

Determinants of Access to Credit in Sri Lanka

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INTRODUCTION AND RESEARCH PROBLEM

There is growing evidence that developing financial institutions and financial markets and improving access to finance has a significant impact on economic development, poverty alleviation and economic stability. However, for various reasons, people are excluded from access to financial services. On the supply side, individuals who are considered high risk and lack collateral are excluded from accessing finance from formal financial institutions. On the demand side, the high cost of financial services, the non-availability of products required by people and the lack of awareness of products, as well as the fear of being rejected prevent individuals from approaching formal financial institutions to access their services. Identifying who is excluded and why people are excluded is necessary to develop appropriate policies to improve access to finance. Further, understanding the level of financial inclusion in a country is important to ascertain the impact of financial reforms and liberalisation on the development of the financial sector. While most studies examine financial inclusion at the aggregate or national level, this empirical study is carried out using data on household indebtedness from the HIES by the Department of Census and Statistics, Sri Lanka. The uniqueness of this empirical analysis is that it includes both households that borrow and those that do not : hence it does not suffer from the problem of data truncation resulting from the omission of non-borrowers. Secondly, since this study is based on the HIES it allows for multiple borrowings by households which is relevant if there are credit constraints in the formal sector and

alternative sources of credit are available. By identifying the determinants of access to credit, the study sheds light on the barriers to accessing finance from formal institutions and provides insights to policymakers to develop a formal strategy to reduce constraints faced by households in obtaining finance from the formal sector.

METHODOLOGY

A univariate probit model is used to estimate the probability that a household has obtained a loan (y), where the binary dependent variable y takes the value 0 if the household has not taken a loan and 1 if the household has obtained a loan. This is further disaggregated into whether the household has obtained a loan from formal sources, informal sources or both formal and informal sources. The dependent variable y_i is related to a vector of explanatory variables (x) including the main income earner's individual characteristics and educational qualifications, general characteristics of households, spatial characteristics and income and asset holdings of households through a linear specification with error term $\varepsilon_i \sim N[0,1]$.

$$y_i = x_i \beta + \varepsilon_i$$

$$\text{and } y_i = 1 \text{ iff } y_i > 0$$

$$\text{so that } \text{Prob}(y_i=1) = \Phi(x_i \beta)$$

Data for the study is from the Household Income and Expenditure Survey 2009/10 conducted by the Department of Census and Statistics. The survey collected information on the indebtedness of households to formal financial institutions such as banks and finance companies, and informal arrangements such as loans from employers, money lenders and retail outlets as well as borrowing through pawning.

RESULTS AND FINDINGS

62 per cent of households surveyed had obtained at least one loan, with around 32 per cent from the formal sector. The empirical analysis found a positive and significant relationship between earnings and borrowing both from the formal and informal sectors. Although there was a positive relationship between the ownership of a house and borrowing from the formal sector it was not significant. There was a positive and significant relationship between having a secondary education or more and borrowing from formal sources. Empirical studies for other regions also find that having an education increases the likelihood of obtaining a loan from formal sources. Gender did not seem to have a bearing on access to credit either in the formal or informal sectors. A private employee or self-employed person was found to have a lower likelihood of obtaining a loan from the formal sector compared to someone working in the public sector. The ability to show a steady source of income probably drives this result. Households in both the rural and estate sectors were more likely to obtain a loan from the informal sector than a household in the urban sector. Except in the Northern Province, all the Provinces other than the Western Province had a greater likelihood of accessing credit from the formal sector.

CONCLUSIONS, IMPLICATIONS AND SIGNIFICANCE

Although Sri Lanka's progress in relation to financial inclusion according to some measures such as account penetration which measures the ownership of accounts at financial institutions, has been impressive, there is still room for improvement in relation to other measures such as access to credit particularly from the formal sector. The study using household level data on indebtedness finds that households have easier access to finance from informal sources than formal, and that household characteristics such as income and education are important determinants of access to credit. The location of the household also determined the access to finance from either

formal or informal sources. The findings of the study highlight the importance of developing a strategy to enhance access to finance from the formal sector, as the lack of access to finance has been identified as a major obstacle to economic growth. From a financial stability stand point as well, access to formal sources of financing should be encouraged; as rapid expansion of credit and growth in unregulated institutions could adversely affect financial system stability. Ensuring adequate protection is also important as this is one of the major impediments to utilisation of financial services by low income groups. This would mean developing a good regulatory and supervision framework¹ particularly encompassing financial institutions that serve lower income segments of the market and establishing a suitable mechanism for consumer protection.

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