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Financial Inclusion, Regulation, and Education in Sri Lanka

Saman Kelegama and
Ganga Tilakaratna

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Saman Kelegama is Executive Director of the Institute of Policy Studies of Sri Lanka (IPS). Ganga Tilakaratna is a Research Fellow and Head of Poverty and Social Welfare Policy Research at the IPS.

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Please contact the authors for information about this paper.

Email: ed@ips.lk; ganga@ips.lk

Asian Development Bank Institute
Kasumigaseki Building 8F
3-2-5 Kasumigaseki, Chiyoda-ku
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500
Fax: +81-3-3593-5571
URL: www.adbi.org
E-mail: info@adbi.org

Abstract

Sri Lanka has achieved a high level of financial inclusion compared to other South Asian countries. Its financial sector comprises a wide range of financial institutions providing financial services such as loans, savings, pawning, leasing and finance, and remittance and money transfer facilities. There is also evidence that a larger share of households in Sri Lanka accesses multiple financial institutions for their credit and savings needs. However, the use of insurance services, ATM facilities, e-payments, and mobile banking, is relatively low. Financial education is ad hoc and lags behind financial innovation and new products. The information technology (IT) literacy rate is only 35% in Sri Lanka, and with the growing IT–finance nexus, financial awareness and education have become all the more important. Strengthening the regulatory framework governing the microfinance sector and client protection is also crucial for improving financial inclusion in Sri Lanka. Much scope remains to improve financial inclusion, particularly related to cost and quality of financial services provided, and the sustainability of financial institutions.

JEL Classification: G20, G21, G28

Contents

1. INTRODUCTION

Financial inclusion has attracted much international attention in recent years and has become a priority issue on many international policy agendas. In the 1980s and 1990s, most international attention was focused on micro-credit, i.e., the provision of credit to low-income households. With the recognition of the importance of other financial services, like savings and insurance, the focus shifted to a more holistic concept—microfinance—that encompasses a broad range of services beyond micro-credit (Armendariz and Morduch 2005; Littlefield et al. 2006; Collins et al. 2009). Despite the increase in microfinance initiatives around the world and the rapid growth of the microfinance industry over the past decade (Reed 2011), a considerable share of households remains without access to financial institutions. In this context, the concept of financial inclusion has recently entered the development discourse, calling for universal access to a broad range of financial services. It focuses on bringing all those who are excluded into the financial sector. As Conroy (2008: 4) argues, "while 'microfinance' has driven 'micro-credit' out of the professional discourse, 'financial inclusion' has not replaced 'microfinance' as an operational concept. Financial inclusion is the most useful frame of reference for considering how poverty might be reduced through provision of financial services. And microfinance [...] remains the most potent weapon available for reducing financial exclusion."

There is no universally accepted definition of financial inclusion. The United Nations (UN) Millennium Development Goal Summit of 2010 defines financial inclusion as "universal access, at a reasonable cost, to a wide range of financial services, provided by a variety of sound and sustainable institutions." According to the Consultative Group to Assist the Poor (CGAP), "financial inclusion means that households and businesses have access and can effectively use appropriate financial services. Such services must be provided responsibly and sustainably, in a well regulated environment." (CGAP 2014). ACCION International defines financial inclusion as "a state in which all people who can use them have access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients. Financial services are delivered by a range of providers, most of them private, and reach everyone who can use them, including disabled, poor, rural, and other excluded populations." (Center for Financial Inclusion 2008: 1)

Stein (2010) identified three key dimensions that define financial inclusion: (i) financial products, (ii) features of financial products, and (iii) delivery channels. He pointed out that financial inclusion requires provision of access to a range of financial products that goes beyond micro-credit to include savings, micro-insurance, payment facilities, remittances, and money transfer, and stressed the need for providing quality financial services at affordable prices in a convenient manner through a range of delivery channels including bank branches, non-bank institutions, and insurance companies.

Financial inclusion has several benefits for individuals and households and for the economy as a whole (UN 2006; Conroy 2008; Stein 2010). Higher levels of financial inclusion increase both economic efficiency and equity (Conroy 2008; Stein 2010). Furthermore, financial inclusion can help the poor to manage their day-to-day needs, to better cope with risks, and to undertake investment opportunities that enable them to improve their income and assets (UN 2006; Conroy 2008; Stein 2010).

Financial education and financial regulation are critical factors in achieving financial inclusion. Financial literacy encompasses many concepts such as financial awareness, knowledge, skills, and capability. Users of financial services should have the knowledge, skills, and awareness needed to make informed financial decisions.

Financial education enables individuals to develop awareness about the financial products and services available to them and helps them become familiar with the characteristics and details of such products (Carpena et al. 2011). Moreover, financial literacy helps borrowers to better assess their repayment capacity and thereby prevent them from over-borrowing.

Financial regulation is another important factor for financial inclusion. In many countries, formal financial institutions such as commercial banks, finance and leasing companies, and insurance companies are governed by a regulatory framework, with the central bank in charge of banking regulation and other bodies, such as the insurance board, in charge of insurance regulations. However, the regulatory and supervisory frameworks for the microfinance institutions are often weak compared with those for formal financial institutions (Zhang and Wong 2014).

This paper analyzes the level of financial inclusion in Sri Lanka and the role of financial regulation and education in achieving financial inclusion. Section 2 discusses financial inclusion in South Asia, with a special focus on Sri Lanka, while Section 3 provides an overview of Sri Lanka's financial landscape. Section 4 provides a detailed analysis of financial inclusion in Sri Lanka, particularly the level of access to financial institutions (including the extent of access to multiple financial institutions) and recent measures to improve financial inclusion. The regulatory framework governing the financial sector of the country is examined in Section 5, while Section 6 briefly discusses the role of financial education in Sri Lanka. Section 7 provides some concluding remarks.

2. FINANCIAL INCLUSION IN SOUTH ASIA: POSITIONING SRI LANKA

According to the Global Findex Survey 2012 (World Bank 2012), about three-quarters of the 2.5 billion people worldwide who live on less than $2 per day do not have a bank account. Financial exclusion is most severe among women and rural residents. In South Asia, only 33% of adults have an account at a formal financial institution—the second lowest share of the world's regions, higher only than Sub-Saharan Africa, but lower than Latin America, East Asia, and the Pacific regions. Moreover, South Asia has the highest gender gap in terms of access to formal financial institutions, compared with other regions. Only about 25% of female adults have access to formal financial institutions, compared with 40.7% of male adults.

Evidence shows considerable disparities in access to formal financial institutions across income groups. In South Asia, only 25.3% of the bottom 40% of the population has formal accounts, compared with 41% of the top 60% of the population. The level of education also has an impact on formal accounts—in South Asia, 54.2% of adults with a secondary education or more have access to formal financial institutions, compared with only 27.8% of adults with primary education or less.

However, there are notable disparities across countries within the South Asian region. According to the World Bank (2012), Sri Lanka has the highest share of adults with formal financial accounts (68%) in South Asia, which is much higher than in India, Pakistan, Nepal, and Afghanistan. Bangladesh has the highest share of adults borrowing from formal financial institutions, followed by Sri Lanka (Figure 1a, 1b).

Figure 1a: Adults with an Account at a Formal Financial Institution

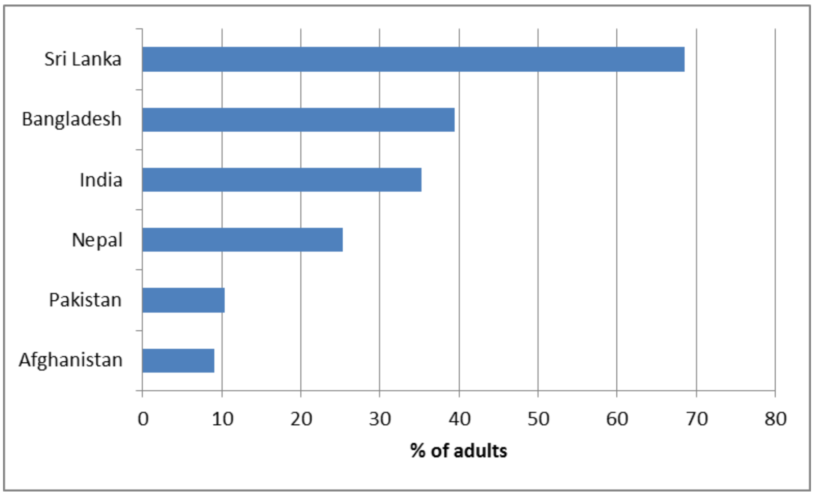
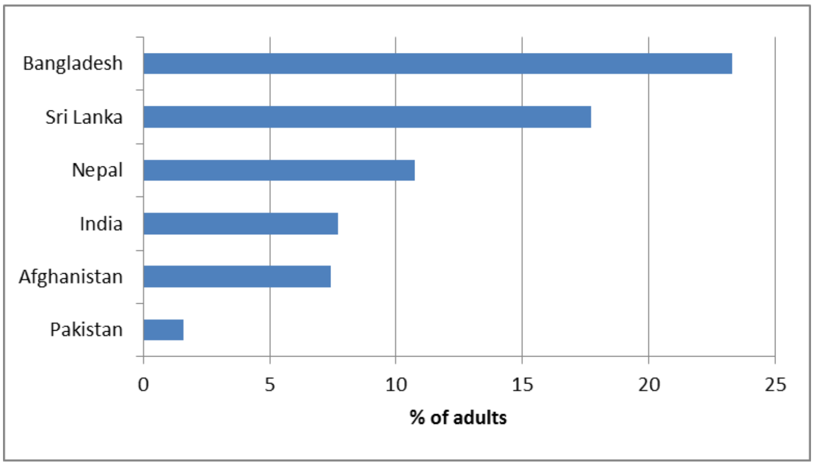


Figure 1b: Adults who Borrowed from a Formal Financial Institution



Source: World Bank (2012).

To ensure financial inclusion, it is important to look beyond the role of formal financial institutions such as commercial banks. In South Asia, microfinance institutions (MFIs), including non-governmental organization (NGO)–MFIs, community-based organizations (CBOs), self-help groups, and co-operatives, play a dominant role in financial inclusion, in particular in terms of ensuring access to financial services for those from low-income groups and for women. About 80% of MFI borrowers in South Asia are women.

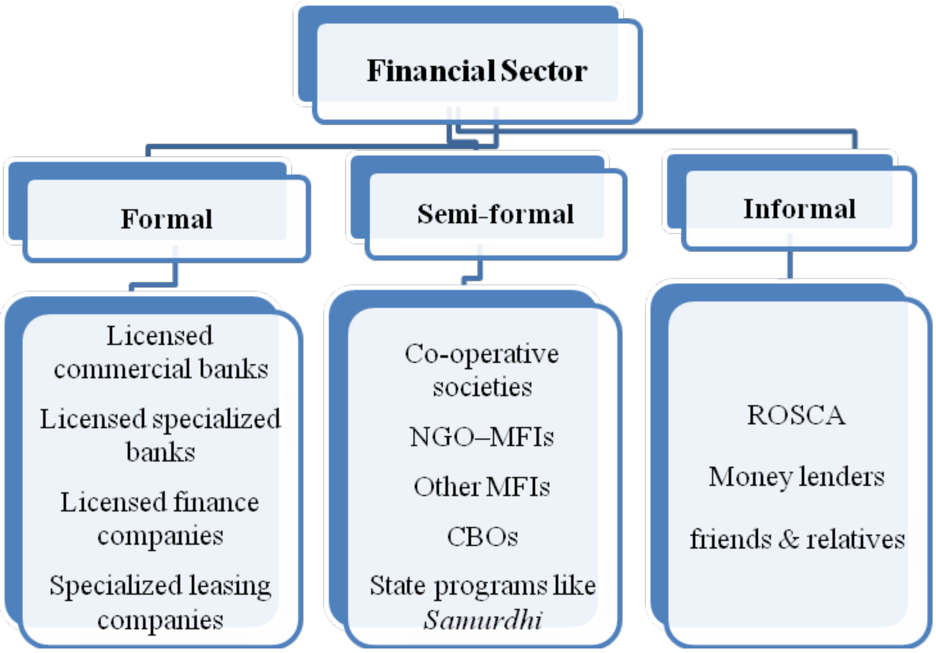
South Asia has a long history of microfinance. Credit co-operatives have been in operation since the early 20th century in many South Asian countries. However, the modern microfinance movement originated in the 1970s. In Bangladesh, the number of MFIs and their clients grew rapidly in the 1990s, followed by India in the 2000s. In Sri Lanka, the microfinance sector expanded in the 1980s and the 1990s and saw further growth in the post-tsunami period (from 2004). Other countries in the region made slower starts, but now have active microfinance sectors. At present, the outreach of microfinance varies considerably across South Asian countries (World Bank 2006). Outreach in Sri Lanka and Bangladesh is high, medium in India and Nepal, and low in Pakistan and Afghanistan. The high coverage of microfinance in Bangladesh was achieved through a few specialised MFIs, like Grameen Bank and the Bangladesh Rural Advancement Committee (BRAC), while the growth in India occurred through the bank–self-help group (SHG) link program. In Sri Lanka, high outreach of microfinance is largely a result of the co-operative societies and government-led microfinance programs (e.g., the Samurdhi program).

While access to financial institutions is still a challenge in South Asia, accessing multiple financial institutions for loans and savings is rather common in many countries, or regions within countries, in South Asia. Multiple borrowing (i.e., borrowing from multiple financial institutions) has become an issue of concern in a number of South Asian countries. For instance, in Andhra Pradesh in India, a large flow of capital into MFIs resulted in aggressive expansion and over-lending of MFIs, leading to multiple borrowing and over-indebtedness among MFI clients. This led to a crisis in the microfinance sector in Andhra Pradesh and in India as a whole in 2010 (CGAP 2010; Wright and Sharma 2010). In Bangladesh too, there is evidence of a high level of multiple borrowing and/or multiple membership among clients of MFIs like Grameen Bank and BRAC (Chaudhury and Matin 2002; Rutherford 2006). Evidence from Pakistan shows about 21% of MFI borrowers has loans from more than one MFI (Chen et al. 2010). In Sri Lanka, multiple borrowing in the microfinance sector has been on the rise (Tilakaratna 2012; Tilakaratna and Hulme 2013), which will be discussed in greater detail in Section 4.2.

3. FINANCIAL LANDSCAPE OF SRI LANKA

Sri Lanka's financial system consists of a wide range of service providers. These include (i) formal financial institutions like regulated banks and leasing and finance companies; (ii) semi-formal institutions like co-operatives, NGO–MFIs, CBOs, and state programs like Samurdhi; and (iii) informal sources of finance such as money lenders and rotating savings and credit associations (ROSCA). The focus of this paper is on the first two categories that form the institutional sources of finance or financial institutions. Semi-formal financial institutions are largely microfinance providers or MFIs.

Figure 2: Financial Services Providers in Sri Lanka



CBO = community-based organization, MFI = microfinance institution, NGO = non-governmental organization, ROSCA = rotating savings and credit association.

Source: Authors' compilation.

Sri Lanka's formal financial sector consists of 24 licensed commercial banks and nine licensed specialized banks, with a network of over 6,400 bank branches and other banking outlets and around 2,500 ATMs.[1] Moreover, there are 48 licensed finance companies (LFC) and specialized leasing companies (SLC), with a network of over 1,000 branches taken together. Recent years have seen a notable expansion in the banking sector as well as the LFC and SLC sectors, with a number of branches being opened in provinces other than the Western Province (CBSL 2013).

Table 1: Distribution of Licensed Banks and Branches

Category	End 2011	End 2012
Total number of licensed commercial banks (LCBs)	**24**	**24**
Total number of LCB branches and other outlets	5,586	5,667
Total number of LCB ATMs	2,235	2,358
Total number of licensed specialized banks (LSBs)	**9**	**9**
Total number of LSB branches and other outlets	812	820
Total number of LSB ATMs	180	180
Total number of bank branches and other outlets	**6,398**	**6,487**
Total number of ATMs	**2,415**	**2,538**
Total number of electronic fund transfer facilities at point of sale machines (EFTPOS)	**27,689**	**27,955**
Number of bank branches per 100,000 persons	**16.5**	**16.8**

Source: CBSL (2013) *Annual Report 2013*.

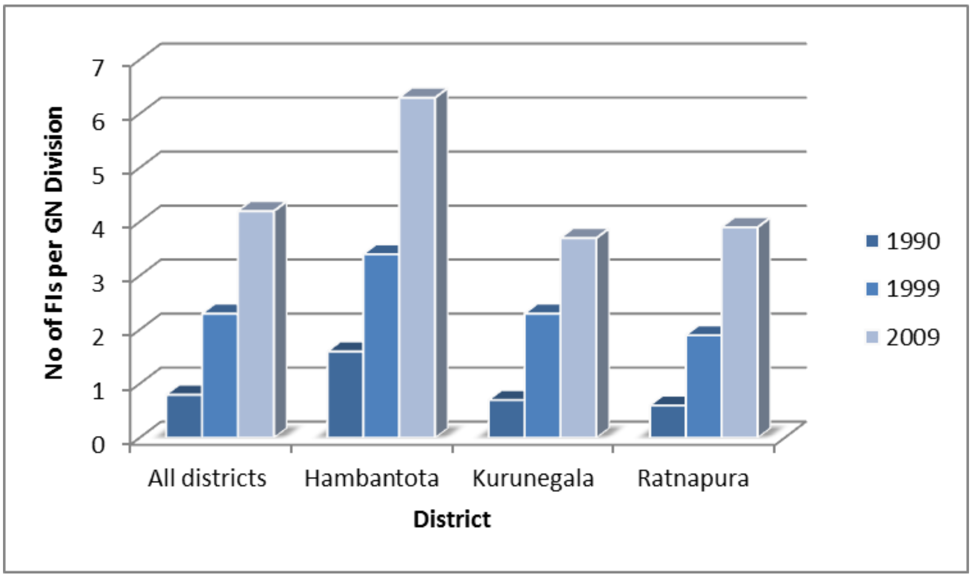
[1] Licensed specialized banks, unlike licensed commercial banks, cannot accept demand deposits from the public and cannot engage in foreign exchange transactions. These include banks such as National Savings Bank and Regional Development Bank.

The microfinance sector of the country comprises a range of different institutions such as co-operative societies, NGO–MFIs, CBOs, development banks, and state programs like Samurdhi. It has a long history that dates back to the early 20th century. The thrift and credit co-operative societies (TCCSs)—the pioneers of microfinance provision in the country—were started in 1906. The establishment of the Multi-Purpose Co-operative Societies (MPCSs) in 1957 and Co-operative Rural Banks (CRBs) as the banking windows of MPCSs in 1964 were early initiatives by the government to improve financial inclusion in Sri Lanka (Charitonenko and De Silva 2002; Gant et al. 2002). The establishment of the Janasaviya Trust Fund in 1991 (currently known as the National Development Trust Fund or NDTF) as an apex lending institution for the microfinance sector, the Regional Rural Development Banks in 1986, and the Samurdhi's Savings and Credit Program in 1997, were some of the important government initiatives during this period (Gant et al. 2002; IPS 2005; Tilakaratna et al. 2005).

The 1980s and 1990s saw growth in the number of NGOs providing microfinance. Moreover, a number of commercial banks entered the microfinance sector primarily as part of their corporate social responsibility (CSR) activities—either through their own microfinance programs or as intermediaries for the credit programs implemented by the Central Bank. Sri Lanka's microfinance sector saw further growth in the post-tsunami period due to an influx of donor funds into the sector (Srinivasan and IPS 2008). Recent years have seen the growth and expansion of MFIs, particularly in the northern and eastern parts of the country.

CGAP (2006) found about 14,000 financial access points, defined as a bank, a co-operative branch, or a society where clients can deposit savings or withdraw loans. Furthermore, there was evidence of multiple financial institutions operating in Grama Niladari divisions (Tilakaratna et al. 2005; Tilakaratna 2012). Tilakaratna (2012) found a steady increase in the number of financial institutions per Grama Niladari division (i.e., density of financial institutions) during 1990–2009, with on average 4.2 financial institutions per division, and that all divisions covered by the survey had multiple financial institutions by 2009 (Figure 3). The density of financial institutions was particularly high in the Hambantota district in the Southern Province (with an average of 6.3 financial institutions per division). The study also found that a high and increasing number of financial institutions were closely linked to the growth and expansion of the microfinance sector. On average, there were 3.9 MFIs per division (compared to 4.2 financial institutions) in the country, and in the Hambantota district the average was as high as 5.3 MFIs.

Figure 3: Density of Financial Institutions in Sri Lanka, 1990–2009



FI = financial institution; GN = Grama Niladari.

Note: Density of financial institutions is defined as the number of financial institutions located within a given Grama Niladari division.

Source: Tilakaratna and Hulme (2013); Tilakaratna (2012).

Empirical evidence suggests a strong presence of MFIs in the Southern Province of Sri Lanka, i.e., the Hambantota, Matara, and Galle districts (GTZ ProMiS 2010; LMFPA 2010). GTZ ProMiS (2010), based on a survey covering MFIs with over 500 clients, found that about 24% of all MFI outlets are concentrated in the Southern Province, where only about 12% of the country's population resides (DCS 2010). LMFPA (2010) also revealed a much higher number of MFI branches in the Hambantota district than in other districts.

4. FINANCIAL INCLUSION IN SRI LANKA

4.1 Access to Financial Institutions

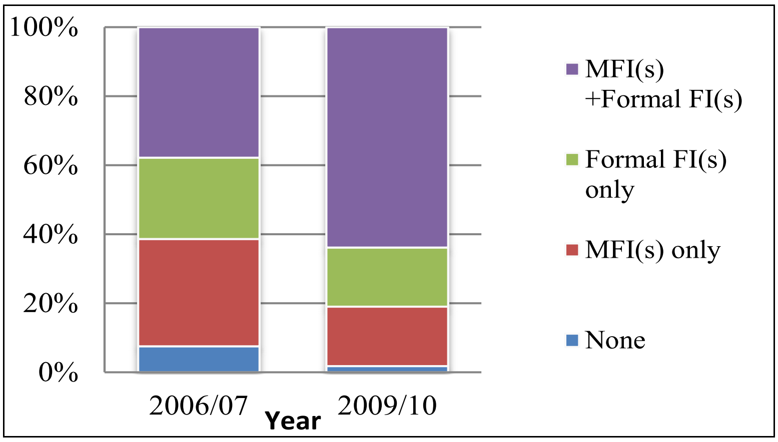
Empirical evidence suggests a high level of financial access in Sri Lanka. GTZ ProMiS (2008) found that 82.5% of households in the country were accessing financial institutions (formal and semi-formal) for loans and savings in 2006/07. Moreover, a two-period survey covering 47 Grama Niladari divisions from three districts revealed that around 92% of households had accessed financial institutions by 2006/07, while it had increased to over 98% by 2009/10.[2] In other words, the share of households that have not accessed financial institutions for loans and/or savings had fallen to around 2% by 2009/10 (Tilakaratna 2012). The study further found that access to financial institutions was high across all income groups, with only around 2%–3% of households from the bottom two income quintiles having neither borrowed nor saved with a financial institution. This is a remarkably high level of financial inclusion for a developing country, and it is much higher than in the rest of South Asia.

[2] The first round of this survey (2006/07) was carried out during October 2006–February 2007 and the second round (2009/10) was during December 2009–March 2010. Hence, 2006/07 and 2009/10 in this paper refer to the above periods.

A considerable share of households across all income groups has accessed both MFIs and formal financial institutions like commercial banks. This is somewhat contrary to the conventional wisdom that low-income groups are excluded from the formal financial sector. As shown in Figure 4, about 64% of households access both formal financial institutions like commercial banks and MFIs for their financial needs. In fact, the share of households accessing both types of financial institutions has increased significantly in recent years, from about 38% in 2006/07 to 64% in 2009/10. Interestingly, a considerable share of households in the lowest-income groups also access commercial banks for their financial needs.

Figure 4: Share of Households Accessing Financial Institutions by Type of Financial Institution, 2006/07 and 2009/10

(% of households)



FI = financial institution, MFI = microfinance institution.

Source: Tilakaratna (2012).

The above findings reveal that the microfinance sector and the mainstream financial sector, that are conventionally believed to be serving distinct segments of the market, have overlapped in Sri Lanka in recent years, serving the financial needs of a broader group of households across a range of income groups. Commercial banks and other formal financial institutions have moved down-market, providing financial services to the lower-income groups, while some MFIs have diversified their services and products, enabling them to attract clients from middle- and higher-income groups. This convergence between the two sectors has contributed to a great extent to the high level of financial access and increasing multiple "clientship" (i.e., accessing multiple financial institutions) in Sri Lanka's financial sector (Tilakaratna 2012).

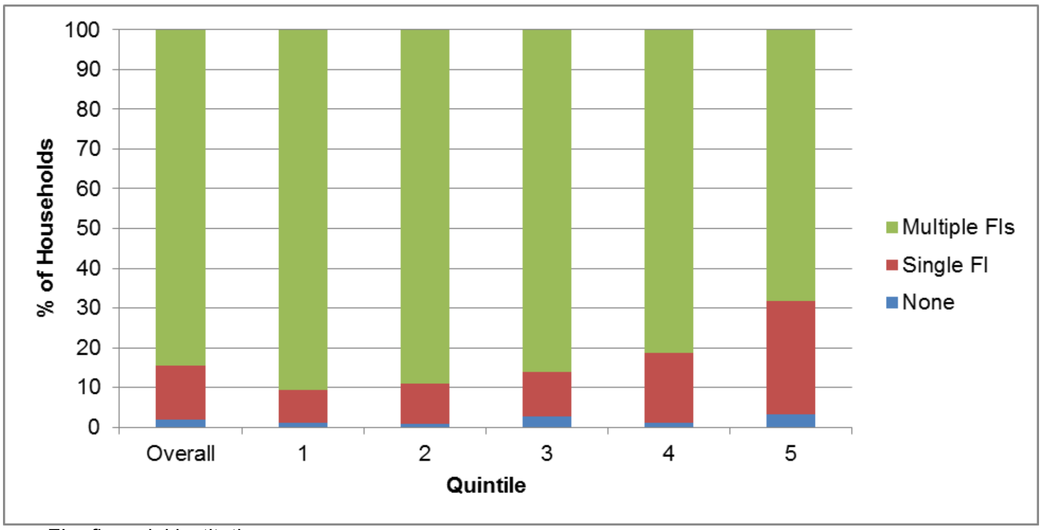
Pawning (gold pledged loans) is one of the key reasons for the widespread use of commercial banks among lower-income households. As pawning facilities can be obtained instantly without any guarantee or compulsory savings, and involves no regular repayment schedules, it is widely used by low-income households to meet their emergency financial needs. Many banks too have made pawning facilities available to clients on attractive conditions (e.g., with loan extensions and possible renewals, increase in loan amounts based on gold prices). However, only a handful of MFIs, such as CRBs and some TCCSs are currently licensed to provide pawning facilities. Safe and reliable savings facilities are another reason why households across all income groups access formal banks. GTZ ProMiS (2008) found that nearly 70% of households in the lowest-income quintile that have savings at a financial institution had saved with formal (state-owned) banks like the People's Bank and the Bank of Ceylon. However, only 23% of households in this quintile had accessed these banks for credit facilities (largely for pawning and subsidized agricultural loans). These banks also offer other financial services such as remittances, foreign exchange, and current account facilities that are not available from MFIs.

While some formal financial institutions like commercial banks have moved down-market to serve lower-income groups, many MFIs have also extended their operations up-market to reach successful clients and those in middle- and even higher-income groups. Some MFIs, like co-operatives, often offer higher rates of interest on their savings compared with regulated banks, thereby attracting savings from members as well as non-members (the latter largely being better-off households). In addition, some MFIs operate during weekends and have longer working hours, providing a more convenient service to clients. Such flexible services together with higher interest rates have allowed MFIs such as CRBs and some well-developed TCCSs, to attract savings from higher-income groups. Furthermore, some MFIs are gradually moving away from their initial objective of poverty alleviation or income generation among the low-income groups, to become more profitable and financially viable institutions. They encourage relatively better-off households (with better repayment capacity) to join them, either by offering relatively larger loans or through special credit schemes targeting higher income groups. Such developments have led to an overlap of clientele served by the formal financial sector and the microfinance sector, contributing to higher levels of financial access and increasing multiple "clientships" in Sri Lanka's financial sector (Tilakaratna 2012).

4.2 Access to Multiple Financial Institutions

With the growth and expansion of financial institutions in recent decades, accessing multiple financial institutions by households has become a common phenomenon in Sri Lanka's financial sector in recent years. Tilakaratna (2012) found that the share of households accessing multiple financial institutions for their credit and savings needs had increased to around 84% by 2009/10 (from an already high level of 60.2% in 2006/07). On average, a household had accessed three financial institutions by 2009/10 for their credit and/or savings needs—a noticeable increase from 1.9 financial institutions in 2006/07. As shown in Figure 5, a large share of households across all income groups accessed multiple financial institutions, with a relatively higher share in higher-income groups. For instance, around 68% of households in the bottom income quintile had accessed multiple financial institutions, compared with more than 90% in the top- income quintile. Moreover, the majority of multiple client households across all income groups had accessed a mix of MFIs and formal financial institutions like commercial banks.

Figure 5: Access to Financial Institutions by Income Group, 2009/10



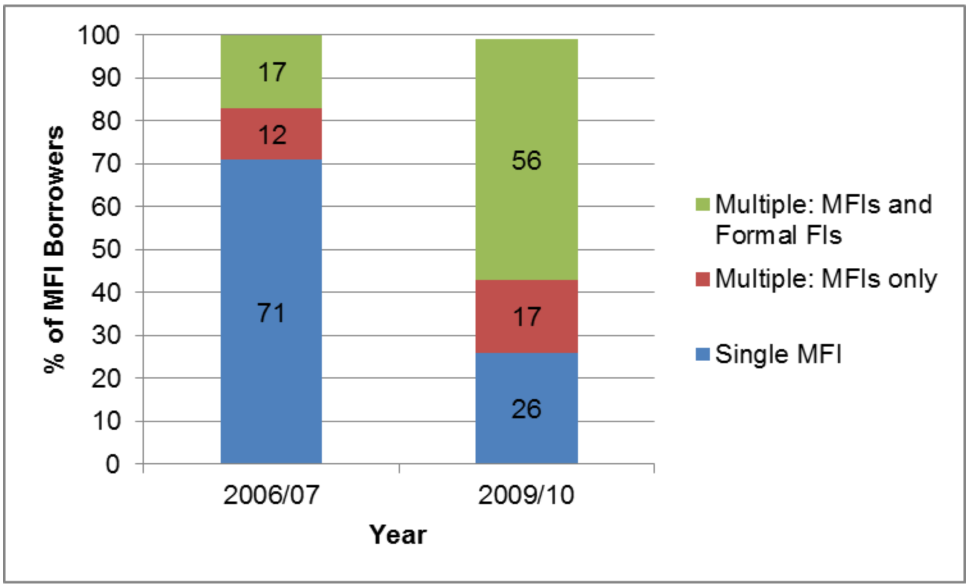
FI = financial institution.

Note: Quintile 1 refers to the highest-income group while quintile 5 is the lowest-income group.

Source: Tilakaratna (2012).

Increasing levels of multiple borrowing (i.e., households borrowing from multiple financial institutions) has become an issue of concern in Sri Lanka's financial sector. Multiple borrowing is particularly high in the microfinance sector and has shown an increase in recent years. As shown in Figure 6, about 74% of MFI borrowers access loans from multiple financial 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 (Tilakaratna and Hulme 2013; Tilakaratna 2013, 2012).

Figure 6: Extent of Multiple Borrowing in the Microfinance Sector, 2006/07 and 2009/10



MFI = microfinance institution ; FI = financial institution.

Source: Tilakaratna and Hulme (2013).

While access to multiple financial institutions by households suggests a high level of financial inclusion in the country, empirical evidence shows an increase in household debt levels particularly among households that borrow from multiple financial institutions. Tilakaratna and Hulme (2013) found that the average debt-income ratio among the MFI borrowers—an important indicator of borrower indebtedness—had increased from 10.5% in 2006/07 to 13% in 2009/10, indicating an increase in the level of debt (or indebtedness) at the household level during this period. In particular, the debt-income ratio of households borrowing from multiple MFIs and/or multiple financial institutions had increased to 15.3% by 2009/10. Although debt levels are still at moderate levels, given the increasingly high level of multiple borrowing in the microfinance sector, careful monitoring of multiple borrowing and repayment capacity of borrowers is needed to minimize any adverse effects on borrowers as well as on institutions.

A number of factors have contributed to the high level of financial access at the household level in Sri Lanka. A wide network of financial institutions—including both formal and semi-formal financial institutions like banks, leasing and finance companies, co-operative societies, and MFIs—with over 14,000 “access points” and multiple financial institutions operating in many areas of the country, is one of the key factors that have contributed to the high level of financial access at the household level. The role of the government as a provider of financial services (through state-owned banks, microfinance programs like Samurdhi, and subsidized credit programs) and as a facilitator is also an important factor. For instance, the government’s Samurdhi’s Savings and Credit Program, which operates through over 1,000 banking societies, serves over two million clients with credit and savings facilities.

Availability of a range of financial services and products, such as savings products (ordinary savings, fixed deposits, children’s savings, and special savings products for women, the elderly, etc.), different types of loans (e.g., housing loans, income generation loans, consumption loans), pawning, money transfer facilities, and insurance through financial institutions are other important contributory factors explaining the high level of financial access in Sri Lanka. Relatively good infrastructure facilities and the country’s geographic characteristics, such as its small size and high population density, in conjunction with relatively high literacy and low levels of poverty, have at least indirectly contributed to the high level of financial access at the household level.

4.3. Recent Measures to Improve Financial Inclusion and Gaps in the System

Various measures have been taken by financial regulators and service providers in recent years to increase financial inclusion in Sri Lanka. According to Jayamaha (2008), recent initiatives by the Central Bank of Sri Lanka (CBSL) and leading commercial banks have enhanced financial inclusion. Some of these measures are: the provision of 10% mandatory credit to agriculture by the banking system; the setting up of a credit and debit management council by the Central Bank; upgrading of the post offices to provide banking and financial services, and the setting up of agency banking through mobile phones. CBSL has also made it mandatory for banks to open two branches in rural areas for every branch opened in metropolitan areas.

In 2002, Lanka Clear was established as a national cheque clearing house and inter-bank payment system and it was transformed in 2012 to a national payment infrastructure provider that basically facilitates domestic transactions via electronic payments. Lanka Clear already covers a little over half of Sri Lanka's ATMs, or about 3,000.[3]

Since recently, commercial banks have been embarking on a strategy of mobilizing savings from the poor. Rural trade fairs, religious festivals, and cultural events are the key events targeted for this purpose. Mobile banking units are used and attractive interest rates are offered.[4]

Technology has also played an important role in the rural outreach of banks. A good example is the National Savings Bank's 'point-of-sale deposits' where bank representatives visit rural homes with point-of-sale electronic devices that connect to a well-known mobile phone network, and take deposits and provide instant electronic confirmation to the depositors. These point-of-sale devices have led to growth in monthly transactions of many bank branches, both in terms of numbers and value (Ratwatte 2012).

Moreover, commercial banks have introduced several measures to provide financial services to migrant workers. Migrant remittances are the highest foreign exchange earner in Sri Lanka, at close to $6 billion and amounting to 10% of the country's gross domestic product (GDP). However, it is estimated that close to 45% of total remittances of migrant workers are sent through informal channels. To try and capture such transfers, commercial banks have introduced e-remittances such as internet banking and e-cash, x-press money, MoneyGram, EZ money, and Telemoney. But there is no data available on how successful these programs have been in making inroads into the informal channels of remittances.

Although financial inclusion is at a relatively high level in Sri Lanka, the IT-based financial instrument usage remains at a low level. Use of debit and credit cards, phone banking, and e-banking are still at a relatively low level in Sri Lanka. According to Colombage (2011), the use of phone banking was only 0.1%, and according to the Central Bank (various issues), the value of retail transactions as a percentage of the total value of the non-cash payments share of credit cards was 1.3% in 2009 and increased marginally, to 1.4%, by 2013, and the same share for debit cards was 0.2% in 2009 and increased marginally, to 0.5%, by 2013.[5] These shares are very low given that close to 1 million credit cards and 10 million debit cards had been in circulation in the economy by 2013.[6] The use of e-banking is still in its early days in Sri Lanka and is positively related to financial awareness, financial education, and the level of income.

Another anomaly in the Sri Lankan financial system is the low insurance coverage despite high level of access to financial institutions. The share of the population covered by insurance schemes was around 12% in the late 1990s (Kelegama 1998). With the expansion of insurance services with private sector participation and banks entering the insurance business after early 2000, insurance coverage had increased to 20% by 2012.[7]

[3] http://www.sundayobserver.lk/2014/06/15/fin32.asp.

[4] A bank that has been successful in rural deposit mobilization is Hatton National Bank with its "Gami Diriya" program.

[5] Table 8.12 of the CBSL Annual Report (2009) and Table 8.19 of the CBSL Annual Report (2013) were used for this estimation.

[6] http://www.sundayobserver.lk/2014/06/15/fin32.asp.

[7] http://www.dailynews.lk/?q=business/micro-insurance-way-forward.

Many MFIs too have extended their outreach to new areas, including to the north and eastern parts of the country in particular in recent years, and expanded their services beyond the provision of credit services to savings, micro-insurance, etc.

Overall, Sri Lanka has a wide network of financial institutions providing households and individuals with access to a range of different financial services such as savings (voluntary and compulsory, ordinary savings, and time-deposits), loans, pawning facilities, leasing and finance services, insurance, money transfer, and remittance facilities. Despite the growth and expansion of financial institutions, there are a number of gaps in the current financial system that need to be addressed. These are related to the cost and quality of services provided, the sustainability of financial institutions (particularly MFIs), clients' knowledge of the characteristics and details of financial services and products, and repayment capacity (i.e., financial education). The current regulatory framework of the financial sector and the level of financial literacy are discussed in the following sections.

Moreover, it is important to note that despite the high level of financial access enjoyed by households and individuals, many of Sri Lanka's small and medium enterprises (SMEs) are faced with barriers to accessing adequate funds. Although adequate data is not available to show the level of access to finance by SMEs in Sri Lanka, several studies have identified access to finance as a key constraint faced by many SMEs in the country (IPS 2002). High rates of interest and collateral requirements are two key barriers to access to finance faced by SMEs.

5. FINANCIAL REGULATION

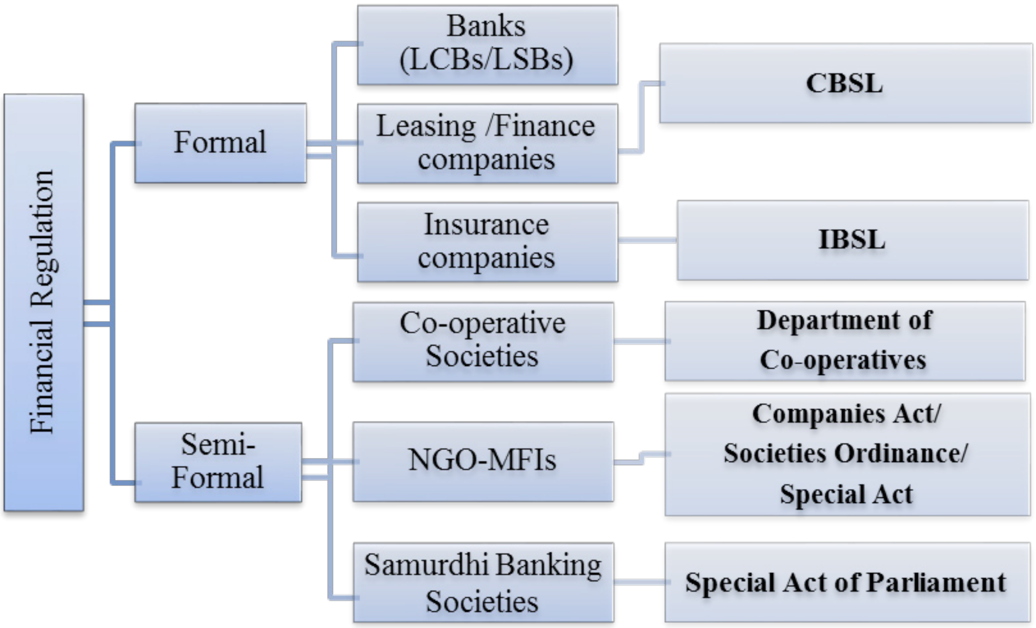
A sound regulatory framework for the financial sector is a key element required for achieving financial inclusion. This section briefly analyzes the existing regulatory and supervisory framework for the Sri Lankan financial sector. It discusses the regulatory framework for the formal financial sector, the regulation and supervision of MFIs, and the gaps in the current framework.

5.1 Formal Financial Sector

The CBSL is the foremost authority that regulates commercial banks, specialized banks, finance companies, finance leasing companies, and primary dealers. Since 2002, the regulatory framework and practice of bank supervision have been strengthened (ADB 2009). The CBSL initiated a risk-based supervision and has introduced new risk management and governance requirements for authorized institutions. In the wake of the 2007 credit boom, the CBSL increased risk-weights for residential mortgage loans and introduced a general requirement for all performing advances. In addition, in 2002 the capital adequacy requirement was increased to 10% (CBSL 2012) of risk-weighted assets, in line with the Basel Committee recommendation that capital requirements in excess of 8% are warranted in countries where the preconditions for effective banking supervision are not in place (ADB 2009). In 2008, this was further developed through the adoption of a modified version of Basel II, which did have a modest strengthening effect since the introduction of an operational risk capital levy seems to significantly offset the reductions in risk weightings for certain assets (ADB 2009). The overall consequence has been to reduce reporting capital adequacy by 80–100 basis points, thus requiring banks to hold capital to sustain the same capital adequacy proportion. However, the positive effect of firming up capital requirements is undermined by weaknesses in loan classification and provisioning.

Supervision of insurance firms is carried out by an independent supervisory authority—the Insurance Board of Sri Lanka (IBSL), which was established in 2001. Contemporary approaches toward insurance regulation and supervision is progressively developed and implemented and would be enabled by the enactment of the new insurance legislation which is under consultation (ADB 2009). Although Sri Lanka has removed tariff controls, the condition introduced for insurance firms to place up to 50% of their reinsurance business with the state-owned National Insurance Trust Fund is a very substantial direct intervention by the government in the industry to keep reinsurance business onshore, and which may reduce the ability of insurance firms to spread their risk.

Figure 7: Regulation of Financial Service Providers in Sri Lanka



CBSL = Central Bank of Sri Lanka; IBSL = Insurance Board of Sri Lanka; LCB = licensed commercial bank; LSB = licensed specialized banks; MFI = microfinance institution; NGO = non-governmental organization.

Source: Authors' compilation.

5.2 Semi-formal Sector

The current regulatory framework for MFIs is a rather weak and fragmented one, under which different institutions are regulated by different departments, ministries, and laws. Differences in the methods and standards of supervision and the absence of a single regulatory and supervisory body have resulted in a lack of uniform standards and a lack of development of a common direction (GTZ ProMiS 2010). This is a major challenge facing Sri Lanka's microfinance sector at present.

Only a few microfinance providers, like the Regional Development Bank and the SANASA Development Bank (categorized as Licensed Specialized Banks), are regulated by the CBSL. The non-bank MFIs, like NGO–MFIs, co-operatives, and Samurdhi Banking Societies, are governed by different bodies and acts (Figure 6).

NGOs involved in microfinance activities can be registered under three main acts: (i) the Companies Act No. 7 of 2007; (ii) the Societies Ordinance of 1891 (as amended by Act Nos. 17 of 1926, 14 of 1932, 55 of 1949, 16 of 1981, and 11 of 2005); and (iii) a Special Act of Parliament. Most of the smaller NGOs are registered under the Societies Ordinance, as it is the simplest method, whereas registering under a Special Act is the most complicated method, requiring NGOs to arrange a bill and publish a notice in the government gazette and the newspapers. Although an NGO can operate without being registered under any of these acts, it is difficult for an unregistered NGO to attract external funds. International NGOs (INGOs) operating in Sri Lanka are not legally required to be registered under any act, but before starting operations INGOs normally sign a Memorandum of Understanding (MoU) with the Ministry of Policy Planning and Implementation or an agreement with the Director of External Resources (McGuire, Conroy, and Thapa 1998; GTZ ProMiS 2010a).

NGOs (or INGOs) are not permitted to mobilize savings from their members or non-members. As per the Banking Act of 1988 and the Finance Act of 1988, an institution has to be licensed as a bank or a finance company to be eligible for collecting deposits from members or non-members, even in the form of compulsory savings. Co-operative societies (TCCSs and CRBs) and Samurdhi Banking Societies are exceptions that are allowed to mobilize savings from their members (as well as non-members) under the acts they are regulated by. But in practice many NGOs mobilize savings from their members at least as compulsory savings or loan securities.

The co-operatives such as the TCCSs and CRBs are governed by the Co-operative Societies Act of 1972 amended by the Act of 1983 and 1992 and regulated by the Department of Co-operative Development. The co-operatives registered under this act are allowed to receive deposits from their members as well as from non-members. However, the lack of prudential regulation of these societies is often a barrier in terms of attracting deposits from non-members on a large scale (McGuire, Conroy, and Thapa 1998; GTZ ProMiS 2010a). The Samurdhi Banking Societies (SBSs) come under the purview of the Samurdhi Authority of Sri Lanka (SASL), which was established under the Samurdhi Authority of Sri Lanka Act No. 30 of 1995. Samurdhi is currently one of the largest microfinance programs in the country, operating through a network of 1,042 Samurdhi Banking Societies and over 34,000 village level societies, and serving over 2 million clients. By law, SBSs are allowed to accept deposits from their members as well as non-members residing within their operational areas.

Establishment of a sound regulatory and supervisory framework for the microfinance sector has long been perceived as necessary to ensure the financial soundness of MFIs and for confidence in them to be built among depositors, borrowers, and funders. Many have argued for a strong regulatory framework to monitor MFIs (Ratwatte 2014). Sound regulation of MFIs would help them to attract external and internal resources (savings), thereby ensuring the sustainability of the organizations, protecting clients, and achieving financial inclusion. The proposed Microfinance Act has provided for the establishment of a Microfinance Regulatory and Supervisory Authority (MRSA) that will be responsible for licensing, regulating, and supervising all the NGO–MFIs and co-operatives engaged in microfinance. One of the important features of the act is that the licensed and registered MFIs will be allowed to accept deposits from their members. This is expected to have significant positive effects on Sri Lanka's microfinance sector, particularly on the NGO–MFIs that are currently faced with legal barriers to mobilize savings from their clients.

However, there is no legal definition of which institutions come under "microfinance" in the draft bill. The draft bill provides the following definition, "microfinance business is the acceptance of deposits and providing financial accommodation of any form and other financial services mainly to low income persons and micro enterprises." The bill states it will not be applicable to licensed banks and finance companies; only to certain companies, societies, and NGOs.

6. FINANCIAL EDUCATION

Developing financial capability and enhancing financial literacy is critical for achieving financial inclusion in a country. It also can play an important role in raising financial awareness, and increasing knowledge, skills, and capability among individuals and households. It can also help borrowers assess their repayment capacity and thereby prevent them from over-borrowing and becoming over-indebted. Financial literacy can be developed through financial education—a process where both the client and the provider play a pivotal role. Providers of financial services should be transparent and disseminate accurate information to their clients.

Empirical evidence suggests that financial education enables individuals to develop awareness about the financial products and services available to them and help them become familiar with the characteristics and details of such products. It is important to design financial education programs with well-defined priorities—developing not only financial numerical skills but also creating awareness about financial products and financial planning tools is likely to more greatly enhance financial literacy (Carpena et al. 2011).

In Sri Lanka, measures to enhance financial literacy have been rather ad hoc in nature and there is no national policy on financial education. Various efforts have been made by service providers such as MFIs and CBOs to increase financial awareness and develop financial skills, but overall, measures on financial education aimed at low-income households remain inadequate. The CBSL also plays an important role in sensitizing the public to the registered financial institutions (under the regulation and supervision of the CBSL) and to the risks of investing with unregistered financial institutions, Ponzi schemes, etc. The Central Bank also from time to time issues circulars, newspaper advertisements featuring registered financial institutions, and sensitizes the public to e-banking, i.e., savings by the mobile banking arms of some commercial banks, e-cash remittances, etc. Despite such efforts, the use of e-payment services, ATM services, etc., remains low. This is due in part to a lack of knowledge about these products among the majority of households, and low-income groups in particular.[8] Moreover, field research confirms that knowledge about interest rates charged by financial institutions and loan repayment conditions remains very limited among low-income households.

In the above context, it is of prime importance to improve financial education among households, in particular those from low-income groups. This is particularly necessary given the growth and multiplicity of financial institutions, the increase in multiple borrowing, and the consequent rise in household debt. Financial education can play an important role in helping clients understand the details of financial services and products, loan repayment conditions, interest rates, and their repayment capacity, thereby protecting them from over-borrowing and becoming over-indebted.

7. CONCLUSIONS

Sri Lanka enjoys a high level of access to financial institutions compared with the other South Asian countries. Its financial sector comprises a wide range of financial

[8] Financial education lags behind financial innovation and new products. The IT literacy rate is still only 35% in Sri Lanka and with the growing IT–finance nexus, financial awareness and education have become all the more important.

institutions—both formal and semi-formal—providing a wide variety of financial services such as loans, savings, pawning, leasing and finance, and remittance and money transfer facilities. There is evidence of multiple financial institutions operating in the majority of divisions of the country, with a larger share of households accessing multiple financial institutions for their credit and savings needs. Access to multiple financial institutions is common across all income groups. A considerable share of households across all income groups access both formal financial institutions like commercial banks and MFIs, implying that the microfinance sector and the formal financial sector—that had in the past served distinct segments of the market—have converged and are now catering to the financial needs of a broad group of clients. The role of the state as a provider (and a facilitator) of financial services, the diversity of financial institutions and services, relatively high human development, and good socioeconomic conditions and infrastructure facilities, are among the key contributory factors behind the high level of financial access in Sri Lanka.

Despite the high level of access to financial institutions for loans and savings facilities, the use of insurance services, remittances (through formal channels), ATM facilities, e-payments, and mobile banking, remains low. This is partly due to lack of awareness of these services among people in low-income groups. Technological innovations, such as mobile banking, can help increase financial inclusion in the country by reducing the transaction costs of reaching out to those in remote areas.

It is true that the transaction cost of taking financial services to un-banked communities is high due to various factors such as small pockets of communities, wide geographical spread, lack of manpower, and lack of supervision. The challenge for banks will be to identify cost-effective and user-friendly delivery channels. For instance, if the commercial banks use the existing operators in the field, such as NGOs and money lenders, that have first-hand knowledge of credit risks and the consumption needs of people, a cost-effective approach could be worked out. It has also been suggested that the commercial banks work to entice those people involved in “seettu” systems to move across to the formal banking systems (Gunawardena 2007).[9]

In the telecommunications industry, pre-paid calling cards have provided access to mobile phones for rural people. Perhaps SMS banking via the local languages may be one way of interacting e-banking with the rural people. Technology-based delivery channels have proved to be the most effective for rural areas.

Financial literacy should also be developed through financial education—a process where both the client and the provider play a pivotal role. Financial capability should be promoted and facilitated among children and youths to create financially responsible citizens in the future. It is important to design financial education programs with well-defined priorities—developing not only financial numerical skills but also creating awareness about financial products and financial planning tools is likely to more greatly enhance financial literacy (Carpena et al. 2011).

Client protection is also critical given the low financial literacy in Sri Lanka. Standards should be set to promote transparency, fair practice, and accountability of financial service providers. Moreover, high and increasing levels of multiple borrowing in the microfinance sector and a consequent rise in debt levels among MFI borrowers, call for careful monitoring of multiple borrowing and credit information sharing among MFIs, along with client protection measures. At present, membership of the Credit Information

[9] Seettu is the traditional system of savings and credit in Sri Lanka. For further details, see: http://www.gdrc.org/icm/inspire/womenbank.html.

Bureau (CRIB) of Sri Lanka is mandatory only for formal financial institutions such as commercial banks, Licensed Specialized Banks, leasing companies, and finance companies, while most MFIs are not integrated into the CRIB. Among other factors, the MFIs are reluctant to share client information due to the weak regulatory legal environment in the sector. However, given the rising levels of multiple borrowing in the microfinance sector, it is important for there to be a mechanism to share credit information of the MFIs' borrowers as well.[10]

Designing the right regulatory infrastructure and policy mix is also crucial for achieving financial inclusion. This requires finding the right balance between protecting clients and fostering an environment that encourages financial inclusion. The current regulatory framework of Sri Lanka's microfinance sector is fragmented, with different types of MFIs being regulated and supervised by different laws and bodies. Moreover, NGO–MFIs face legal restrictions on accepting deposits from their members, making them heavily dependent on external funds. In this context, it is important to allow MFIs to accept deposits from their clients to ensure the institutions' viability, while supervising them under a sound regulatory framework to enhance the depositors' credibility. Regulations should be designed to enable MFIs to raise funds from multiple sources to enable them to create a diverse mix of financial products with appropriate risk management. Policies should be designed to incentivize good financial performance—subsidies from the government and donors should be used to complement but not compete with private capital. In addition, regulatory infrastructure should encourage technological innovations such as mobile banking to help improve financial inclusion in Sri Lanka.

[10] Establishing a Microfinance Credit Information Bureau presents many challenges, even in Bangladesh, after many years of experience with microcredit (Islam 2014).

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