

Efficiency of Small Financial Institutions in Sri Lanka Using Data Envelopment Analysis

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Abstract

In Sri Lanka, the formal rural financial sector comprises a large number of small financial institutions (SFIs). Among SFIs, cooperative rural banks (CRBs) play an important role in meeting the rural credit needs in rural sector in Sri Lanka. CRBs have gained an increasing share of financial assets, which has been particularly helpful for satisfying the growing demand for loans and advances in poor people in the country. However, performance of SFIs in Sri Lanka is less than satisfactory and highly criticised today. Poor performance has been attributed to poor management of assets and consequently, the sustainability of these institutions is uncertain. Moreover, an attention to the efficiency of SFIs in Sri Lanka is more concern to the general public given collapses of several formal and informal SFIs. Hence, aim of this study is to evaluate the overall efficiency of SFIs in Sri Lanka by taking all CRBs operate in Sri Lanka. CRBs established in 1964 and end of 2010 there are 1,933 branches operate in all 25 districts of the country. Data envelopment analysis (DEA) is used to measure efficiency. The study found that the efficiency of CRBs in Sri Lanka have declined during the study period of 2005 to 2010. Further found that there were significant differences in the efficiency of CRBs by geographical locations and the efficient banks are closely associated with size of the Banks. The findings of this study may convince industry decision makers to establish more comprehensive policy settings for promoting particularly, CRBs activities, and overall all SFIs in Sri Lanka's rural financial sector.

Keywords: efficiency; data envelopment analysis; small financial institutions; cooperative rural banks.

INTRODUCTION

The financial service sector in Sri Lanka composed of an organised sector and an unorganised sector. The organised sector comprises diverse range financial services institutions such as commercial banks, finance companies. However, the unorganised sector mainly comprises small financial institutions such as Cooperative based banks, and the majority representing individual money lenders and pawn brokers. The organised financial service sector regulated by Central Bank of Sri Lanka (CBSL) comprises licensed commercial banks, licensed specialised banks, registered finance companies and specialized leasing companies. Licensed commercial banks have been permitted to provide all banking services. Hence, they play a central role within the financial services sector. They have the capacity to provide liquidity, and also are responsible for payment services, thereby facilitating all entities to carry out their financial transactions. In 2010, there were twenty two commercial banks, comprising two state owned institutions, nine privately owned institutions and eleven foreign banks, operating with 1,933 branches throughout the country (CBSL 2010). In addition, the emergence of small financial institutions has also been recognised for the provision of banking services in Sri Lanka. These specialised institutions provide only certain financial services, such as insurance services, stock brokering, and microfinance services to customers. As small

financial institutions, the member base cooperative rural banks (CRBs) have an extensive network throughout the country. At the end of 2010, multipurpose cooperative societies (MPCS) operate 235 CRBs with 1,933 branches (CBSL 2010) and approximately 8500 thrift and credit cooperative societies (TCCs-Sanasa) contribute, particularly to the rural financial service sector in the country. CRBs have been permitted to take deposits from the members and provide loans and advances under the *Cooperative Societies Act No. 5 of 1972*. In addition, Samurdhi banking societies, which operate under Samurdhi Authority² of Sri Lanka, focus on financial services in rural financial sector. Although all of these small financial institutions are not regulated or supervised by the CBSL, they play a vital role for the development of small businesses and microcredit demand in particular rural parts of the country. Table 2.1 presents types of small financial institutions which provide finance activities in Sri Lanka end of 2009.

¹ The first cooperative law in Sri Lanka was enacted in 1911. After several amendments, the *Cooperative Societies Act no.5 of 1972* remains the principal law at present.

² Established under the *Samurdhi Authority Act No 30 of 1995*