Microfinance as a Regular Commercial Banking Product

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Hatton National Bank is the largest private commercial bank in Sri Lanka and one of the handful of commercial banks in the world that have initiated microfinance programs. The bank launched its program in 1989 as an integral part of its operations, motivated by two business objectives. First, the program aims to protect the bank’s market share from state-owned rural banks and nonbank microfinance institutions such as credit cooperatives, especially in rural and semiurban areas, where more than 75 percent of the country’s population lives. Second, the program is an investment in the future: it targets microfinance clients with the potential to grow into small enterprises in the formal sector.

This Note profiles Hatton National Bank’s microfinance operations, highlighting two questions: How does a privately owned bank downscale part of its operations for microfinance? Is microfinance consistent with a profit orientation?

Target market

Sri Lanka is a low-income economy with a per capita income in 1995 of US$635. As in other economies, the country’s poor can be differentiated into five categories:

- The near poor—those at the top of the poverty pyramid, who have stable wage employment but low earning power.
- The entrepreneurial poor—those whose enterprises employ five or more people.
- The self-employed poor—those who work for their own account and may employ others.
- The laboring poor—those employed full time as unskilled labor.
- The ultra poor—those at the bottom, who depend on others’ earnings.

Hatton National Bank has focused its microfinance program on the top three layers of the pyramid—the near poor, the entrepreneurial poor, and the self-employed poor. To this target market the bank’s microfinance program has adapted its regular credit and deposit services. The program covers sectors ranging from fisheries and aquaculture to construction materials, trading, and garment-making.

The portfolio

In 1989–95, the microfinance program reached an average of 2,100 borrowers a year, financing 12,654 projects with US$4.6 million in total loans. The average loan during this period was...
US$360. More than 40 percent of loans fell in the range of US$190 to US$480, and more than 25 percent in the range of US$480 to US$960. Annual interest rates on microloans—at 19 to 25 percent, and averaging 21.8 percent in 1995—are not much higher than those on the bank’s regular commercial loans, which average 21.2 percent. In 1989–95, the program’s loan recovery rate was 97 percent.

Loans are structured to match the revenue and cash flow patterns of microfinance borrowers. Almost half the loans are for periods in excess of two years. Business expansion loans for equipment, machinery, or shop improvement have repayment periods of up to three years. Most loans at these longer maturities go to repeat borrowers; these loans make up 33 percent of all loans by the program. Working capital loans of less than a year account for about 20 percent of loans approved. Start-up loans account for a third of the bank’s microloan portfolio. Typical start-up loans are less than 25,000 rupees (US$480) and are unsecured. Program officers work closely with prospective start-up clients to review operating plans and develop a project loan proposal.

Savings products include savings accounts, fixed deposits, and savings certificates. In 1989–95, the microfinance program mobilized 44,500 deposit accounts, with average balances of US$145, for US$8.05 million in total deposits.

**Downscaling operations**

Microfinance units operating in remote rural areas are attached to the bank’s regular branches. The bank’s existing branch network enables the microfinance program to reach borrowers at a low cost and provides administrative support for its accounting, financial reporting, and communication requirements at little additional cost. These external economies have been key to the microfinance program’s success. The links with the branches and the oversight from the bank’s head office facilitate problem resolution and program monitoring. They also enable the microfinance units to bring to the head office’s attention the products and microenterprises that can be showcased for marketing purposes.

The microfinance operation is based on relationship banking. Hatton National Bank has selected experienced staff from its mainstream banking operations to run the microfinance program. Based in villages, usually in the area they come from, the banking officers work closely with clients. They develop an information base about clients’ asset turnover cycles, absorption of financing, transaction costs, risk, and collection patterns. Since most loans are not secured by collateral, such information is indispensable for managing costs and achieving high repayment rates.

To ease microfinance borrowers’ access to credit, Hatton National Bank modified its regular loan application and processing procedures and its collateral requirements. The microfinance program’s loans are well within the limits of the amounts that branch managers can approve themselves. Guarantees from two existing clients of the bank suffice to secure loans of up to Rs 100,000 (US$1,925). Loan application forms were simplified, and the time from application to evaluation to disbursement is normally only two to three days. Borrowers gain access to progressively larger loans by repaying existing loans on time and by maintaining profitability in their business operations, which are monitored by the loan officers.

The bank has also modified deposit services to suit the rural villages served by the microfinance program. Depositors can open accounts with small amounts and earn interest while maintaining small balances. The interest rates offered to the program’s clients are similar to those offered to the bank’s regular clients. But while the bankwide interest expense averaged 9.1 percent in 1995, the microfinance program’s averaged 11.75 percent, because its deposits are predominantly interest-bearing savings and time deposits.

After the fourth year of the program, deposit balances exceeded outstanding loans by in-
creasingly larger amounts, and by the end of 1995, they were 4.3 times the outstanding loans. These excess deposits have generated revenue opportunities for Hatton National Bank in other areas of banking. For rural households, they have led to important deposit services that would otherwise be unavailable.

**Profitability**

According to unaudited financial data from internal management reports, the microfinance program broke even by the end of its third year of operation, in 1992. Since that year, its revenues have covered both funding costs and direct operating expenses, including loan loss reserves, and it has started to generate operating profits (figure 1).

As an integral part of regular operations, the microfinance program incurs virtually no additional costs for supporting infrastructure—for branch office overhead, data automation, or communications facilities. There has been ample room in the bank's capital adequacy position for the risk assets generated by the program's lending operations. Moreover, the microfinance program generates adequate operating revenues—through interest charges and service fees on its loans and through an internal funds transfer credit for excess deposits. The bank's central treasury "buys" excess deposits from the program's units and from regular branches and "sells" them to units whose loans exceed their deposits. In this internal funds transfer system, the transfer price is the same for program units and regular branches, both of which operate as profit centers. This uniform pricing avoids biases in favor of the microfinance program relative to regular branches, or in favor of either deposit or lending operations of the program's units. The transfer price is used as a management tool, signaling the need for adjustments in emphasis between loan generation and deposit mobilization.

The productivity of microfinance officers, however, is lower than that of their counterparts in the bank's regular branches. The difference is accounted for by the smaller market base and smaller transactions in the microfinance program. In 1995, assets averaged US$175,250 per employee bankwide, and gross revenues US$21,150 per employee. In the microfinance program, the productivity was 29 percent lower, at US$124,000 in assets per officer, and gross revenues were 14 percent lower, at US$18,175 per officer.

![FIGURE 1 OPERATING RESULTS FOR THE MICROFINANCE PROGRAM](image)

The bank as a whole also outperforms the microfinance program in the ratio of noninterest operating expense to average loans outstanding. This ratio was 8.3 percent bankwide in 1995, while for the microfinance program it was 17.1 percent (11.6 percent for direct administrative expenses in salaries, allowances, and travel expenses and 5.5 percent for loan loss provisions). The cost difference, which is not recovered in the pricing of microloans, indicates the size of the internal cross-subsidy that management is willing to bear to pursue its objectives of promoting market share and market penetration in rural areas.

While the annual interest rates on microloans are not much higher than those on the bank's regular commercial loans, the higher transaction costs of microloans again indicate that the loan pricing policy includes an element of
cross-subsidy. But the bank’s management seems satisfied that the microfinance program’s operating and administrative costs (including loan loss provisions) are adequately covered by the total revenues.

The bank uses the same standards and procedures for portfolio classification and provisioning for both microfinance and regular loans. The microloans are thus administered under prudential banking regulations. A loan is considered overdue when a payment is one to thirty days late, and past due when a payment is thirty-one to ninety days late. When a payment is more than ninety days late, the loan is placed on a cash (nonaccrual) basis and classified as nonperforming. In 1995, overdue installments were 1.3 percent of the microfinance program’s outstanding loans, while loans past due and doubtful made up 3.8 percent of its total outstanding portfolio. The microfinance program annually sets aside an amount equal to 5 percent of its outstanding portfolio as reserves against possible loan losses. By contrast, bankwide reserves are about 1.75 percent of the total portfolio. The microfinance program’s larger provisioning is conservative and reflects the higher credit risks of the mostly unsecured microloans.

**Future challenges**

The microfinance program’s loan portfolio constituted less than 2.0 percent of Hatton National Bank’s total unsecured loans at the end of 1995, and the program’s deposits only 2.3 percent of the bank’s local currency deposits. The microfinance client base is small compared with those of, say, BancoSol in Bolivia and Bank Rakyat Indonesia, which are fully licensed commercial banks devoted solely to microfinance. But the track record of Hatton National Bank’s microfinance program demonstrates that it is a profitable and sustainable business, with potential for further growth. The experience shows that institutional commitment, operating autonomy, and a management environment that encourages responsive procedures enhance the program’s sustainability. Through the program, the bank is achieving its twin objectives of entering rural markets for banking services and building relationships with enterprises that may eventually grow into larger businesses.

But the program’s continued expansion depends on the availability of experienced mainstream banking staff, from whom the bank’s management selects the program’s officers. It also depends on the program’s continued ability to exploit the external economies in using the bank’s physical facilities and infrastructure. Another important issue that the bank will need to address as the microfinance program grows is the pricing of its loans. Global experience in microfinance argues for pricing that reflects the higher transaction costs and risks associated with microloans in order to minimize cross-subsidy and enhance sustainability. But differential pricing for microloans might be a difficult public relations issue for the bank because the integration of its microfinance program with its regular operations brings its microfinance and regular bank clients together under the same roof.

Finally, the bank will have to address the application of prudential banking regulations to its microloans. These regulations are generally biased against unsecured loans because of the adverse risk classification, but they have not yet been a deterrent to the microfinance program. As the program grows, however, this issue will become increasingly important, as it has in other countries facing the expansion of microfinance programs by formal banking sector institutions.

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