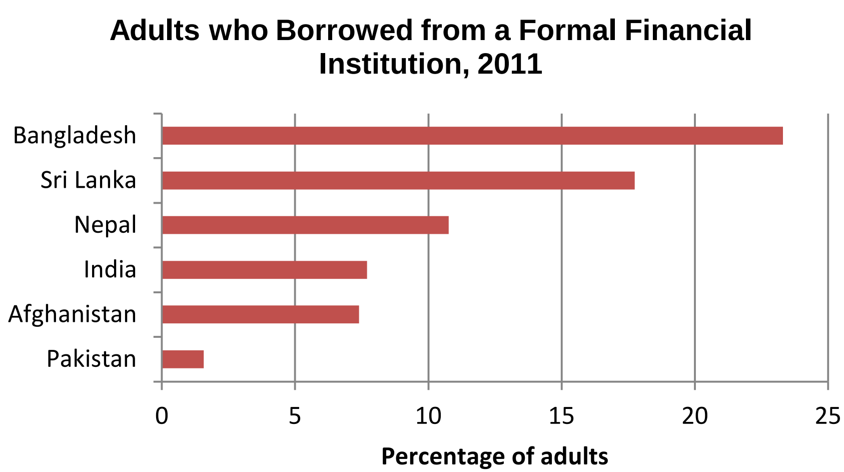
- Steady increase in density of FIs during 1990-2009
- Average of 4.2 FIs per GN division (all divisions with multiple FIs)
- Higher density of FIs in Hambantota district (6.3)
- High and increasing density of FIs is closely linked to growth of MFIs (3.9 MFIs per division)
- When taking FIs located outside the division but close proximity and accessible to HHs, mean FIs increases to 5.2



Source: Based on the survey of GN Divisions (2009/10).

Intra-regional variation with regard to access to formal FIs: Positioning Sri Lanka





Notable disparities across countries within South Asia:

- Sri Lanka has the highest % of people with formal financial accounts (68%), followed by Bangladesh (39%)

- Bangladesh has the highest % of people borrowing from formal FIs, followed by Sri Lanka

Measures Taken to Improve Financial Inclusion

Measures taken by the Government

- Central Bank of Sri Lanka Road Map of 2011 clearly states that the objective is to achieve 100% Financial Inclusion by 2015 (Side No. 124)
  - 10% mandatory credit to the agriculture sector by the banking system
  - Setting up the debit and credit management council by the CBSL
  - Upgrading the post offices to provide banking and financial services and agency banking through mobile phones
  - Mandatory for banks to open two branches in rural areas for every branch opened in metropolitan areas
  - Tax benefits for banks which provide credit to enterprises outside the Western province
  - Lanka Clear transformed in 2012 to a national payment infrastructure provider -- about half the ATM machines are now covered
  - Etc.

Measures taken by Commercial Banks, Specialized Banks, & Mobile Phone Cos

- Commercial Banks (CBs) have entered MF as a deliberate policy or as a part of Corporate Social Responsibility (CSR) activities either through their own MF programme or as intermediaries for credit programmes implemented by others
- Mobile banking units of CBs target rural trade fairs, religious festivals, cultural events, etc
- Point-of-sale electronic devices to connect to well-known mobile phones networks to take deposits with instant electronic confirmation (NSB)
- Introducing E-Banking: E-remittances, e-cash, x-press, MoneyGram, eZcash, Telemoney, etc., for instance, Dialog Telecom expected to reach a huge portion of its 7.5 million customer base at the time of launching ‘eZcash’ in 2012
- Issuance of banking cards -- close to 1 million Credit Cards and 10 million Debit Cards

Selected Financial Inclusion Indicators

From a Formal Banking Perspective

From the Microfinance Perspective

Commercial Banks Cross Country Access to Finance (CGAP, WB, 2010)

Country	Deposit accounts per 1000 adults	Deposit value % of GDP	Deposit average account value % of income per capita	Bank branches per 100,000 adults	ATMs per 100,000 adults
Bangladesh	316	50	232	5.2	na
India	747	55	108	10.1	7.3
Pakistan	229	30	207	8.7	4.1
Sri Lanka	1892	40	28	9.5	12.3
Malaysia	2063	105	73	10.5	54.0

Random Indicators Financial Inclusion: Commercial Banks/ Insurance

- Accounts per 1000 adults and ATM spread is higher in SL than other South Asian countries, but
- India’s Commercial Banks deposit value as percentage of GDP at 55 is much higher than Sri Lanka’s 40; perhaps this explains why India’s domestic savings per GDP is at 30% compered to Sri Lanka’s 18%
- Although SL has higher branches and ATMs, it ranks lower than other South Asian countries for average deposit account value for per capita income
- Despite wider banking outreach, SL has not been successful in promoting financial products and getting masses into the banking system
- This is also the case with life insurance: the coverage was 12% in 1997 which has now (2012) increased to 20% -- still low for a lower middle income country

Random Indicators: E-banking

- The value of retail transactions as a percentage of the total value of non-cash payment share of Credit Cards was 1.3 % in 2009 which marginally increased to 1.4% in 2013
- The same share for Debit Cards was 0.2 % in 2009 which marginally increased to 0.5% in 2013
- Usage of mobile cash is 0.1 % of total non-cash payments although mobile phone ownership exceeds 20 million (Colombage, 2011)
- Still close to 45% of remittances of migrant workers are sent through informal channels
- E-facilities for financial access exist but the utilization is not satisfactory
- Absence of sustainability of the attempts taken for Financial Inclusion is clearly indicated

Multiple Borrowing in the MF Sector - 2006/07 & 2009/10

No. of MFIs/FIs Accessed by MFI borrowers	Total No of MFIs/FIs accessed by MFI Borrowers					
	Including only the MFIs accessed			Including all FIs accessed		
	2006/ 07	2009/10	% change in HHs	2006/ 07	2009/ 10	% change in HHs
Single borrowers	84.2%	65.5%	-7.7%	71.2%	26.3%	-49%
Multiple borrowers	15.8%	34.5%	203.4%	28.8%	73.7%	255%
Total borrowers	**100.0%**	**100.0%**		**100.0%**	**100.0%**	
Total borrowers	184	255	71	184	255	71
Mean MFIs/FIs	1.2	1.5		1.4	2.3	
Maximum no. of FIs	3.0	7.0		5.0	7.0	

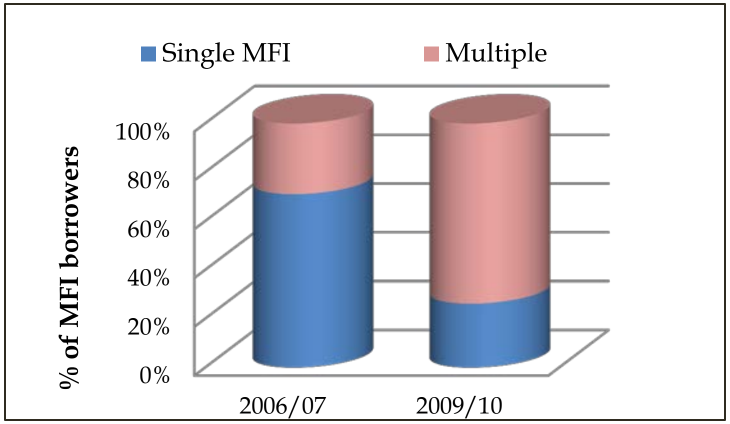
Source: Panel household survey (2006/07 and 2009/10).

Multiple Access / Multiple Borrowing

Sri Lanka :

- Increasingly high levels of multiple borrowing -- the share of MFI clients borrowing from multiple institutions has increased significantly in recent years
- MF loans are small thus borrowers are tempted to take loans from multiple sources to get a big sum of money

Share of MFI borrowers accessing multiple institutions



- Most multiple borrowers access a mix of MFIs and formal financial institutions, like commercial banks (the latter being used largely for pawning facilities)

- Multiple borrowing is seen across all income groups
- Evidence shows that the <u>debt levels among MFI clients, particularly among multiple borrowers, have increased in recent years</u> – bringing concerns to the MF sector of Sri Lanka

Constraints to Financial Inclusion in Sri Lanka

- There are number of constraints/ barriers to financial inclusion in Sri Lanka. They are broadly :

- Demand-side constraints
- Supply-side constraints
- Regulatory constraints

Demand-Side Constraints

❑ Financial literacy / financial education

- Financial literacy encompasses many concepts such as financial awareness, knowledge, skills and capability
- Developing financial capability and enhancing financial literacy is critical for any financial inclusion strategy to succeed
- Users of financial services should have the knowledge, skills and awareness needed to make informed financial decisions
- Financial education has been found to have limited impact in equipping individuals to evaluate complex financial trade-offs that require high numerical skills. However, financial education enables individuals to develop awareness about the financial products and services available to them and help them become familiar about the details of such products
- Financial literacy also help borrowers understand their repayment capacity and thereby prevent them from over-borrowing

Fragmented Financial Education in Sri Lanka

- Central Bank issues from time to time circulars, news paper advertisements on registered Financial Institutions
- Some sensitization of the public on e-banking: e.g., savings by the mobile banking arms of some commercial banks, e-cash remittances, etc.
- Regional branches of commercial banks also engages on promotional work but not on direct financial education
- In sum, financial awareness measures are ad hoc in nature

Other Demand-Side Constraints

- Lack of identity or financial history is another barrier to access financial services like savings, loans and pawning from formal FIs

- Lack of collateral (e.g. ,assets) , guarantors and regular sources of income are other barriers faced by poor/ low income groups to access formal Financial institutions

- Most SMEs complain that they have problems of accessing formal financial institutions due to the collateral issue

Supply-Side Constraints

- Conventional banking practices exclude large sections of the population due to requirements such as maintenance of minimum balances, withdrawal charges and rigid documentation

- Lack of access to efficient, convenient and safe payment systems

  - Electronic payment infrastructure out of reach for the financially excluded
  - Poor households in Sri Lanka operating in the informal economy rely on cash and physical assets (jewelry, livestock) which are riskier and costlier

- Limited reach and high cost involved in conventional service delivery mechanisms

  - Current formal banking infrastructure (branch-based operations) set up to serve high-value, low volume transactions
  - Sri Lanka has been slow to utilize technology to connect low-income households to the formal financial sector

Supply-Side Constraints (cont)

- Limited understanding of clients and their needs
- Sustainability of institutions is particularly a challenge in the microfinance sector
- Low average loan sizes of MFIs that are associated with relatively high transaction costs

Regulatory Framework in Sri Lanka

- Current regulatory framework is fragmented - different types of MFIs are regulated by different laws /bodies – differences in methods and standards of supervision and absence of a single regulatory and supervisory body have resulted in lack of uniform standards
- Non-bank MFIs like NGO- MFIs face legal barriers to accept deposits from their members → dependence on external funds
- MF bill is still under discussion in Sri Lanka
- Proposed MF Act – all licensed and registered MFIs are allowed to accept deposits from public

Regulatory Framework

- Initially countries create a relaxed environment for MFIs to grow, but gradually tightens the regulations
- India - Andhra Pradesh crisis (in 2010): A large flow of capital into the MFIs resulted in an aggressive expansion and over-lending of MFIs, leading to multiple borrowing and over-indebtedness among clients
- India considered MFI legislation after over borrowing led to system instability, however, the MFI Bill has still not been passed by the Lok Sabha
- Regulation should be designed for MFs to raise funds from multiple sources to enable them to create a diverse mix of financial products

Regulatory Constraints

- Inadequate financial regulatory infrastructure in the microfinance sector Supervisory and regulatory frameworks for MFIs weak
  - Heavy government involvement in the sector without a coherent regulatory framework
  - Level of transparency and financial disclosure relatively low in the sector making it difficult to monitor and assess MFIs
  - Has weaken management and governance of MFIs

- Weak or absent credit bureaus
- MFIs and low income clients are often excluded from credit bureau services
  - Providers are reluctant to share client information due to the weak legal environment in the sector
  - There is confusion over who should implement a microfinance specific credit bureau

- Inadequate client protection

Issues and Challenges

- Improving Financial Literacy
- Capacity Building of MFIs
- Branchless Banking: Utilizing Technology to Develop Innovative Business Models and Delivery Systems
- Regulatory Framework: Working out the Right Balance

Issues and Challenges

❑ Improving Financial Literacy

- Financial literacy should be developed through financial education giving importance to the language – this is a process where both the client and the provider play a pivotal role
- Financial capability should be promoted and facilitated amongst children and youth to create financially responsible citizens in the future
- It is important to design financial educational programmes with well defined priorities – not only financial numerical skills but also creating awareness about financial products and financial planning tools likely to have greater impact on improving financial literacy
- Providers of financial services should be transparent and disseminate accurate information to clients – regulatory environment should be designed to facilitate this

❑ Capacity Building for MFIs

- There is a need to improve governance with a focus on expanding the scope of services offered while improving the quality of services
- More emphasis should be placed on understanding the clients <u>needs</u> and developing <u>new market segments</u> – e.g. Brazilian boat micro finance services in the Amazon rain forest; Market saturation in Bangladesh has led to MFIs placing greater emphasis on lending to small businesses
- Most MFIs still use a single product approach but providing a range of products is essential
- MFIs need to widen their funding sources to become financially viable –taking out commercial loans, taking deposits

Issues and Challenges

- **Branchless Banking :Utilising Technology to Develop Innovative Business Models and Delivery Methods**
  - Mobile banking has become a growing force for inclusion, particularly as an efficient payment system – mobile payments are relatively cheaper than other methods of transferring money and has a wider reach African countries have set a good example by popularising mobile money – in Kenya 73% of the population were mobile money (M-PESA)customers in 2011
  - In Sub-Saharan Africa where traditional banking has been hampered by poor infrastructure , mobile banking has expanded to 16% of the market
  - In South Asia, Pakistan has made impressive progress through the <u>EasyPaisa</u> service offering over the counter basic payment services
  - Bangladesh has also gained momentum through its <u>bKash</u> mobile banking service reaching 3 million accounts
  - Mobile banking would act as the first step in bringing the financially excluded into the digital financial infrastructure and the <u>key challenge in Sri Lanka is to strengthen awareness on the IT-Finance nexus</u>

Issues and Challenges

Regulatory Framework

- Designing the right regulatory infrastructure and policy mix - Finding the right balance between protecting clients and fostering an environment that encourages financial inclusion

- Client protection

    - Client protection is critical given the low financial literacy in Sri Lanka
    - Standards should be set to promote transparency, fair practices and accountability
    - Implementing credit bureaus is critical to effectively monitor and supervise MFIs
      (Pakistan has been successful in implementing a credit reporting system for microfinance. The State Bank of Pakistan in partnership with the Pakistan Microfinance Network and the Pakistan Poverty Alleviation Fund launched MF-CRIB , a dedicated credit information bureau for microfinance)

- Enabling MFIs to develop in a sustainable way

    - Regulations should be designed to enable MFIs to raise funds from multiple sources to enable them to create a diverse mix of financial products (e.g. commitment savings accounts) with appropriate risk management
    - Policies should be designed to incentivise good financial performance – subsidies from the government and donors should be used to complement but not compete with private capital

- Regulatory infrastructure should encourage technological innovation in the finance sector (e.g. Mobile banking)

Concluding Remarks

- FI should not be confined to a Corporate Social Responsibility (CSR) policy of a commercial bank, rather it should be a part of the overall banking strategy under sustainability (under ‘People’ of triple bottom line: Profits, Planet, People)
- Like Commercial Banks introducing “priority banking” to enhance the bottom line, there is a need to embark on “barefoot banking” and in this process the commercial banks should study how best to make use of grassroots level intermediaries to make those people at “informal finance” level to “formal finance” level
- Develop a rich data base on the finance sector, in particular on access to finance, to facilitate evidence based research and then making policy recommendations to improve financial inclusion

Thank you

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