

FINANCIAL INCLUSION: STATE OF THE ART IN NEPAL

- Nara Hari Dhakal¹

Abstract

This paper analyzes the state of the art on financial inclusion in Nepal. This paper documented the access to financial services to the poor and disadvantaged group to be around 1.2 million with outreach skewed in the accessible areas with negligible or no access to financial services in remote areas. The study emphasized that ensuring financial inclusion is an arduous task and requires a holistic approach encompassing strategies for awareness raising, financial education, technical advice on different dimensions of money management, debt counseling, saving mobilization, provision of affordable credit services, research and development. In order to promote financial inclusion, there is a need to develop and apply specific strategies to expand the outreach of their services using combinations of lending methodologies, market led approaches to new product development, fostering linkages with local communities and promoting the use of technologies. Despite several challenges, there has been significant progress towards financial inclusion in Nepal. Continuity and sustainability of the achievements to date has been the main challenges in the days to come. There is a need to undertake several policy measures to continue keep financial sector as vibrant and dynamic as it could be to enable the use of existing opportunities while overcoming the challenges outlined in this paper in order to sustain the achievements so far. In view of this future work in financial inclusion in Nepal should revolve around conducting access to finance survey, creation of systematic client profile, reaching the unreached, linking clients with non-financial service providers, mainstreaming the operation of financial cooperatives, capacity development of financial service providers towards industry needs, innovation on new product development and diversification, mainstreaming revolving fund and promoting adoption of modern technologies among financial institutions.

BACKGROUND

Nepalese banks and financial institutions witnesses tremendous growth in volume and complexity over the last two decades. Despite making significant improvements in all the areas relating to financial viability, profitability and competitiveness, there are concerns that banks and financial institutions have not been able to include vast segment of the population, especially the underprivileged sections, into the fold of basic services they offer. There is significant financial exclusion. Internationally there have been significant efforts to study the causes of financial exclusion and designing strategies to ensure financial inclusion of the poor and disadvantaged. The reasons may vary from country to country and hence the strategy could also vary but efforts are being made to enhance financial inclusion considering its potentials to lift the financial condition and standards of life of the poor and the disadvantaged.

Financial inclusion refers to the delivery of financial services to the vast sections of disadvantaged and low income groups at an affordable cost. Since, unrestrained access to public goods and services is considered to be the *sine qua non* of an open and efficient society, considering that financial services possess basic features of the public good, it is essential that availability of financial services to the entire population without discrimination is the prime objective of any public policy.

The scope of financial inclusion can be expanded in two ways. First, financial inclusion can be ensured through state-driven interventions by way of statutory enactments², and second, there is a need of a voluntary effort by the financial institutions itself through the design and implementation of various strategies to bring poor and disadvantaged groups within the ambit of financial sector. When financial institutions do not give the desired attention to certain areas, the regulators have to step-in to address the issue.

¹ Program Coordinator/Rural Finance Sector Specialist, Rural Finance Sector Development Cluster Program, Ministry of Finance / Asian Development Bank

² For instance the Community Reinvestment Act in the US and making it a statutory right to have bank account in France and many others.

This is the reason why in Nepal, Nepal Rastra Bank is placing a lot of emphasis towards promoting more inclusive financial sector development.

In Nepal the focus of the financial inclusion at present is confined to ensuring a bare minimum access to a savings bank account without frills to all and effort to ensure access to credit. However, internationally financial exclusion has been viewed in a much wider perspective. Having a current account/savings account on its own, is not regarded as an accurate indicator of financial inclusion. There could be multiple levels of financial inclusion and exclusion. At one extreme, it is possible to identify the 'super-included', i.e., those customers who are actively and persistently courted by financial services and who have at their disposal a wide range of financial services and products. At the other extreme, there are financially excluded, who are denied access to even the most basic of financial products. In between these two are those who use financial services only for deposits and withdrawals of money and access to credit services. But these persons may have only restricted access to financial system and may not have enjoyed flexibility of access offered to more affluent customers.

Consequences of financial exclusion vary depending on nature and extent of services denied. It may lead to increased travel requirements, higher incidence of crime, general decline in investment, difficulties in gaining access to credit or getting credit from informal sources at exorbitant rates and increased unemployment, etc. The small business may suffer due to loss of access to middle class and higher-income consumers, higher cash handling costs, delays in remittances of money and so forth. According to some researches, financial exclusion can lead to social exclusion.

Against this backdrop, this paper aims at analyzing the state of the art on financial inclusion in Nepal. The information used in this paper is obtained through a review of available secondary data and literatures on access to financial services in Nepal. The paper is organized into four sections. After this introductory section, sector two analyzes the state of financial inclusion in Nepal. The section three analyzes the opportunities and challenges for ensuring financial inclusion in Nepal and the paper ends with conclusions and recommendations in section four.

STATE OF FINANCIAL INCLUSION

Overview

Efforts to promote financial inclusion in Nepalese financial sector have been outcome of the strategies implemented by the Government of Nepal (GON), the bilateral and multilateral development partners, and private sector. History of financial inclusion dates back to mid 1950s. Experiences has shown that access to cheap finance is not very important for the poor and disadvantaged groups, rather they need quick, simple and easy access to finance at no or low transaction costs.

Diversity of retail financial institutions is a key feature of the Nepalese financial sector which has been the outcome of several efforts of the GON during this period. Introduction of deprived sector lending scheme, policies to encourage financial institutions to open more branches outside the Kathmandu valley, incentives for the emergence and growth of new financial institutions namely financial cooperatives, Grameen Bikas Banks (GBBs), Sana Kisan Bikas Bank (SKBB), Rural Microfinance Development Centre (RMDC), etc. to reach the unreached through financial services and licensing two new types of financial institutions namely development banks and finance companies with lower capital requirements are some of initiatives of the GON to promote financial inclusion. Other characteristics features of efforts towards financial inclusion in Nepal includes diversity of financial service providers, high interest of NGOs, INGOs, bilateral and multilateral agencies on financial inclusion, many trials, inadequate documentation and sharing among planners and policy makers, more promoters and less

or no practitioners in remote areas, and lack of alignment and harmonization of resources following on financial sector with the plans and policies of the government.

Financial inclusion in Nepal is guided by the provision of deprived sector lending requirements for banks and financial institutions in the annual monetary policy, Microfinance Policy 2008, Bank and Finance Institutions Act 2006, Act for NGOs involved in Financial Intermediation 1999 and Co-operative Act 1992. Within this provision, financial institutions engaged to promote financial inclusion are commercial banks (CBs), development banks (DBs), finance companies (FCs), microfinance development banks (MDBs), financial intermediary NGOs (FI-NGOs) and financial cooperatives. As of May 2011, there 31 CBs, 89 DBs, 88 FCs, 20 MDBs, 43 FI-NGOs and over 8,000 financial cooperatives and over 230 small farmers' cooperatives limited (SFCLs). There are thousands of savings and credit groups (SCGs) promoted by various community based initiatives implemented by the government and non-government sector.

CBs, DBs and FCs are involved on indirectly on promoting financial inclusion to meet their deprived sector lending requirements. Monetary policy 2010/11 requires CBs, DBs and FCs to invest at least 3%, 2.5% and 2% of their total loan portfolio on deprived sector either directly or through Microfinance Institutions (MFIs)³. There are networks of financial service providers namely Nepal Federation of Savings and Credit Cooperatives Union Nepal, Grameen Nepal Network, Centre for Microfinance, Microfinance Association of Nepal, Institutional Network of Alternative Financial Institutions, Nepal Micro Bankers Association, Nepal's Bankers Association and Association of the Development Bankers and four wholesale microfinance service providers such as RMDC, SKBB, CBs/DBs/FCs and Rural Self Reliance Fund that are directly engaged on promoting financial inclusion in Nepal. Further, large numbers of national and international NGOs are also engaged on promoting community based financial services for the poor and disadvantaged groups.

Despite repaid expansion of formal financial sector, informal system still dominant in Nepal. Current supply of finance for the poor and dis-advantaged groups is estimated to be around Rs. 20,000 – Rs. 22,000 millions. Potentials of thousands of informal savings and credit groups (PAF and other) and financial cooperatives that exist throughout the country are inadequately used and almost forgotten.

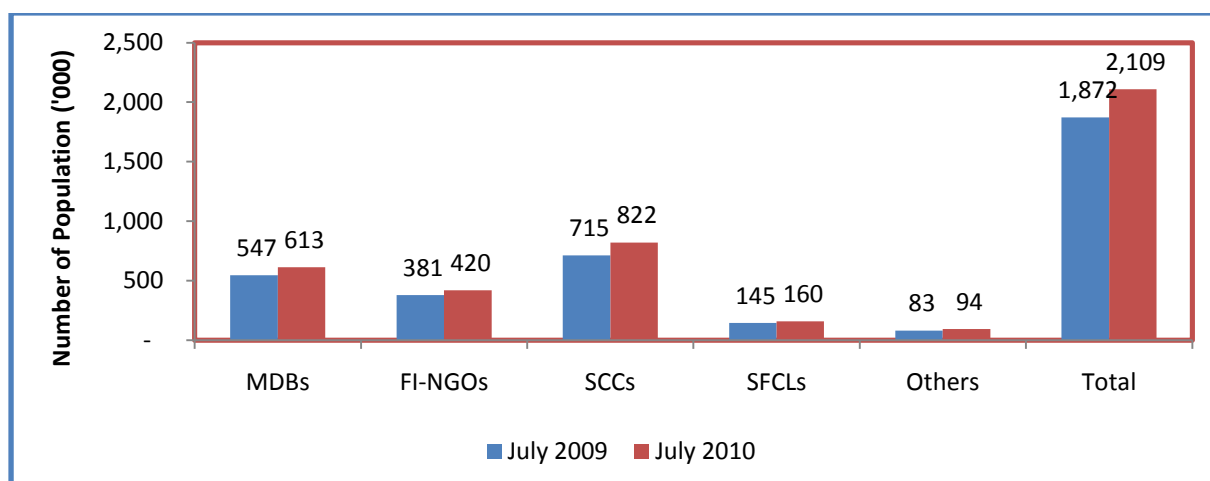
Lending modalities such as individual lending, Grameen, solidarity group lending, village banks, village savings and loan schemes, cooperatives and self reliance group are tried in Nepalese financial market one or the other form to promote financial inclusion by financial intermediaries. The Grameen type of model is most common in lending methodology among financial service providers (FSPs) for promoting financial inclusion in Nepal.

Outreach of Financial Services

There is lack of reliable information on outreach of financial services through FSPs in Nepal. The assessment is always problematic in case of community based FSPs which hardly reports to regulatory authorities in regular basis. The work has been further complicated due to scattered existence of these FSPs in almost all 75 districts and absence of proper system of information flow on their operation. In view of this, assessing outreach of financial services from the poor and disadvantaged groups is always an approximation in case of the community based FSP like SCCs. Relatively reliable information is available in case of commercial oriented FSPs.

³ Nepalese MFIs are GBBs, MDBs, FI-NGOs and financial cooperatives.

Figure 1: Status of Access to Finance in Nepal in July 2009 and 2010



As of May 2011, community based FSPs exist in all the 75 districts of Nepal. All types of FSPs exist in Tarai and there are very few FSPs in mountain districts. SCGs exist throughout Nepal. In terms of scale of operation, SCGs have largest presence while FI-NGOs have the lowest. There are hardly any clusters or villages in rural Nepal without SCGs. There are cases where a typical household is a member of more than one SCG and created confusion to SCG members on their legitimacy and institution development.

Table 1: Outreach of Financial Service in Nepal as of July 2010

S.N.	Type	As of July							
		Savings Clients				Loan Clients			
		2007	2008	2009	2010	2007	2008	2009	2010
1.0	Community based	655,220	821,073	861,456	982,821	332,253	400,304	568,042	642,029
1.1	SCCs	524,761	677,111	715,667	822,398	209,905	270,845	429,400	493,439
1.2	SFCLs	130,459	143,962	145,789	160,423	122,348	129,459	138,642	148,590
2.0	Commercial oriented	697,961	845,401	1,011,658	1,126,250	562,310	655,266	748,404	829,511
2.1	CBs/DBs	119,500	89,700	83,213	92,815	119,500	89,700	83,213	92,815
2.2	MDBs	392,761	456,382	547,000	613,090	322,741	372,034	418,559	464,912
	GBBs	174,664	170,598	176,490	177,590	159,834	153,520	159,982	160,979
	Private MDBs	218,097	285,784	370,510	435,500	162,907	218,514	258,577	303,933
2.3	FI-NGOs	185,700	299,319	381,445	420,345	120,069	193,532	246,632	271,784
3.0	Total	1,353,181	1,666,474	1,873,114	2,109,071	894,562	1,055,569	1,316,446	1,471,540
	Duplication	0.21	0.21	0.21	0.21	0.18	0.18	0.18	0.18
4.0	Adjusted outreach	1,069,013	1,316,515	1,479,760	1,666,166	733,541	865,567	1,079,486	1,206,663

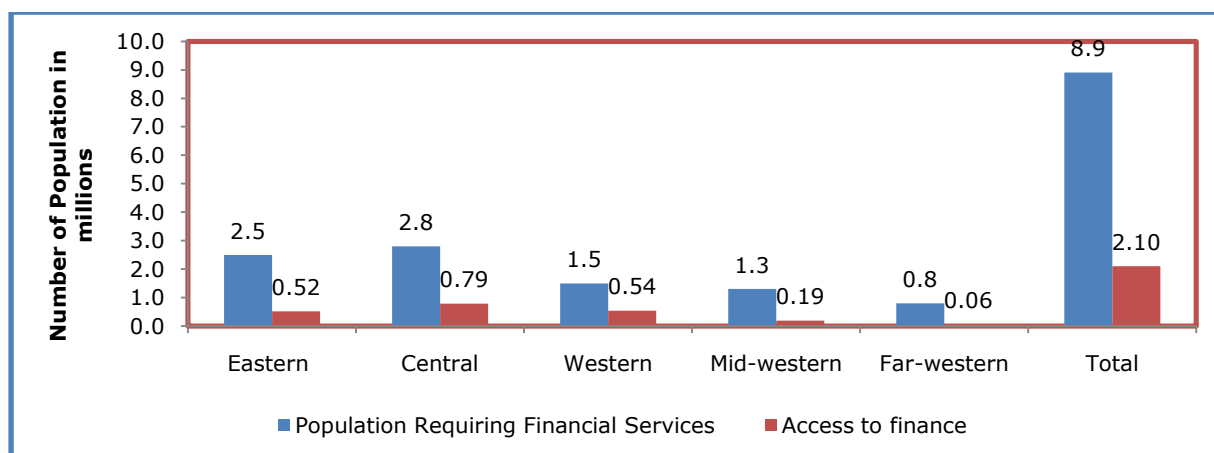
Source: Compiled by the Author using available secondary sources.

As of July 2010, total number of clients served by these FSPs is estimated at 2,109,071 savings clients and 1,471,540 loan clients. This estimate, however, does not take into accounts issue of duplication and financial services extended through SCGs. For instance, using the same Grameen Bank methodology, the private MDBs and FI-NGOs compete with GBBs and there are areas in Tarai where market is highly competitive and almost saturated. Intensity of duplication is estimated at 21% and 18% for savings clients and loan clients respectively. With adjustment on duplication, it gives effective numbers of HHs served by existing FSPs to be 1,666,166 savings clients and 1,206,663 loan clients.

Market for and Outreach of Financial Services

Field observation, review of researches and discussions with Chief Executive Officer and other key staff of major Nepalese FSPs revealed that it is not only people below poverty line but also those at the border line also need access to financial (micro) services. It has been assumed that promoting financial inclusion in Nepal must revolve around reaching these segments of population with financial services. Based on this assumption, market for financial inclusion has been estimated at 5.684 million people living both in accessible and inaccessible areas.

Figure 2: Gaps on Financial Inclusion in Nepal



With the estimation that market for financial inclusion to be 5.684 million population and net access to financial services in Nepal to be 1.667 million savings clients and 1.207 million loan clients, there is significant gap as far as financial inclusion is concerned. Nepalese financial sector has yet to bring significant number of poor and disadvantaged groups under its ambit. State of financial inclusion is highly skewed. Financial inclusion is more in central development regions, followed by western development regions, eastern development regions, mid-western development regions and far-western development regions.

Table 2: Rate (%) of Market Penetration on Financial Inclusion in Nepal as of July 2010

Development Regions	Market for Microfinance Services (Millions)	Access to Services (Millions)		Market penetration rate (%)	
		Savings	Loan	Savings	Loan
Eastern	1.469	0.413	0.299	28.1	20.3
Central	1.670	0.627	0.454	37.5	27.2
Western	1.007	0.428	0.310	42.6	30.8
Mid-western	0.935	0.151	0.109	16.1	11.7
Far-western	0.604	0.048	0.034	7.9	5.7
Total	5.684	1.666	1.207	29.3	21.2

Source: Compiled by the Author using available secondary sources.

With the estimated market for financial inclusion of 5.684 millions, market penetration of savings services and loan services has been estimated at 29.3% and 21.2% respectively. The market penetration rate is low in far-western development region, followed by mid-western development region, eastern development regions, central development regions and western development regions. Further, it indicates that there is still a significant section of poor and disadvantaged groups yet to be serviced by Nepalese FSPs in order to promote financial inclusion.

Key Features of Nepalese Financial Sector

Over the past 20 years, Nepal's financial sector has become deeper with the rapid growth of number and types of financial intermediaries. Efforts to promote financial inclusion has been characterized by many trials, inadequate documentation and sharing among planners and policy makers, as a result many of the experimentation getting failure results are winded out without bringing it to the notice of the government and regulatory authorities. Distribution of access to finance is highly skewed and concentrated in accessible areas. Enhancing access to financial services in remote areas is a challenge. In remote areas, there are more promoters and less or no practitioners.

There is high interest of NGOs, INGOs, bilateral and multilateral agencies to promote financial inclusion. There has been effort to provide direct support on promoting financial inclusion and there are cases wherein some international promoters are engaged in expanding access to finance in partnership with established and sustainable FSPs. Despite repaid expansion of formal financial sector, informal system still dominant in Nepalese financial sector. Potentials of the large number of the informal SCGs promoted by organizations like Poverty Alleviation Fund and (PAF) and other bilateral and multilateral institutions are not adequately used and almost forgotten. Further, potentials of financial cooperatives to promote financial inclusion have not been adequately used.

Though most of the commercials actors such as CBs, DBs and FCs are indirectly engaged on promoting financial inclusion, there are instances where some regional level DBs are aggressively engaged to enhance access to finance for the poor and disadvantaged groups. There is a case of missing middle and there is no specialized agency for lending to small and medium enterprises. Duplication and unhealthy competition is common feature in most urban and peri-urban areas. Most of the financial institutions are concentrated in few urban centers. Large volume of foreign remittance send by migrant workers seems is yet to be integrated with formal system

There is unmet demand for credit services and there is significant demand for other financial savings such as savings, insurance and money transfer by the poor and disadvantaged groups. Remittance is yet to be mainstreamed into productive sector. Both the supply and demand side indicators show that, despite government efforts, formal financial institutions have not been able to ensure financial inclusion and cases of financial exclusion is quite significant. The access to and use of formal financial services are generally limited, the problem is more acute for small business and low-income households. There is a need to increase focus on ensuring financial inclusion in remote areas and deepening the financial services in accessible areas while addressing the issue of duplication or multiple borrowing.

OPPORTUNITIES AND CHALLENGES FOR IMPROVING FINANCIAL INCLUSION

The mode of financial sector development so far has been characterized by a hugely expanded network of FSPs namely CBs, DBs, FCs, MFIs, FI-NGOs, SCCs and SFCLs. It is absolutely beyond any doubt that financial access to masses has significantly improved in the last 20 years. But the basic question is, has that been good enough. As outlined earlier, access to financial services has not been uniformly encouraging, highly been biased and with significant distributional inequity. There is a tremendous scope for financial coverage to improve standards of living of deprived people through deepening of financial services in accessible areas and expansion of services in remote areas.

With a view to enhancing the financial inclusion, as a proactive measure, since few years, NRB in its Annual Monetary Policy since few years has urged financial institutions to review their existing practices to align them with the objective of financial inclusion. More specifically NRB exhorted the financial institutions, with a view to achieving greater financial inclusion, to make available basic banking facilities to all.

In order to promote financial inclusion, the financial institutions should come out of inhibited feeling that very aggressive competition policy and social inclusion are mutually exclusive. Basically financial services need to be “marketed” to connect with large population segments and these may incur justifiable promotional costs. Nevertheless, the opportunities are plenty and these opportunities exist in areas of research and development, setting industry standards, business expansion, partnership promotion, private sector participation, using potentials of SCGs, expansion of remittance services, use of technology and development of financial infrastructure. Future of ensuring financial inclusion in Nepal is not comfortable. In order to sustain the growth and development of microfinance sector there is a need to address the challenges facing the sector. Some of these challenges are ensuring financial viability and sustainability, improving governance and management, enforcing regulation and supervision system, reducing cost of fund, increasing capacity of human resources, promoting the use of technologies, improving portfolio quality, addressing competition in accessible areas, reaching the hardcore poor, client protection, geographical remoteness and addressing the issue of multiple borrowing.

Nepalese financial sector is gradually becoming competitive. Though, healthy competition is expected to enhance quality and efficiency in services but cut-throat competition is not desirable. Competition among FSPs is expected to bring down the interest rate on loans and improves credit availability, due to apparently cut-throat competition among FSPs, there is sign that it is spoiling clients’ attitude and undermines credit discipline. Undue competition is developing chances of overlapping and duplication services among the clients. This results on financial services being concentrated in areas close to market places while raising the chances of clients racketing and making it easy to staff meeting the given target. Unhealthy competition also promotes over indebtedness causing misuse of loan funds making it difficult to understand the clients’ exact situations. This also helps clever clients to play one FSPs against the other ultimately resulting in rampant default in loan repayments. Target setting of outreach for the staff could bring/has brought a situation of unhealthy competition among FSPs trying to work in more accessible areas. This consumes much of their attention and resources and the poor in the remote corners are left out from access to finance. This also leads to misunderstandings between FSPs with regard to the selection of operating areas and target people. In the bid to show off good performance and attract more clients, the FSPs most often forget the social values, ethics and regulatory requirements, which in turn might bring more problems for their sustainable operation. In the process, the FSPs would not try for deepening their services to the downtrodden and ultra poor but concentrate most of their efforts and resources in providing financial services to less needy or non-targeted people in the densely populated close by market areas. This attitude is emerging as a serious challenge towards promoting financial inclusion in Nepalese financial sector.

CONCLUSIONS AND RECOMMENDATIONS

Ensuring financial inclusion is an arduous task. Addressing financial exclusion requires a holistic approach encompassing effective approaches to awareness raising, financial education, technical advice on different dimensions of money management, debt counseling, saving mobilization, provision of affordable credit services, research and development. In order to promote financial inclusion, FSPs need to develop and apply specific strategies to expand the outreach of their services using combinations of lending methodologies, market led approaches to new product development, fostering linkages with local communities and promoting the use of technologies.

Despite several challenges, there has been significant progress towards financial inclusion in Nepal. Continuity and sustainability of the achievements to date has been the main challenges in the days to come. There is a need to undertake several policy

measures to continue keep financial sector as vibrant and dynamic as it could be to enable the use of existing opportunities while overcoming the challenges outlined in this paper in order to sustain the achievements so far. In view of this future work in financial inclusion in Nepal should revolve around conducting access to finance survey, creation of systematic client profile, reaching the unreached, linking clients with non-financial service providers, mainstreaming the operation of financial cooperatives, capacity development of the FSPs towards industry needs, innovation on new product development and diversification, mainstreaming revolving fund and promoting the adoption of technology among FSPs.

FSPs need to redesign their business strategies to incorporate specific plans for promoting access of their services to low income group treating it both a business opportunity as well as a corporate social responsibility in order to promote financial inclusion. FSPs need to use all available resources including technology and expertise for the cause of financial inclusion. Though apparently, taking financial services to the sections constituting "the bottom of the pyramid" may not be profitable but the fact that even the relatively low margins on high volumes can be a very profitable proposition should be carefully capitalized. There exist potential that financial inclusion may emerge as commercial and profitable business but this requires that FSPs should think access to finance outside the conventional thinking and in an innovative way.

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