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Risks Assessment and Mitigation in Micro Finance Lending in a Post-Conflict Environment: The Case of the Northern Province in Sri Lanka

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Abstract
The main objective of this paper is to assess the vulnerability and risk related to the loan schemes being implemented by MFIs/Banks in the north. The methodology that was adopted includes a mixture of qualitative and quantitative research methods. It constituted of participatory social research and questionnaire survey methods. As far as risks faced by financial institutions are concerned operational risks are rated as very significant. According to the findings of the study, the common risk management practices adopted by the financial institutions are character assessment, forced savings, and eligibility requirements. Recommendations for credit risk reduction can be considered from two points of views: (1) reduction of the credit risks of the borrowers and the reduction of credit risks of the MFIs. The paper proposed certain general recommendations as well as specific recommendations for MFIs to deal with credit risk.
Keywords: Microfinance, Credit risk management, Post-war conflict

1. Introduction

Unemployment is one of the most daunting economic challenges facing youth in the former conflict-affected and border districts in the North and East of Sri Lanka which in turn has repercussions on self-esteem and social recognition. According to the Department of Census and Statistics, the youth unemployment rate was 17 percent in these areas in 2011, which is the highest among all age groups with males at 11.6 percent and females at 27.1 percent. Although official employment data for former conflict-affected and border districts is unavailable, it is estimated that 30 percent of the population in the Northern and Eastern provinces is unemployed of whom 28 percent are youth, as opposed to a national rate of 4 percent. Even though the economies in the Northern and Eastern provinces grew by 27 percent in 2011 (Central Bank), this has not translated into quality employment and enterprise development opportunities for the local communities. Daily labour is the main source of income for 37% of the population in former conflict affected areas. The bulk of the development activities and private and public investment projects employ skilled and semi-skilled labour from outside the region due to shortage of skilled workers within. Many of the unemployed youth have no job training other than formal schooling. Hence, the problem is not just a lack of jobs, but also a lack of employable and business development skills due to inadequacy of training infrastructure as well as the means to acquire business development support services and skills due to poverty. Micro and Small Enterprises (MSEs) are critical for promoting growth and are especially valuable in generating employment opportunities for women and youth, with MSEs contributing to over 50% of the GDP. The potential for MSE development in former conflict affected areas are curtailed by low levels of technology, lack of infrastructure facilities, lack of technical and managerial skills and lack of access to credit. The UNDP Socio-Economic Baseline Analysis (SBA) 2010-2011 finds 86.8% of households being aware of credit facilities and yet, 76.7% of the same reporting difficulties accessing credit. This confirms that the expansion of financial services to the Northern and Eastern Provinces have not necessarily increased access to credit to generate or expand production, trade or businesses.

Despite the spread of the financial services market and the increasing geographic presence of financial-service providers in the former conflict-affected areas, underprivileged and excluded communities are still facing challenges accessing financial services due to issues of collateral, stringent loan assessments and a risk-averse enterprise culture. One of the serious issues in microfinance sector in general, and in conflict-affected areas in particular, is risk management. Though risk management has been a part of business for many years, it is a relatively new discipline among microfinance institutions (Ayayi 2010, Bradbury 2010). Therefore, it is important to look at ways of ensuring high quality and affordable financial services are accessible on an equitable basis for targeted youth with a view of supporting expansion of businesses and creating a credit history for them in the long-term. To this end, the United Nations Development Programme, Colombo initiated the Youth Enterprise Development Project (YED) to support targeted youth through grants for skills training, assets or collateral to qualify for financial services from the formal sector in target communities in the Ampara, Polonnaruwa, Anuradhapura Vavuniya and Jaffna districts.

2. The Youth Enterprise Development (YED) Project

The principal objective of the YED project was to promote social cohesion through enterprise development for youth in the target communities in the above districts. The strategy of the sub project was to promote enterprise development in the five target districts, by increasing the opportunities and capacities of youth to engage in income generation activities, whilst also using it as a vehicle for improving relations between communities through a focus on shared benefits.

Under this sub project, through an intense process of information, guidance, mentoring and technical assistance, youth were supported to produce competitive business plans that meet the requirements of a formal bank screening process. Upon selection, the project provided a grant component as complementary support for implementation of business plans. It was given as in-kind support for the selected critical items of the respective business plans. This was not given in cash for working capital. The bank will facilitate for working capital through loans. The Project approved the business plans for favourable loans from the formal financial sector. With a view to ensuring clients are properly informed and the loan conditions are pro-poor in nature, the UNDP and its technical business development service providers (BDS) mediated between the financial service providers and client beneficiaries to create linkages and facilitate access to customized loans which include pro-poor characteristics.

The objectives of this paper include:

To assess the vulnerability and risk related to the loan schemes being implemented by MFIs/Banks in the north.

To assess the risks associated with micro-finance lending to clients including the risks associated with repayment capacities, beneficiaries' intention regarding debt repayment and factors influencing them;

To assess the risks associated with micro-finance lending institutions and motivation of formal financial institutions to support client businesses;

To provide recommendations on the possible credit risk reduction measures.

3. Methodology

The methodology that was adopted includes a mixture of qualitative and quantitative research methods. It constituted of participatory social research and questionnaire survey methods, specifically including the following:

i) Comprehensive desk review of the official records, documents and reports and other available literature;
ii) Conducting participatory social research [key informant interviews (KIIs), focus-group discussions (FGDs) and expert observations] to assess context;
iii) Meetings with project staff both at head office and project levels;
iv) Meetings with micro finance and formal financial institutions to gather data and information required to assess the effectiveness, appropriateness, sustainability and conflict-sensitivity of the micro finance lending project interventions;
v) A questionnaire survey of the beneficiaries.

The questionnaire survey included 33 respondents from Jaffna district and 23 respondents from Vavuniya district selected randomly from among those respondents who participated in the Focus Group Discussions (FGDs). The ratio of male and female respondents varied according to the numbers who participated in FGDs in both districts, but every attempt was made to keep to a 50:50 male to female ratio. In Jaffna district 33 respondents were interviewed in the questionnaire survey and out of this number 21 have obtained loans through the Youth Enterprise Development (YED) project. Twelve (12) respondents have not received the UNDP grant and / or loans from banks due to various reasons including the inability to find guarantors who are acceptable to the banks, and rejection of business plans submitted to the banks. Even if the financial institutions are approached with a business plan developed by a certified BDS provider, the financial institutions may reject the application due to the lack of fixed assets as security, such as land. Some beneficiaries received grants from the UNDP but not the loans from financial institutions, because YED project is not yet completed. As far as the grant is concerned beneficiaries of some DS divisions have been already selected. However, the whole idea of YED is not the giving of grants but to support youth to initiate or expand enterprises. Therefore, the main aim of the UNDP is to develop their entrepreneurial skills with viable business plans. Additionally as complementary support in order to implement business plans the UNDP is facilitating access to finance and/or provision of grant based on the requirement/ performance. Therefore by attending to training the beneficiaries do not fulfil eligibility to obtain grants.

In Vavuniya district none of the respondents obtained loans from the banks due to Project involvement but 23 respondents were interviewed who have obtained micro-finance loans from other micro-finance institutions such as Sanasa (Thrift and Credit Cooperative Societies Union) and Women's Rural Development Society (WRDS) as well as micro-finance loans from formal financial institutions such as banks.

In the Vavuniya district, the YED project activities were not fully completed. The UNDP office in Vavuniya has completed more than 80% of YED activities which include screening; entrepreneur training through partners such as the Industrial Services Bureau (ISB), CEFE Net Sri Lanka and Nucleus Foundation; business plan formulation; mentoring support and forming initial linkages with the banks. However the UNDP complementary support (grant) is to be materialized through future projects. Hence, in this paper the information provided in respect of the Vavuniya district is not directly related to the YED project. Nevertheless it provides a general situation of the micro-finance activities within the district. Under such circumstances the consultant with the concurrence of the UNDP officials decided to treat the sample of the Vavuniya district as a Control Group.

The participants for the FGDs were selected from the project locations in Koppai, Thellipalai, Chankanai, and Sandilipay DS Divisions in the Jaffna District. Around 52 beneficiaries were selected randomly from these project locations and three FGDs were held. In the Vavuniya district two FGDs were conducted in Vengalachcheddikkulam and Vavuniya South DS Divisions. The sample in Vavuniya consisted of 30 beneficiaries who were selected randomly from the FGD participants. Out of this number 23 were interviewed using the structured survey questionnaire. A number of financial service providers or MFIs such as Hatton National Bank (HNB) Sampath Bank and Sanasa, which were involved in providing microfinance facilities to the clients of the YED project and to the control group clients in the above locations, were also interviewed as Key Informants. Five key informants were interviewed in Vavuniya and four in Jaffna.

Although initially it was planned to conduct separate FGDs for MFI personnel in Jaffna and Vavuniya districts, this was not possible due to two reasons. A) the lending institutions, i.e. the banks, are involved in direct lending to the beneficiaries but FGDs with the bank personnel could not be held due to very small numbers. B) the banks do not use local level, small scale MFIs as conduits for channelling credit to the clients in the Jaffna district. In Vavuniya district, however, there are local level MFIs such as Sanasa Branch Cooperatives and Women's Rural Development Societies. But it was not possible to hold FGDs due to insufficient numbers of MFI personnel. Therefore these personnel were interviewed as Key Informants.

4. Assessment of beneficiary (Entrepreneur) Risks

Entrepreneur risks are linked with the risks associated with defaults including repayment capacities, beneficiaries' intention regarding debt repayment and factors influencing them (Verbano and Venturini, 2013). There are many sources of this risk: (1) Environmental reasons which include structural factors such as seasonality, inflation, or the vagaries of the weather such as droughts, floods, and cyclones; (2) Personal problems emanating from unexpected emergencies such as sickness or unexpected death of a family member, loss of employment, fires and theft; and high costs associated with life cycle events such as marriage, funerals, educating children; (3) Business problems such as risks associated with operating an enterprise or taking a loan, business losses and inflation; and (4) Political reasons such as change of government.

There are several strategies that individuals and households use ahead of time to protect against these risks. These strategies include diversifying income sources, building up physical, financial, human and social assets, and focusing on good money management. Loosing loan securities, facing adverse social consequences, loss of self-esteem and loss of confidence can be identified as impacts of loan defaults on borrowers.

5. Assessment of Risks faced by Lending Institutions

Microfinance lending institutions, in this case the banks which are involved in direct lending to clients face three kinds of major risks. They are (a) bankruptcy resulting from poor operational control, poor risk management, external political environment and fluctuations in foreign exchange rates (b) fraud and (c) portfolio risk resulting from for example large number of borrowers defaulting simultaneously.

Alternatively these financial institution risks can be categorized into at least four types of risks that are usually present in most lending activities of MFIs (GTZ 2000). They are (a) operational risks (credit risk, fraud risk, security risk), (b) financial risks (interest rate risk, liquidity risk, risks linked with assets and liabilities, foreign exchange risk), (c) institutional risk (drift from social mission and business mission and dependence) and (d) external risks (legal framework, competition, material environment, human factor which means the psychological, cultural, behavioural, and other human attributes that influence decision-making, the flow of information, and the interpretation of information by individuals or groups and macro economy).

The sustainability of the project can be measured in terms of repayment rate, interest rate, and the number of beneficiaries in the women's groups. As far as the sustainability criteria is considered it means that making the loans available to clients in the long run by maintaining financial sustainability of the scheme. When repayment rate is high financial sustainability is increased and the MFIs can provide more loans because of the favourable liquidity position. When market interest rates are charged, MFI can earn profits and sustainability of the scheme can be maintained without giving interest subsidies to the clients. When the number of female clients is high one can expect a higher repayment rate thereby increasing the financial sustainability.

Conflict sensitivity was ascertained by examining whether violence, disputes, misunderstanding of conflicts, misunderstanding of different ethnicities etc. increased or decreased after the project. Almost all the key informants have said that these criteria have been reduced. In summary the majority of the key informants feel that the effectiveness, appropriateness, sustainability, and conflict sensitivity of the YED project are in line with the project objectives.

6. Experience of the Youth Enterprise Development Project (YED): Key Findings

There are a limited number of microfinance products available through the YED project in Jaffna district other than loans. The loans are given for small enterprises, business loans, self –employment loans and agricultural loans. In the Vavuniya district, in addition to these loan products, loans for housing are also provided.

From the KIIs and FGDs it was revealed that the numbers of loans granted are too small in both districts and so are the average amounts of loans granted. At the KIIs and FGDs held in both districts it was also revealed that the number of loans is few due to stringent lending criteria adopted by banks and other financial institutions.

From the KIIs and FGDS it was further revealed that although the repayment rates were high during the initial months, later repayment rates reduced by almost 50% due to a number of reasons such as personal problems, heavy expenditure on life cycle events, business losses, environmental issues, use of funds for the purchase of consumer durables on easy payment terms, and even for meeting the costs of house construction.

Very short repayment periods and high interest rates were some of the other negative issues mentioned. Some financial institutions are asking for sureties who are government employees, and many borrowers are unable to find such sureties. Providing surety through SHGs is not a strategy adopted by the YED sub project.

There are four kinds of risks associated with microfinance projects. They are a) risks associated with the project itself b) entrepreneur risks c) MFI risks and d) country risks. At the KIIs and FGDs the significance of these four types of risks were ascertained. In the case of risks associated with the YED sub project those respondents in Jaffna district have identified social/ attitudinal risks as either very significant or significant and economic risks as significant or important. Another attitudinal risk which was revealed from the field observations of the research team was that a fair number of beneficiaries who received grants or loans have migrated to foreign countries or moved into other districts such as Kilinochchi.

In Jaffna business problems like losses and inflation are considered as either very significant or significant problems while environmental reasons are also treated as significant or important. Personal problems like emergencies and life cycle events have been rated as important by some beneficiaries. In Vavuniya district business problems like losses and inflation are rated as either significant or important. Environmental reasons are rated as important by some of the respondents.

As was expressed at the KIIs, FGDs and beneficiary survey there are several strategies that individuals and households use ahead of time to protect against these risks. These strategies include diversifying income sources, building up physical, financial, human and social assets, and focusing on good money management.

The impacts of loan default on borrowers were ascertained through KIIs, FGDs and personal interviews. Loosing loan securities, facing adverse social consequences, loss of self-esteem and loss of confidence have been rated as either very significant or significant by the key informants of the banks and the government. However, the majority of the respondent beneficiaries in the Jaffna district who have received benefits from the YED project have said these impacts are not important while some others have said they are important. In the Vavuniya district the majority has declared those impacts given in the above paragraph are not important.

As far as risks faced by financial institutions are concerned operational risks are rated as very significant and significant by many key informants interviewed. Financial risks including liquidity risks and risks related to assets and liabilities have also been considered as significant by a number of key informants. Institutional risks including the drifting from social mission, and business mission and dependency have been considered as very significant or significant by many of the key informants. Under external risks, competition, macro-economy and legal framework have been considered as significant by some of the key informants

The common risk management practices adopted by the financial institutions in the Jaffna and Vavuniya districts are character assessment, forced savings, and eligibility requirements. All other risk management practices excepting centre collection have been rated as significant by the majority of key informants particularly from banks.

It was found that access to markets, sales, access to credit and community development has increased dramatically. However it is the majority view that these criteria along with others such as income, employment, nutrition, gender empowerment, savings and social capital have increased slightly. On the other hand, the majority of the key informants have said that the poverty levels have decreased slightly, but the beneficiary view was mixed.

In this study, the project performance was also measured in terms of effectiveness, appropriateness, sustainability and conflict sensitivity. As far as outreach is concerned many key informants namely bank officials and beneficiaries expressed the view that outreach has increased but marginally. Most of the key informants were of the view that the gender empowerment has increased through the involvement of the activities of the Women's Rural Development Societies (WRDS).

Repayment rates were considered adequate by most key informants. Loan portfolios of the banks have increased marginally because only 21 beneficiaries have obtained loans from the banks under the YED sub project. Almost all the key informants are of the view that the project successfully addressed beneficiary needs. The project is fitting for the purpose of youth enterprise development.

The sustainability of the project is measured in terms of repayment rate, interest rate, and the number of beneficiaries in the women's groups. Repayment rate has been considered as good or adequate by most of the key informants. Women's groups are not formed among the beneficiaries of the YED project in Jaffna district because it is not a declared objective of the sub project. In summary the majority of the key informants feel that the effectiveness, appropriateness, sustainability, and conflict sensitivity of the YED project are in line with the project objectives.

7. Recommendations for credit risk reduction:

Recommendations for credit risk reduction can be considered from two points of views. These are reduction of the credit risks of the borrowers and the reduction of credit risks of the MFIs.

7.1. Reduction of Beneficiary risks

Entrepreneur/beneficiary risks are linked with the risks associated with defaults including repayment capacities, beneficiaries' intention regarding debt repayment and factors influencing them. Repayment capacities are badly affected by two reasons namely, low income, and committing major part of the income for payments of instalments of higher purchase agreements entered into for the purchase of consumer durables. This practice is spreading swiftly in these two districts according to some key informants. Low incomes result from business or crop failure. Some beneficiaries have no intention of repaying because of their long dependence on relief aid and externally supported livelihoods. As was revealed in the FGDs, their thinking is that one day these loans will also be written-off as done in many government sponsored loan schemes like the New Comprehensive Rural Credit Scheme.

According to the survey of beneficiaries/borrowers, causes of beneficiary risks or factors influencing them in the Jaffna and Vavuniya districts include business problems like losses and inflation which are considered as either very significant or significant problems while environmental reasons are also treated as significant or important by 18.2% of the 23 respondents. Personal problems like emergencies and life cycle events have been rated as very significant by some beneficiaries who participated in FGDs.

As was expressed at the KIIs, FGDs and beneficiary survey there are several recommendations that can be made which individuals and households can use ahead of time to protect against these risks. These recommendations include:

a) Diversifying income sources including crop diversification: diversification involves broadening the activities of a business into other new potential money making ventures. By taking on new activities, a business can supplement what it has traditionally done and increase the likelihood of a successful future. This ensures income security, increased incomes and the ability to expedite debt repayments.

b) Introducing micro-insurance programmes, for example crop insurance: micro-insurance is a mechanism to protect poor people against risk (e.g. accident, illness, death in the family, and natural disasters) in exchange for payments tailored to their needs, income, and level of risk. It is aimed primarily at the developing world´s low-income workers, especially those in the informal economy who tend to be underserved by mainstream commercial and social insurance schemes.

Micro-insurance allows policyholders to recover and rebuild after a crisis. It can mean avoiding difficult, often devastating risk coping measures such as putting children to work, eating less food, or selling productive assets. It promotes resilience and contributes to the Millennium Development Goals, including reducing hunger and child mortality, and improving maternal health.

In the event of shock, the benefits of micro-insurance go beyond financial help (Townsend 1995) as it can, (i) reduce risk: Insurance can play a critical role in reducing risk, since insurers have an incentive to prevent risks from occurring; (ii) stimulate productivity and asset accumulation: The working poor invest more in their livelihoods, and get higher returns, if they are protected by insurance. They can also build savings through a long-term life insurance policy; and (iii) deliver tangible benefits: Insurance with tangible benefits, such as a hot line for medical advice or health camps can make a huge difference in the lives of millions.

c) Building up financial, physical, human and social assets

Poor households use assets to protect themselves against risks and vulnerability. Loss management strategies are designed to improve the household's ability to cope with loss after it has occurred.

Financial Assets: Beneficiaries view membership of MFIs as a key financial asset since it provides loans for working capital and to purchase productive assets. In many cases beneficiaries are able to increase profits which they have used to broaden their asset base and therefore protect against risk both in the short and long term. Still others use MFI loans to re-stock after loss or switch businesses in response to threats and opportunities. Credit has enabled beneficiaries to smooth consumption during periods of low income or crisis, thereby precluding the need for households to liquidate productive assets or cripple their businesses by draining working capital. Contrary to declared use, MFI loans can also be used to respond to crises. Savings allow households and individuals to store current income for future protection against risks, a strategy perceived as one of the distinctive characteristics of the wealthy. Savings are also viewed as being extremely important as a source of liquidity in times of emergencies to improve household economic security by smoothing consumption when income flows are interrupted (Wright 1999).

Physical Assets: Most beneficiaries are striving to invest in physical assets as protection against risk. There are three broad categories of physical assets: (1) Household assets: Savings in cash and in-kind assets (held as stores of value- livestock etc.) and household items (utensils, furniture etc.); (2) Passive investment assets (houses/land for rent etc.): Requiring less daily effort by the owner; and (3) Key productive assets: Equipment used to generate income. These are usually the very last assets to be sold in crisis.

Human Assets: The most important investment is in children's education, which is viewed as a route for upward mobility and a form of social security for parents in their old age. Investments in health are also seen as important for protecting the productivity of the household's labour force and more effective use of the household resources.

Social Assets: The two key social assets used in the face of crisis are friends and relatives (reciprocal borrowing arrangements) and Group Credit.

In many cases the groups are playing an important role in the development of these assets.

d) Conducting awareness programmes focusing on good money management. Some beneficiaries tend to misuse credit at times even on unnecessary expenditure such as drinking and smoking and hence run into difficulties in repaying the loans. When money is used for such unnecessary expenditure some beneficiaries do not have the capacity to save money. Therefore it is recommended that future projects go beyond business planning into provision of mentoring and counselling support in order to ensure that continuous and timely support is available for entrepreneurs in implementing their business plans. This will contribute to reducing the rates of failure of enterprises. However, it is recommended that these programmes are conducted in collaboration with awareness programs on good money management as well.

There are many areas of public policy that impact vulnerability and income variability that are clearly outside social protection, and which are beyond the control of individual beneficiaries. They include: (i) maintaining macro-economic stability such as controlling inflation; (ii) implementing preventive measures against natural disasters, such as measures like the provision of irrigation facilities for cultivation; (iii) making investments in infrastructure development (for example, roads and water supply); (iv) investments in health and education facilities; and (v) promoting household savings

7.2. Reduction of MFI Risks:

There are a number of risk management practices that can be adopted for reducing micro-finance institution risks. These practices are commonly adopted by successful MFIs all over the world. It is shown below that some of these practices are not applicable to the YED sub project loans as such loans are given on an individual basis, or the banks are already adopting these practices in implementing the loan scheme.

a) Peer Lending: Group lending is a model created to mitigate the risk of lending money to poor who could not offer any collateral. In this model, the money is lent to a group of people, making the group accountable for the repayments. So even in an event when a group member is unable to make the repayment for some time, the rest of the group has to make the repayments. In this approach what is envisaged is applying peer pressure for repayment of the loan. However in the YED sub project, loans are given on an individual basis. But in the case of loans given by MFIs such as Sanasa and WRDS in the Vavuniya district peer lending can reduce risks faced by the MFIs.

b) Character assessment (i.e. 5 C's used by financial institutions for screening the borrowers, including character (past history of loan repayment, prudent money management practices), capacity to repay the loans, collateral, capital and conditions): Character assessments reduce the risk of future loan default resulting from credit or fraud risk. However, in providing loans under the YED sub project a thorough screening of the borrowers are undertaken and hence this recommendation is applicable only to the loans granted by Sanasa and WRDS in the Vavuniya district.

c) Varied loan terms: A variable rate loan is a loan where the interest rate can change, based on changes in market rates of interest. MFIs may also offer variable rate loans for a longer term. In the case of YED sub project loans, the beneficiaries have said the repayment period is too short, thus resulting in large sized loan

instalments. The practice of varied loan terms reduces liquidity risks.
d) Collateral requirements: Reduce credit risks. This is practiced by the banks which provide loans under YED sub project. But this recommendation is applicable to the loans granted by Sanasa and the WRDS in Vavuniya district.
e) Loan approval processes: Reduce transaction or fraud risks. This aspect too is given due consideration in the case of YED sub project loans in the Jaffna district.
f) Centre collection: A small MFI / or a self-help group can collect the loan repayments from member borrowers and deposit in the lender's bank account. This reduces transaction and fraud risks. Centre collection is not applicable to YED sub project loans in the Jaffna district, because the loans are given on an individual basis. However this becomes important where loans are channelled through conduit institutions, like Sanasa branch cooperatives and WRDS in the Vavuniya district.

8. General Recommendations

Increase the level of assistance provided through the sub project: At the FGDs and KIIs many beneficiaries expressed the view that the assistance provided by the sub project is too small. According to them the UNDP grant as well as the bank loans is small in size and therefore inadequate to start a new business, and/or expand or modernize the existing ones. Therefore the beneficiaries have to depend on informal sector loans, or sale/ mortgage of assets to bridge the gap between the amount of assistance provided through the sub project and the actual amount of money required for such investments. When money is raised from informal sources such as money lenders the rate of interest charged is very high when compared with the interest rates of the formal sector institutions such as banks.

Reduce interest rates: Under this sub project interest rates are not subsidised. When providing loans from banks through the sub project the interest rates charged are market rates of interest which are higher than the interest rates charged by other government-sponsored loan schemes. Most of the beneficiaries expressed the view that they cannot earn very large profits from their MSEs to pay the higher interest rates on loans and this also affects badly the repayment capacity of the loans obtained. However, from the banks point of view charging a market rate of interest is necessary to ensure the sustainability of the loan scheme. In that case if the interest rates to the borrowers are to be reduced, the UNDP may have to pay a subsidy on interest to the banks.

Be flexible on collateral / surety: Many beneficiaries said that the banks are very strict on the collateral / surety. Most banks ask for sureties who are government employees. Most beneficiaries are unable to find such sureties, because there are only a limited number of government employees living in their areas. Also, for some loans lands are considered necessary as collateral. Most of the beneficiaries own small plots of lands for which they sometimes do not have title deeds. Therefore the beneficiaries made a request to the banks to accept inter-se guarantee (guaranteeing each other's loans between or among borrowers themselves) as collateral / surety.

Use local level MFIs as conduits: In the YED sub project loans are provided directly to the beneficiaries by the banks. The banks are giving loans on market rates of interest and they adopt very stringent lending criteria such as thorough screening of borrowers and also they are very strict on collateral / surety. When small scale MFIs operate as conduits it is possible to form Self- Help Groups (SHGs) and practice group lending. Group lending has many advantages over individual lending: It improves the bargaining position of the group; reduces loan transaction costs of both lenders and borrowers; offers strong economic incentives to its members such as lower interest rates and price discounts on inputs among others; promotes economies of scale in technical assistance; reduces risk of loan default due to joint liability among group members; gains access to credit where they are discriminated against as single borrowers; plays a crucial role in mobilizing rural savings. These are useful since economic theory posits that savings create investments and this will act as a boost for rural development.

However there are drawbacks in the group lending schemes as well. They include (1) paying for someone else: While the group lending model is designed so that the group covers the cost of someone that is unable to pay, this often causes tension within the group, even among friends. When many of the business owners are struggling to make ends meet themselves, the last thing they want to do is have to pay more to cover someone else's loan. (2) group attrition: While there is no shortage of people wanting to receive a loan, there is a very high attrition rate as people decide they no longer want loans at a later stage. This usually stems from an unwillingness to attend weekly meetings, the above-mentioned un-satisfaction with paying for others, among other issues. (3) differences in abilities and knowledge level: For microfinance organizations that also provide capacity classes to their clients, a big challenge they face is the wide variety of learning abilities, education levels, and levels of motivation. By allowing groups to be formed based on geographical location or outside of the control of the organization, it is very difficult to effectively help teach each group essential business skills.

This sub project has selected individual lending over the group lending approach. But it became clear from the FGDs that the beneficiaries prefer group lending.

Increase the breadth of outreach: The number of beneficiaries assisted by this sub project is too small according to the KIIs and FGDs held. This may be due to the fact that the availability of the funds for the implementation of the sub project is limited. If more funds can be made available and if the banks adopt less stringent lending criteria there is a possibility of increasing the number of persons benefitting from the project.

Increase the repayment period: Many beneficiaries who attended FGDs expressed the view that the repayment period of the loans is too short. This result in fairly large loan instalments that have to be repaid and many borrowers find it difficult to afford to pay such large instalments.

Expedite the grant and loan process: Many beneficiaries complained that there are long procedural delays in releasing the grants and loans. This is because four partner organizations (UNDP, ISB, CEFE Net Sri Lanka and nucleus Foundation) operating within the same limited timeline results in delays in information exchange and aggravate the problems of coordination. However, the UNDP holds regular meetings to exchange information and monitor progress against the milestones of individual partners. Timely reporting of issues, challenges and lessons learnt by each partner are also being done to expedite the grant and loan process. Loans are also delayed due to various reasons including the inability to find guarantors who are acceptable to the banks and rejection of business plans submitted to the banks. It appears that the UNDP has adopted several measures to avoid such delays. But the beneficiaries are still saying that there are delays in releasing the grants and loans. Expediting the processes of providing grants and loans further require changes in the beneficiary selection process and relaxation of such criteria could affect the long term sustainability of the lending through increased loan defaults. Striking a balance between the two is therefore a sine-qua-non.

The government of Sri Lanka should establish a national information sharing system of SMEs. This can increase the SMEs' loss of corporate defaults and cut financial institutions' high costs of building their own information systems for SMEs risk management practices.

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