MICROFINANCE INDUSTRY REPORT

Nepal

2009

Produced by The Banking with the Poor Network in collaboration with the SEEP Network
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i. Acknowledgements

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For RMDC, Senior Manager Mr. Ram Dayal Rajbanshi, prepared this report by collecting data from a variety of industry sources including published reports, online resources and institutions. RMDC staff assisted in gathering data from different sources. RMDC CEO Mr. Shankar Man Shrestha closely supervised Mr. Rajbanshi in analysing and preparing the Assessment. Dr. Rabindra Shakya, a freelance economist and former Secretary of the Government, edited the report.

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ii. Foreword

This microfinance industry report was completed as a Banking with the Poor Network (BWTP Network) activity within the Citi Network Strengthening Program, in collaboration with the SEEP Network and funded by the Citi Foundation.

The Citi Network Strengthening Program supports the development of Microfinance Assessments for national and regional level networks. The purpose of the BWTP Network Industry Reports is to provide an overview of the microfinance sectors in which the BWTP Network operates. These assessments aim to extend beyond the performance of individual institutions, and focus on the development of the microfinance market as a whole by being both descriptive and analytical in nature. The aim of these assessments is to provide an outlook on each industry that is a valuable resource to the BWTP Network, its members and the wider microfinance community.

The ARCM is a review of the microfinance sector in Nepal, and constitutes a new contribution to Nepal BWTP Network's Asia Resource Centre for Microfinance. This report builds on a country profile completed by the BWTP Network in 2006. Prepared under the guidance of the BWTP Network, this industry report includes a country overview, a financial sector overview, a summary of government initiatives and regulations, the status of the retail microfinance sector and support institutions, an overview of funding sources, the impacts of microfinance and the upcoming challenges and opportunities for the microfinance industry in the country. The Rural Microfinance Development Centre Ltd. (RMDC) has prepared this report based on the data available from different reports and institutions and from its own considerable experience in this field.

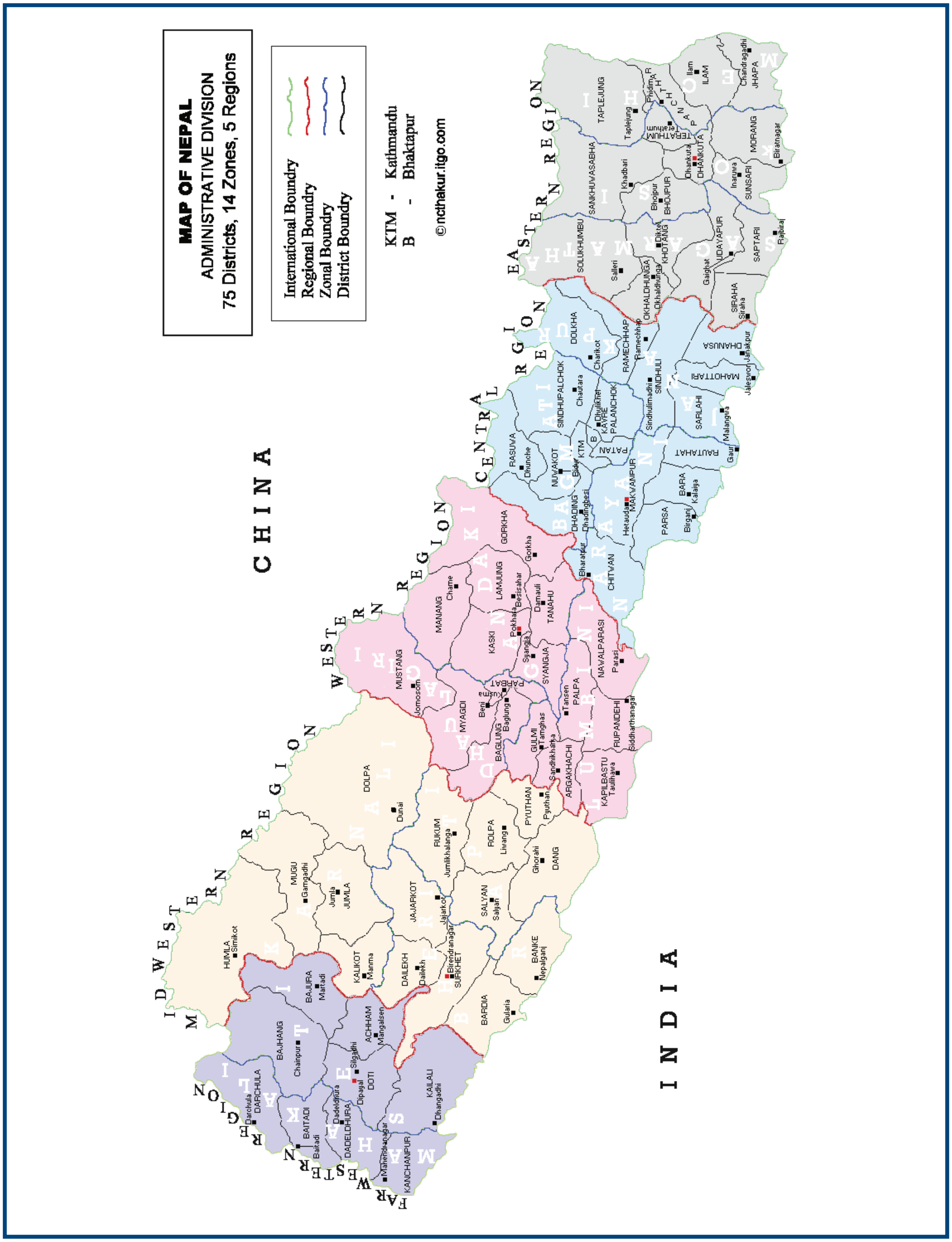
The ARCM is based on the exchange of dialogue and information at national and regional levels in South and Southeast Asia, and aims to constitute a one-stop learning and information hub for BWTP members and other microfinance actors in Asia. The ARCM promotes increased outreach and efficiency of financial services for the poor in South and Southeast Asia, services that are essential in the fight against poverty in the region, improving the lives of millions through asset building and increased income.

The ARCM has two main objectives:

First, the ARCM aims to encourage partnerships and cooperation in Asia, among microfinance providers and supporters, and between providers and financiers, in order to increase financial support for microfinance schemes and to increase peer learning.

Second, the ARCM aims to build a knowledge management platform accessible to all microfinance actors in the Asia region, in order to increase institutional capacity, to increase the dissemination of innovations, and to develop best practice standards in microfinance.

iii. Map of Nepal



Source: http://ncthakur.itgo.com/map04.htm

iv. Contents

v. Abbreviations

ADB	Asian Development Bank
ADBN	Agriculture Development Bank of Nepal
AEPC	Alternative Energy Promotion Centre
ARCM	Asia Resource Centre for Microfinance
BFIA	Bank and Financial Intermediation Act
BFIO	Bank and Financial Intermediation Ordinance
BSP	Biogas Sector Partnership Nepal
BWTP	The Banking with the Poor Network
CB	Commercial Bank
CBO	Community-Based Organisations
CO	Community Organisations
CSD	Centre for Self-help Development
DB	Development Bank
DEPROSC	Development Project Services Centre
FAOq	Food and Agriculture Organisation of the United Nations
FINGO	Financial Intermediary NGO
FORWARD	Forum for Rural Woman Ardency Development
FY	Fiscal Year
GBB	Grameen Bikas Bank
GON	Government of Nepal
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit GmbH
MFDB	Microfinance Development Bank
MFI	Microfinance Institution
NCDB	National Cooperative Development Bank
NGO	Non-Government Organisation
NUBL	Nirdhan Utthan Bank Ltd.
NRB	Nepal Rastra Bank
OSS	Operational Self-Sufficiency
PRA	Participatory Rural Appraisal
PWR	Participatory Wealth Ranking
RMDC	Rural Microfinance Development Centre Ltd.
RRDB	Regional Rural Development Bank
RSRF	Rural Self-Reliance Fund
RUFIN	Rural Finance Nepal
SCC	Savings and Credit Cooperative
SFCL	Small Farmers Cooperative Ltd.
SFDP	Small Farmers Development Bank
SKBBL	Sana Kissan Bikas Bank Ltd.
UNDP	United Nations Development Program
VDC	Village Development Committee

vi. Exchange Rate

2 October 2008

US Dollar 1.00 = Rs 74.55

1. Country Overview

1.1 Geography

Nepal is a small, land locked country surrounded by the People's Republic of China to the north and by India to the east, west and south. Nepal has extreme topography and climate. The altitude ranges from 70 meters to 8,848 meters, and the climate varies from tundra to polar. The country stretches from east to west with a mean length of 885 km and widens from north to south with a mean breadth of 193 km.

Geographically, the country is divided into three east-west ecological zones: the Northern Range – Mountain; the Mid Range Hill; and the Southern Range – Terai (flat). In the Northern Range, the Himalayas form an unbroken mountain range which contains eight peaks higher than 8,000 meters, including Mt. Everest on the boarder with China. The middle range is captured by mountains, high peaks, hills, valleys and lakes. The Southern Range, with a width of almost 16-32 km, is the continuation of the Gangetic plain of India and consists of dense forest areas, national parks, wildlife reserves and conservation areas.

The country is divided into five north-south administrative development zones: Eastern Development Region, Central Development Region, Western Development Region, Mid-Western Development Region and Far-Western development Region. The country is further divided into 14 zones and 75 districts. The districts are further divided into smaller units, called Village Development Committees (VDCs) – (total 3915) and Municipalities (total 58).

1.2 Population and Demographics

According to the Population Census 2001, the annual growth rate of the population is 2.25%. Based on this growth rate, the total population of the country in 2007 reached 26.4 million with an almost equal proportion of males and females. According to the latest National Living Standard Survey 2004 (NLSS 2004), 39.6% of the total population is younger than 15 years, 7.6% are 60 years and above, and the remaining 52.8% represent the economically active population (15-59 years).

The overall dependency ratio of the country was 89 in 2003-04, which has come down from 97 in 1995-96.[1] It is much lower in urban areas (63%) than in rural areas (95%). The average household size in the country is 5.3 according to the NLSS in 2004. Among the ecological zones, the average household size is the highest in the Tarai (6.7) and the lowest in the Hills (4.9). Among the total households, 19.6% are headed by females. Among the development regions, the

1 The dependency ratio refers to the age-population ratio between those not in the labour force (the dependent variable) versus those in the labour force.

Table 1: Population and Demographic Data, Nepal

	2005	2006	2007
Total population (millions)			26.4
Economically active population			52.8%
National poverty line (US$)	324	348	385
% of population living below the national poverty line	30.9	31	31.8
Adult literacy rates (%)	49	54.1	54.1
% of population living in rural areas	86.1		
Life expectancy			63.7
Population growth (%)	2.25		

Sources: *http://www.cbs.gov.np, http://www.adb.org/Statistics/pdf/Basic-Statistics-2007.pdf (2004), http://www.unicef.org/infobycountry/nepal_nepal_statistics.html (2005)*

Western region has the highest proportion of female headed households (28.7%) while the Central has the lowest (15.7%). 29.4% of households in the rural west mountains and hills are headed by females, while this figure is only 14.1% in the Eastern Tarai.

1.3 Poverty and Macroeconomic Situation

The National Living Standard Survey 2004 estimates that nearly one-third of the total population (31.8%) live below the poverty line. The Gini coefficient, which is an approximate measurement of the gap between the rich and the poor, is 41.4. Over the last few years, the annual GDP growth rate in the country has been very low, staying within a range of 2.5% and 3.1% and averaging 2.5% for the FY 2006-07. At the current prices, the annual per capita income in 2006-07 stood at US$ 383.

The population lives mostly in the rural areas of Nepal (86.1%), where basic social and economic infrastructures are lacking. Nearly 80% of the population are employed in agriculture and related activities, which does not reach its productive capacity due to the lack of necessary infrastructure (such as irrigation, improved seeds, fertilizers) and technology. A considerable percentage of the labour force (mainly the youth and educated people) are leaving Nepal in search of employment every year.

Since the 1990s, the Nepalese government has instituted a program of economic reforms that involves the reduction of business licenses and registration requirements for trade and foreign investment. The program also includes a reduction of subsidies, privatisation of state industries, and downsizing of the civil service in order to cut government expenditure. However, political instability over the last decade or so has hampered the government's ability to forge consensus among political parties to implement important economic reform measures.

Agriculture (mainly horticulture), tourism, hydropower and forestry are among the major areas of investments for broad-based development of the country. Areas of growing interest for foreign investment include, among others, hydropower and tourism. Situated between two fast growing economies (China and India), Nepal has the potential to grow socially and economically, provided permanent peace is restored and basic social and economic infrastructure are developed in the country.

Table 2: Macroeconomic Indicators

	2004/05	2005/06	2006/07
Annual Growth of GDP (%)	3.12	2.80	2.50
Per Capita GDP (US$)	328	350	383
Annual Change in Real Per Capita GDP (%)	1.11	0.76	0.53
Export of Goods and Services/GDP (%)	14.58	13.60	12.48
Import of Goods & Services/GDP (%)	24.54	23.82	19.55
Inflation Rates (%)	4.5	8	6.5
Interest Rates			
Commercial Savings (%)	3	2.5	2.5
Commercial Lending (%)	11	10	10
Public Savings (%)	4	3	3
Public Lending (%)	14	12	12
Exchange Rates (Nepalese rupee/s per US Dollar) (%)	73.8	71.9	71.9
Employment (employment to population ratio)	57.80%	57.80%	57.80%
Workers remittances of employees received (US$)		1.1 billion	1.5 billion

Sources: *www.cbs.gov.np, www.img.org/external/pubs/ft/weo/2007/02/weodata/download.aspx, www.ilo.org/public/english/employment/strat/kilm/index.htm;www.bfr.nrb.org.np/statistics/interest_rate_structure, www.adb.org/public/english/employment/strat/klim/index.htm; http://red.nrb.org.np/publications/economic-reports/Economic_Reports_2006_07.NEW.pdf*

2. Financial Sector Overview

Over the past two decades, Nepal's financial sector, along with the number and type of financial institutions, has grown rapidly due to reforms and liberalization in the sector. The microfinance sector has become more diversified in recent years because of the commercialization of microfinance NGOs and their transformation into microfinance development banks. Yet in most parts of the country, the access to financial services remains limited to a small segment of the population. About half of Nepal's households do not have access to formal financial services, which includes banks, financial-intermediary NGOs (FINGOs), cooperatives and finance companies. The informal sector, on the other hand, includes money lenders, traders, friends and Dhikuti[2]. Poorest of the poor mainly borrow from family and friends and this source makes up the largest source of informal loans. In comparison to urban people, rural people are deprived of bank services, as most of these formal financial institutions are located in the urban areas. Bank procedures are perceived as cumbersome by rural and low-income people.

Only 28% of Nepalese households have an account with a bank or have taken a loan from a bank. Another 25% have an account or loan from a formal financial institution other than a bank. Some 28% rely solely on informal financial sources, while 20% are financially excluded and receive no service from the formal or informal financial sector[3]. Total rural credit requirement in the country is estimated at Rs 23.3 billion, while the total supply from the formal and semi-formal sectors is only Rs 9.6 billion[4]. Of the approximately 2.1 million households living below the national poverty line, nearly half are deprived of services from the formal microfinance sector.

In recent decades, Nepal has seen exponential growth in the number of its financial institutions. A number of retail microfinance institutions (MFIs) have formed to provide financial services to the poor. The commercial banks (CBs) do not lend directly to the poor, but rather provide wholesale funds to these retail MFIs under the mandatory Deprived Sector Credit Program. CBs are the largest providers of loans larger than Rs 50,000; whereas microfinance institutions (MFIs), such as microfinance development banks (MFDBs), financial-intermediary NGOs (FINGOs) and savings and credit cooperatives (SCCs), are the predominant direct providers of microfinance services to low-income households and rural people. MFIs serve clients for small loans generally below Rs 50,000. MFDBs largely serve in the Tarai; whereas FINGOs and cooperatives are the largest service providers in the hills and mountains.

Regarding the share of the market, MFDBs are the largest MFIs in the country. One MFDB serves 25,000 - 80,000 clients, a FINGO 2,000 – 30,000 clients, an SCC 50-200 members, and a Small Farmers Cooperative Limited (SFCL) 200-700 clients. All these institutions serve only their members. These MFIs generally provide short-term loans of less than 18 months for productive uses such as agriculture, livestock, poultry, petty trading, and grocery stores. Except for SCCs, MFIs in general do not provide loans for consumption or social activities. Most of them offer compulsory group saving and voluntary individual savings services. A few microfinance banks and cooperatives now offer remittance transfer service products. Due to the lack of insurance services available in rural areas, most MFIs have offered some institution-based protection schemes related to livestock death and life insurance.

With the objective of supplying wholesale funds to retail microfinance organisations, four wholesale lending agencies have been established in Nepal over a period of two decades. The Rural Microfinance Development Centre Ltd. (RMDC) and Sana Kisan Bikas Bank Ltd. (SKBBL) are the two large wholesale lending organisations. The Rural Self Reliance Fund (RSRF), which is being managed by the central bank, offers funds to NGOs, cooperatives and the Agriculture Development Bank of Nepal (ADBN). Additionally, the National Cooperative Development Bank has been established with the aim of providing funds to SCCs.

2 Dhikuti is a traditional Rotating Savings and Credit Association (ROSCA) in Nepal.
3 Ferrari, A., G. Jaffrin, S. R. Shrestha, 2006. *Access to Financial Services in Nepal*.
4 Majorano, Francesca, 2007. *An Evaluation of the Rural Microfinance Development Centre Ltd. as a Wholesale Lending Institution in Nepal*, p.2

Remittances have been one of the major sources of foreign currency for the country in recent years. Due to the lack of employment opportunities and under-employment situation in the country, youth and adults go abroad for employment and in turn send remittances to their families. The proportion of households that receive remittances is 34% in Nepal, having grown from 23% in 1995-96. Rural areas have a higher proportion of recipients compared to their urban counterparts. In particular, 40% of households in the mountains and hills of Western Nepal receive transfer income. The average income transfer in the form of remittance was Rs 34,698 per recipient household in 2003-04. Per capita remittance for the whole population stands at Rs 2,100.

Despite the vibrant microfinance sector in Nepal, there is still a scarcity of MFIs. Only a very few cooperatives can be considered as MFIs, as they lack focus and institutional capacity. Most NGOs are also at a nascent stage of development, with weak systems, leadership, staff capacity and organisational culture and structure. The growth of microfinance in Nepal is therefore constrained by the limited number of capable microfinance providers and limited capability of the public-owned MFDBs. Most of the FINGOs and cooperatives do not have adequate capacity and sufficient equity capital to borrow funds from commercial sources. The growth of existing MFIs is also difficult due to their low level of capacity and the regulatory environment in the country.

3. Government Initiatives, Laws and Regulations

The Government of Nepal (GON) and the country's Central Bank, Nepal Rastra Bank (NRB), have undertaken quite a number of initiatives for the promotion and development of the microfinance sector in the country. In 1974, NRB directed two national commercial banks, the Rastriya Banijya Bank (RBB) and the Nepal Bank Limited (NBL), to invest five percent of their total deposits in small industries. Since 1990, all commercial banks (CBs) have been required to allocate 12% of their portfolio to the 'Priority Sector', including 3% to the 'Deprived Sector'. Because of the creation of new wholesale funds and the liberalisation of the financial system, NRB gradually phased out the policy by mid-July 2007. However, the 3% Deprived Sector requirement, which is directed at the poor, is being continued. NRB has also directed all development banks and finance companies to disburse at least 1.5% and 1% of their loan portfolios, respectively, to the poor. A penalty equal to the highest interest rate charged on loans is to be imposed on any of the banks that do not meet the prescribed requirements. The banks can choose to lend the required amount to the end clients directly, or disburse it through loan or equity in other microfinance institutions. However, the commercial banks are either paying huge penalties to NRB or parking their funds at finance companies through microfinance banks like regional rural development banks instead of disbursing them directly[5]. As of mid-July 2007, Rs 26.9 billion has been injected into the Priority Sector, while Rs 6.8 billion has been disbursed to the Deprived Sector[6].

In 1975, the government-owned Agriculture Development Bank of Nepal (ADBN) commenced the implementation of a pilot micro-credit project, the 'Small Farmers Development Project' (SFDP), which was later converted into a program and implemented in large scale all over the country. In the 1990s, NRB executed a number of microcredit projects such as the Production Credit for Rural Women (PCRW), Micro-Credit Project for Women (MCPW), Third Livestock Development Project (TLDP), Poverty Alleviation in the Western Terai (PAWT) and Community Ground Water Irrigation Support Project (CGISP). From 1992-1996, five Regional Rural Development Banks (RRDBs) were established with the major ownership held by NRB and the government. With the objective of providing wholesale loans to NGOs and cooperatives, the government provided seed-money of Rs 20 million to NRB in 1991 to establish the Rural Self-Reliance Fund (RSRF). Later, the government and NRB contributed more to the fund to expand microcredit operations in the country.

In the Tenth Plan (2002-07), the government fixed key targets for microcredit programs, such as gradual privatisation and structural reformation of the five RRDBs, to increase outreach to the poor. The Poverty Reduction Strategy/Tenth Plan encompasses the Millennium Development Goals (MDGs) and focuses on four strategically important areas: broad-based sustained growth; improvement in the access and quality of infrastructure, social and economic services in the rural areas; targeted programs for social and economic inclusion of the poor and marginalised communities; and good governance to improve service delivery, efficiency, transparency and accountability.

The Strategy had a number of distinct features, such as:

- Targets to reduce the level of poverty and enhance social and human well-being of the people as is consistent with the MDGs;
- Due recognition of the role of community organisations (COs) and non-government organisations (NGOs) in the development process;
- Commitment to decentralisation and functional devolution;
- Use of logical framework methodologies to institutionalise results-based management in planning through defining institutional tasks and responsibilities;
- Prioritisation of development programs guaranteeing resources and intensive monitoring; and

5 Majorano, Francesca, 2007. *An Evaluation of the Rural Microfinance Development Centre as a Wholesale Lending Institution in Nepal*, p.1
6 http://red.nrb.org.np/publications/economic_reports/Economic_Reports_2006_07.pdf

- Elaborate monitoring and evaluation provisions, including a commitment to annual poverty monitoring, process monitoring and reporting (IMF, 2007)[7].

The Government also developed some strategies for the reform of the rural finance sector[8], they being: (i) broad-based financial services be provided through private institutions at market interest rates, (ii) directed and subsidized lending programs be ultimately phased out with the provision of alternative private financial institutions catering such services, (iii) restructuring of ADBN to improve its performance, (iv) augmenting the flow of credit by giving priority to establishing development banks at regional and local level, and (v) organisational and institutional strengthening of RRDBs through NRB.

The current Three Year Interim Plan 2007/08 – 2008/09 – 2009/10[9] aims at assisting the growth of agriculture and rural areas by increasing outreach of professional microfinance services through diversification of microfinance tools. The related policies in the Interim Plan are:

- NRB will play a coordinator's role in an effective manner for the development of healthy microfinance in the country.
- Microcredit will be taken as a powerful instrument for poverty reduction.
- The concerned banks will be encouraged to reopen their closed rural branches or open up new branches in the rural and remote areas.
- RSRF will be reformed as 'National Microfinance Fund'. The Fund comprises of contributions from the Government, NRB, international agencies and individuals. Provisions will be made to exempt tax on the contributions to the fund.
- Following a review of its structure, program and resources, National Cooperative Development Bank (NCDB) will be mobilized as an intermediary for rural and microcredit supply.
- Performance standards will be determined for monitoring and supervision of rural and microcredit services.
- A national Microfinance Policy will be issued for strengthening of the microfinance sector.

In view of increasing demand for microcredit and its critical role in poverty reduction in the country, the Government of Nepal issued a 'National Microcredit Policy, 2007' with an aim to create a conducive financial infrastructure and legal environment for the promotion and development of the microfinance industry and to use microfinance as a tool for poverty reduction in the country. The specific objectives of the policy are: (i) increasing the outreach of microfinance services to the women and families of the low-income group, (ii) making easy and widespread access to quality microfinance services for the target group, (iii) strengthening institutional capacities of microfinance service providers, (iv) formulation of necessary microfinance laws, and (v) development of appropriate institutional infrastructures for maintaining financial discipline and accountability in the whole industry.

3.1 Laws and Regulations

The first law of Nepal is 'Muluki Ain, 1963', which contains both substantive and procedural laws covering criminal and civil matters. It is also the general law of the country. Until the early 1990s, commercial laws and legal frameworks for effective functioning of the corporate sector were not in place.

The 'Constitution of Nepal, 1990' provided a base for the creation of a revolutionary environment for the development of the financial sector. In February 2004 a new Banking and Financial Institution Ordinance (BFIO) was passed with the objective of bringing all banks and financial institutions under one law. Until that time, banks and financial institutions were established under separate acts. For example,

7 IMF (2007). Nepal: *Poverty Reduction Strategy Paper Progress Report*. IMF Country Report No. 07/176, Washington.
8 Financial Sector Strategy Statement – prepared jointly by the Ministry of Finance, National Planning Commission, and provided to the World Bank on 19 July 2000.
9 Bhabuk 'Parjivi' (2007). *Tin Barsiya Antarim Yojana (2064/65-2066/67)* – this reflects the Nepal calendar whereby a Nepali calendar year falls over two Gregorian calendar years.

commercial banks were established under special Acts specifically related to their category. The Agriculture Development Bank of Nepal was included under the Agriculture Development Bank Act 1968, while the development banks were licensed under the 'Development Bank Act, 1995'.

As a result an umbrella act, the 'Bank and Financial Institutions Act' (BFIA), which was enacted earlier as an ordinance, was passed in 2006. All commercial banks, development banks, finance companies, microfinance development banks are regulated under the umbrella law 'BFIA, 2006' as 'Class A', 'Class B', 'Class C' and 'Class D' institutions respectively. The apex microfinance organisations are also regulated under the same umbrella act 'BFIA, 2006' as 'Class D' financial institutions. As per the Act, a foreign bank or financial institution, in joint venture with a Nepalese organisation or citizen, or through its subsidiary organisation having its full share, can provide microfinance services in the country with permission from NRB and the Government.

NRB Policy, in recent years, has been positive towards the development of the microfinance sector. The new regulation of NRB has made a provision that facilitates the establishment of microfinance development banks (MFDBs) with a very low level of capital. A small MFDB can be established with paid-up capital of Rs 10 million to operate in three districts outside Kathmandu. For operating in 4-10 districts outside Kathmandu, the paid-up capital requirement for a MFDB is Rs 20 million, and for a national level microfinance bank Rs 100 million is required. For every Rs 2.5 million of additional capital, another district can be included under a MFDB's area of operation. With a view to expand microfinance programs in the hills and mountains, NRB also allows MFDBs to expand their programs to an additional five hill districts without injecting additional paid-up capital. The promoters in the banks can hold up to 70% of the share capital and a minimum of 30% shares should be floated to the general public. Foreign investors can hold a minimum of 20% - 85% stake in the bank. These banks can provide loans to the poor up to Rs 60,000 without collateral and above the amount up to Rs 150,000 for micro-enterprise with physical collateral.

Financial intermediary NGOs (FINGOs) have been issued licenses by NRB for conducting microfinance operations under a special act named the 'Financial Intermediaries Act, 1998 (amended in 2002)'. An NGO cannot operate a microfinance program without getting a license for financial intermediation from the central bank. Before getting a licence of microfinance operation from NRB, an NGO has to be registered with the respective District Administration Office. However, recently NRB stopped providing new licenses to NGOs until a separate second-tier organisation for regulating the financial NGOs is established.

Savings and Credit Cooperatives (SCCs) are regulated by the Department of Cooperatives, under the 'Cooperative Act, 1991'. A group of 25 persons in a community can apply to the District Cooperative Office for registration of a SCC. As per the law, a SCC can provide service only to its shareholder members. A few years back, NRB had given Limited Banking License to a few cooperatives to allow them to serve non-members too. NRB has now stopped issuing such licenses to new cooperatives due to its inability to supervise these institutions regularly. It has been found that most of these cooperatives have not adhered to the directives of NRB.

4. Microfinance Sector Development

4.1 Historical Perspective

The history of the cooperative dates back to 1956, when 13 cooperatives were established by the Government in the Chitwan district. Some development pundits mark the establishment of the cooperatives as the beginning of microcredit programming in Nepal. However, the cooperatives were unable to operate in a sustainable manner and were eventually closed. In 1974, the Nepal Rastra Bank (NRB) directed two national level commercial banks, the Rastriya Banijya Bank (RBB) and the Nepal Bank Limited (NBL), to invest five percent of their total deposits in small industries. The following year, the Agriculture Development Bank (ADBN), assisted by the FAO, launched the Small Farmers Development Project (SFDP) pilot project in two districts, one in Terai and another in a hill district. After the successful implementation of the pilot project, the SFDP was implemented by ADBN throughout Nepal and served about 200,000 small farmers. It consequently became the first and largest microcredit program in the country. The SFDP program later suffered from poor portfolio quality and the high costs of operation. To address the problem, ADBN, with the technical support of the German development organisation GTZ, created an operating model in 1993 after seven years of action research which they termed the Small Farmers Cooperative Limited (SFCL). The credit groups instituted under the SFDP of ADBN have been gradually transformed into autonomous SFCLs.

In 1981, the NRB directed RBB and NBL to implement what was called the Intensive Banking Program (IBP), which was another credit program targeted at the poor. Additionally, in 1982 the Production Credit for Rural Women (PCRW) project was launched through the two national commercial banks and ADBN which was aimed exclusively at the women. The program was expanded to most of the districts; however, the outreach was limited to a few villages close to the bank branches. With technical assistance provided by the Banking with the Poor Network (BWTP), RBB tried to link credit groups formed by NGOs with the bank, but the linkage program was unable to continue after a few years due to the lack of consistency and continuity of the institutional policy of RBB.

With the aim of developing sustainable grass-roots microfinance institutions in the country, another women-focused project, the 'Microcredit Project for Women' (MCPW), was initiated in 1994 with assistance from the Asian Development Bank (ADB). The project was implemented in 12 districts and five municipalities with the social mobilisation support of 90 NGOs. During the entire project period of seven years, MCPW recommended 20 NGOs as potential financial intermediaries. They acquired good social mobilisation skills but lacked the financial operation skills required to operate as financial intermediaries. None of the NGOs were able to conduct microfinance operations on their own during the project period.

During 1992-96, five regional rural development banks (RRDBs), one in each of the five development regions, were established with the objective of providing microcredit services to the poor throughout the country. Over this period these institutions incurred heavy losses due to deteriorating portfolio quality and high staff costs. In general, these organisations lacked proper systems, trained manpower, effective monitoring and supervision, and professional management. For these reasons, they could not access the required funds for their operation from commercial banks and the apex wholesale lending institutions for lending to their clients. Meanwhile, the RRDB Restructuring Plan was formulated by the NRB with a view to revitalising them and providing new impetus to their operations. The plan recommended their gradual privatisation by the NRB and that the government divest its shares to allow private sector involvement. Subsequently, the NRB has divested itself of the ownership of two of these banks, namely the Eastern RRDB and the Central RRDB. Similarly, the NRB's share in the Western RRDB has also been handed over to the private sector. However, the NRB still holds 63.11% and 68.46% of shares in the Mid-Western RRDB and the Far-Western RRDB respectively, and the shareholding of the Government of Nepal in the Eastern RRDB (8.25%), the Western RRDB (16.5%), the Central RRDB (16.5%) and the Far-Western RRDB (8.46%) have remained unchanged since their inception.

In the late-1990s, a number of financial intermediary NGOs and private microfinance banks also started microfinance programs in the country. Following the Grameen Bank model of Bangladesh, the NGO Nirdhan commenced its microfinance program in 1993 in the Western Development Region, which was transformed into the Nirdhan Utthan Bank Ltd. (NUBL) in 1999. NUBL is now operating in 11 districts and is serving approximately 89,879 clients. Similarly, the Centre for Self-help Development (CSD) started a microcredit program using the Grameen model in three Terai districts in 1994. In 2002, CSD also promoted the Swablamban Bikas Bank Ltd. (SB Bank) and transferred a major portion of its portfolios to the bank. SB Bank is now operating in 15 districts and is serving 76,999 clients.

In the eary-2000s, three private microfinance development banks, Chhimek Bikas Bank Ltd. (CBB), Deprosc Bikas Bank (DBB) and Nerude Microfinance Developmet Bank Ltd. (NMDB), were established. The number of financial intermediary NGOs (FINGOs) registered with NRB reached 47; one of these has not renewed its license for financial intermediation. The NRB has stopped issuing licenses to new NGOs for financial intermediation since 2006 until after promulgation of the BFI Act. The bank is in the process of forming a special second-tier regulatory body, which will regulate and supervise microfinance NGOs and microfinance banks. However, the action on this is considered by many in the industry to be too slow.

In the late 1990's, four wholesale lending organisations were established for financing MFIs. In 1991, the NRB established the 'Rural Self-Reliance Fund' to provide financial support to NGOs and cooperatives. The Government recognised the need for a professional apex microfinance organisation and the Rural Microfinance Development Centre Ltd. (RMDC) was established in 1998 with the support of the NRB and the ADB, with majority ownership being held by the NRB (26%) and 13 commercial banks (67%). Presently, the commercial banks are the major owners of RMDC, holding 90.57% of its total paid-up capital.

Sana Kisan Bikas Bank Limited (SKBBL) is another wholesale lending organisation incorporated in July 2001 to finance small farmer cooperatives (SFCLs). In 2003, a National Cooperative Development Bank was established under the 'Cooperative Act, 1991' with a mandate for financing cooperatives in the country.

4.2 Performance of MFIs

The microfinance market in Nepal can be divided into two categories: formal and informal.

Formal Sector

The formal financial sector is composed of 23 commercial banks, 58 development banks, 79 finance companies, 10 microfinance development banks (MFDBs), 16 financial cooperatives holding Limited Banking Licenses, 2,692 SCCs, 219 SFCLs and 47 FINGOs. Among these institutions, only MFDBs, FINGOs, SFCLs and SCCs provide microfinance services directly to the poor.

Of the 10 MFDBs, five are government-promoted Regional Rural Development Banks (RRDBs) and five are private sector-owned banks. Three of the RRDBs have been privatized in the recent years. The private MFDBs are: (i) Nirdhan Utthan Bank Ltd. (NUBL), (ii) Swablamban Bikas Bank Ltd (SBB), (iii) Chhimek Bikas Bank Ltd. (CBB), (iv) Nerude Microfinance Development Bank Ltd. (NMDB) and (v) Deprosc Microfinance Development Bank Ltd. These private MFDBs are performing better than the government promoted RRDBs in terms of outreach, portfolio quality, efficiency and profitability.

As of December 2007, RRDBs served a total of 168,812 clients, whereas the private MFDBs served 289,018 clients. The MFDBs operate in 50 districts (26 hill districts and all 24 Terai districts). They are allowed to provide microcredit to their clients of up to Rs 60,000 without collateral and on group guarantees. They can also provide micro-enterprise loans of up to Rs 150,000 to the graduated clients with or without physical collateral. Some of them have also been providing remittance transfer services to the clients in partnership with commercial banks.

In addition, as of December 2007 the average number of members per RRDB was 57,804, average savings balance Rs 170 million and average loan outstanding Rs 401 million. Importantly, 42% of their loan portfolio has been financed out of the mobilisation of members' savings. Their clients' average loan outstanding stood at Rs 9,668 and savings balance at Rs 2,732. All of the private MFDBs have attained over 129% operational self-sufficiency (OSS).

There are 2,692 SCCs which serve 358,312 people.[10] Most of the SCCs are rural based and target all community members irrespective of their social and economic status. SCCs operating in urban areas generally serve a wealthier population. These organisations do not like to be called microfinance institutions (MFIs), as they consider all community members as their target group. Most of these cooperatives have emerged spontaneously; only some rural SCCs have emerged with the assistance of local or international NGOs. They usually comprise 25 to 200 members. Among them 199 are associated with RSRF, while twenty-three of them have been partners of RMDC.

In partnership with RMDC, 23 SCCs have increased their microfinance clients considerably. All their members are women from poor families. As of December 2007, on average one RMDC-partner SCC serves 3,100 members, their savings balance stands at Rs 5.1 million and their loans outstanding at Rs 14.9 million. Their clients' average loan outstanding stands at Rs 6,880 and savings balance Rs 1,715. They have become operationally self-sufficient and are progressing towards financial sustainability. The largest three SCCs in terms of the number of microfinance clients served are: (i) Sahara Nepal Savings & Credit Cooperative, Jhapa, (25,990), Karnali Savings & Credit Cooperative, Jhapa (7,377) and Royal Savings and Credit Cooperative, Syangja (4,149). Most of the RMDC-partner SCCs have attained operational self-sufficiency.

Only a small number of the 16 financial SCCs operate microfinance on a small scale, for example the Women Cooperative Society and BISCOL, which both combine Grameen Bank and cooperative principles.

There are now around 219 SFCLs, which serve 129,000 small farmers. Most of the SFCLs were formed out of the small farmer groups previously organised by the Small Farmers Development Program of the Agricultural Development Bank of Nepal. These organisations can access wholesale funds from SKBBL (a special apex institution established for financing them), RMDC, RSRF and the commercial banks. However, almost all of them have borrowed from SKBBL. One SFCL has around 500 clients. Most of them have confined their services to one village development committee (VDC).

10 www.microfinance.org.np/microfinance.html#outreach

Table 3: Members, Savings and Loan Outstanding of Private MFDBs (As of December 2007)

S.N.	Name of MFDBs	Members	Savings (Rs)	Loan Outstanding (Rs)
1	Nirdhan Utthan Bank Ltd.	88,879	202,301,000	666,750,000
2	Swalamban Microfinance Development Bank Ltd.	76,999	226,534,000	431,583,000
3	Chhimek Bikas Bank Ltd.	69,009	194,807,000	517,661,000
4	Deprosc Bikas Bank Ltd.	25,226	59,601,000	239,525,318
5	Nerude Microfinance Development Bank	28,905	56,131,000	147,363,000
	Total	289,018	739,374,000	2,002,882,318
	Avg.	57,804	147,874,800	400,576,464

Source: *Rural Microfinance Development Centre Ltd. (RMDC)*

The number of financial intermediaries NGOs (FINGOs) registered with the NRB totals 47. Until mid-July 2007 these were serving 257,956 clients. Of the 47 FINGOs, 24 have become partner organisations (POs) of RMDC. The three largest FINGOs, measured by clients served, are DEPROSC-Nepal (39,194), Forum for Rural Women Ardency Development (34,917) and CSD (33,040).

The top ten FINGOs, which serve over 5,000 members, are: (i) DEPROSC, Kathmandu, (ii) FORWARD, Sunsari, (iii) Centre for Self-help Development (CSD), Kathmandu, (iv) Jeevan Bikas Samaj, Morang, (v) Mahuli, Saptari, (vi) Nepal Women Development Centre, Lalitpur, (vii) National Education and Social Development Organisation (NESDO), (viii) Manushi, (ix) CYC, Baglung, and (x) Srijana Community Development Centre, Siraha. Of these ten FINGOs, nine are POs of RMDC.

On an average, one RMDC-partner FINGO serves 9,360 members. All of them have been implementing the Grameen Bank model with slight modifications in operating systems and products to suit local conditions. As of mid-July 2007, the average loan outstanding and savings balance per member for these organisations' stood at Rs 6,121 and Rs 1,688 respectively. Other FINGOs have not made such progress in terms of outreach and quality. The outstanding loans for these 47 FINGOs was Rs 775.6 million in mid-July 2007.

Informal Sector

Of the aggregate supply of rural credit, nearly three quarters comes from informal sources. According to the World Bank, 47.3% of the bottom quintile of the population exclusively relies on informal loans, while this percentage drops to 24.7% in case of the top quintile[11]. Easy access, very simple loan decision making processes, quick delivery of loans, flexibility in loan size and its utilisation are some of the reasons for the use of informal sources of loans.

International NGOs have also been supporting microfinance programs at different levels. The UNDP, through its District and Local Governance Strengthening Projects[12] (DLGSP), have instituted a considerable number of community organisations (COs), serving a good number of community members in those project districts. Savings and credit activities are the core activities of the COs. In order to reach institutional sustainability, COs are now being oriented towards developing themselves into FINGOs or savings and credit cooperatives.

Between 1998 and 2001, PACT Nepal promoted

11 Majorano, Francesca, 2007. *An Evaluation of the Rural Microfinance Development Centre as a Wholesale Lending Institution in Nepal*, p.4

12 www.dlgsp.org.np/coverage.php (Decentralized Local Governance Support Program, a joint project of the Government of Nepal, UNDP and Norway).

Table 4: Members, Savings and Loan Outstanding of Government Promoted RRDBs (As of December 2007)

S.N.	Name of RRDBs	Members	Savings (Rs)	Loan Outstanding (Rs)
1	Eastern Rural Development Bank	57,734	179,622,000	748,064,000
2	Central Rural Development Bank	42,670	134,025,264	383,511,205
3	Western Rural Development Bank	36,786	113,100,000	466,883,000
4	Mid-Western Rural Development Bank	19,457	77,046,000	215,711,000
5	Far-Western Rural Development Bank	12,165	39,511,992	148,649,298
	Total	168,812	543,305,256	1,962,818,503
	Avg.	56,271	181,101,752	654,272,834

Source: *Rural Microfinance Development Centre Ltd. (RMDC)*

Table 5: Top Ten Microfinance Institutions of Nepal (As of December, 2007)

S.N.	Microfinance Institutions (MFIs)	Members	Member Savings (Rs In '000)	Loan Outstanding (Rs In '000)
1	Nirdhan Utthan Bank Limited (NUBL)	88,879	202,301	666,750
2	Swablamban Microfinance Development Bank Ltd.	76,999	226,534	431,583
3	Chhimek Bikas Bank Ltd.	69,009	194,807	517,661
4	Eastern Grameen Bikas Bank Ltd.	57,734	179,622	748,064
5	Mid-Zone Grameen Bikas Bank Ltd.	42,670	134,025	383,511
6	DEPROSC-Nepal	39,194	76,046	328,068
7	Western Grameen Bikas Bank Ltd	36,786	113,100	466,883
8	FORWARD, Sunsari	34,917	51,695	164,333
9	Centre for Self-help Development (CSD)	33,040	86,306	172,922
10	Jeevan Bikas Samaj	29,134	42,074	133,352

Source: *Rural Microfinance Development Centre Ltd. (RMDC)*

around 1200 village banks (VBs) in 19 Terai and two hill districts of Nepal. In December 2001, RMDC organised an interaction workshop with PACT Nepal and VB promoters with the objective of establishing a partnership with VBs, which turned out to be unsuccessful due to rigidity in operating modality. The VBs have not had a strong focus on their financial sustainability and have therefore been gradually disappearing.

There are over 20,000 informal community-based organisations, such as self-help groups and rotating savings and credit associations (ROSCAs), moneylenders, traders, friends and relatives. Friends and families are the main providers of informal loans in both urban and rural areas; they provide 84.4% and 60.5% of total informal loans respectively.

4.3 Service Delivery Methodologies

A number of methodologies have been used in the country by retail microfinance providers for the delivery of microfinance services to their clients. These include, the Grameen Bank model, cooperative model, SFCL, village bank and community based organisations or self-help groups. Among them, the Grameen Bank, cooperative and SFCL models are the major microfinance service delivery methodologies in the country.

The Grameen Bank methodology of microfinance was first introduced to Nepal in the early 1990s by two NGOs, Nirdhan and CSD, and the five Regional Rural Development Banks (RRDBS). Currently, this model has been adopted by a large number of microfinance organisations. These mostly operate in the Terai region (plains area), where the population is dense and road, market and other infrastructure is comparatively more developed than in the hills and mountains. The methodology is based on peer groups with each group consisting of five members, and groups of three or more are incorporated into a centre. Loans are provided to the clients without physical collateral and the group members guarantee each other's loan repayments. The target group of the program are poor families. The poor households are identified through a number of techniques, such as Participatory Wealth Ranking, Participatory Rural Appraisal or household surveys. Following identification, the eligible clients participate in a week-long pre-group training to be made aware of the microfinance procedures in detail, and for organisation into small groups and centres.

Regular meetings (mostly fortnightly) of a centre are held in a pre-specified meeting place located near to clients' residences, where respective clients gather and MFI staff can facilitate the meeting. During the meeting, field-staff collect saving deposits, loan repayment instalments and loan demands from members and verifies the utilisation of disbursed loans. The five RRDBs still follow the weekly meeting and other procedures of the traditional Grameen Bank model, whereas other Grameen model replicating MFIs have been using fortnightly meetings and have adjusted the model to suit local conditions and requirements.

This methodology is also being used in the hills and mountains with slight modifications (such as monthly meetings) to suit the geographical conditions. They typically offer general loans, seasonal loans, and specific loans (sanitation, housing). These institutions offer savings products, such as compulsory education savings, pension fund savings and voluntary savings, and micro-insurance schemes to cover risks related to clients' and their life and health and their livestock. Community-based small livestock insurance schemes have been used by many of these organisations. Most of the FINGOs, microfinance cooperatives and microfinance development banks follow the Grameen Bank model.

The Cooperative model is a traditional community-based rural finance model. As per the 'Cooperative Act, 1991', a group of 25 persons from a community can form a cooperative by registering it with the Department of Cooperatives, the Ministry of Agriculture and Cooperatives. SCCs are not included under the regulatory framework of the central bank, except those which have a Limited Banking License from within previous regulatory structures. The SCCs holding Limited Banking Licenses can serve non-members as well as members. These organisations target all community members irrespective of their social and economic status. Presently, most of the beneficiaries of these organisations have been from well-off families, and the average membership of these organisations is around 100 per institution. Most SCCs mobilise their member savings to provide members with loans for consumption and productive activities.

Loans provided by SCCS have a minimum term of three months and can be extended for more than 18 months, covering specific purposes, such as agriculture, micro-enterprise, housing, or in some cases, emergency or social causes. SCCs are supposed to be self-regulated, which is often not effective due to the lack of cooperative education among the members or shareholders of the organisations. Additionally, these organisations do not have effective supervision from higher authorities. As a result, most of them do not have proper accounting, sound management or good governance. However, this model has been found to be a more suitable financing model for the hills and mountains.

Small Farmer Cooperative Limited (SFCL) is the Nepalese cooperative model developed in 1993 after seven years of action research by ADBN with the technical support of GTZ. Its unique feature is having three tiers in its institutional structure. It has credit solidarity groups at the lowest level (the village level), an inter-group at each Ward level and a main executive committee at the institutional level. The executive committee is formed among the representatives of the inter-groups. The credit groups organise meetings regularly, where they collect savings and loan instalments. The groups collect loan applications from individual members at the regular meetings and forward these to their respective inter-groups. The inter-groups then appraise the loan applications and forward these to the executive committee with recommendations. Finally, the executive committee makes decisions on approval or disapproval of the loan proposals. The executive committee is responsible for overall management of the organisation. An SFCL confines its services within a VDC[13] and targets mainly small farmers. The loan can be given with or without collateral. On average, a SFCL has served around 500 members.

13 VDC (Village Development Committee) is the lowest level organisation of people. Its geographical area is divided into 9 Wards. There are about 4,000 VDCs in the country.

The Latin American Village Bank (VB) model was also tried in Nepal by the Women Empowerment Project (WEP) of USAID through PACT Nepal between 1998 and 2001. VBs are community-managed credit and savings associations designed to provide financial services to rural women of a community regardless of their social and economic status. A VB, consisting of 40-50 women, begins with a literacy and savings program for six-months; later they mobilise member savings as loans among themselves for productive or consumption activities. During the project period, VBs were promoted through the local NGO partners of PACT Nepal, which provided training to the associations centred on building the capacity of membership and management committees. The project also lent a small fund to build up the 'external account' of the village bank, which was then lent to members following the project phase out. Overall, the instituted VBs are gradually disappearing from the industry.

Self-help Groups (SHGs) and community-based organisations (CBOs) promoted by different programs and projects implement savings and credit activities in most cases. These informal groups can be transformed into formal organisations as savings and credit cooperatives or FINGOs. For example, a large number of community organisations (COs) have been formed under the social mobilisation program of the UNDP Local Governance Strengthening Project. Under the project, a small revolving fund is provided to these COs for expanding their credit program. Since the activities of COs are influenced by local level political institutions (Village Development Committees and District Development Committees), their sustainability has been an issue. To this end, the project is providing reorientation training to these SHGs for their institutional sustainability and is trying to link them with banks and financial institutions. Similarly, the Poverty Alleviation Fund (PAF), which was created by the Government of Nepal with support from the World Bank, has also been providing a considerable amount of grant funding (up to Rs 5 million per VDC) to local CBOs for lending to individuals for income-generating activities. However, there is a danger that these kinds of subsidy-oriented programs will create dependency amongst the rural families.

4.4 Information Technology in Microfinance

The majority of the MFIs in the country currently maintain their accounts and records manually. Most of them have one or two desktop computers in their head offices, which are being used for preparing reports and doing complex calculations. Although many of the institutions wish to computerise client transactions, they are limited by the cost of obtaining the technology. Limited infrastructure in terms of electricity, telecommunications, hardware and software services are other constraints to the application of computer technology to the microfinance industry in Nepal. In recent years, a few large microfinance institutions, such as NUBL, CBB, NMDB, have been attempting to develop their own software through local consultants. S.B. Bank has also contracted a local company to customise standardised microfinance software available at an open source. The standard software available in the commercial market is prohibitively expensive for the small MFIs in the country. Donor agencies will play an important role in the development and application of information technologies in the microfinance sector in the country.

4.5 Microfinance and Access to Energy

Microfinance in being used in Nepal to increase the access levels of cheap, renewable energy to poor households. This is being undertaken under the auspices of a program of the Alternative Energy Promotion Centre (AEPC), established by the Government of Nepal, which is implemented by the Biogas Sector Partnership Nepal (BSP) and with the assistance of international organisations such as SNV and Winrock International.

Microfinance institutions are providing loans products for biogas systems for domestic use under the AEPC program. These biogas systems are used to replace firewood, kerosene, and LPG and are therefore a valuable source of renewable energy. As of late-2007, over 173,000 Nepali households have biogas systems, making it the country with the highest per capita number of systems in the world.

The AEPC program provides price subsidies for the construction of bio-gas plants for domestic use of between NR 5,000–11,500 (US$ 69–159) per plant, and this is dispersed through BSP-approved companies. Biogas loan funds are also provided to MFIs at 6 percent per annum for two years without collateral, or for three years with collateral. An additional subsidy is also provided for poor consumers (Hilman et. al, 2007).

Support to the microfinance sector for 'energy lending' is provided by organisations such as Winrock International. Winrock have trained 300 MFIs in the financing of biogas plants and renewable energy, as well as providing capacity building and technical assistance. To date, this program has enabled 150 MFIs to provide loans to 5000 poor households to an amount exceeding 1 million US dollars.

The success of the model used in Nepal has provided opportunities for households in terms of the sale of biogas slurry and the WWF, with the assistance of Winrock International, has developed the Biogas Gold Standard VER project which is currently undergoing a process of validation and provides opportunity for the increased sustainability of the AEPC program.

4.6 Microfinance 'Meso-Level' Organisations

The Rural Microfinance Development Centre Ltd.

RMDC has been playing a promotional and developmental role since its inception in 1998, when there were only a few capable MFIs. As of December 2007, RMDC has promoted and developed 50 MFIs from their inception. RMDC aims to increase the number of retail MFIs by identifying potential institutions (cooperatives or NGOs) operating in different parts of the country and then assisting them to become quality MFIs through intensive training and technical support, along with providing loan funds for lending to their clients. RMDC trains the executive committee members, managers and field staff of MFIs through interactive class-room trainings, on-site technical assistance, on-the-job training of trainee staff and study visits which expose MFIs to industry best practices. RMDC also provides technical and financial support to its partner organisations in order to improve the organisational and occupational skills of clients.

As of December 2007, RMDC has trained 10,100 MFI staff and 365,000 clients. CSD, SB Bank and several other institutions have been used by RMDC as training institutions for start-up MFIs. Trainees are provided with the opportunity to stay, work and develop their knowledge, skills and attitude at these institutions. About 6,000 MFI staff and clients have been trained at the branches of CSD and SB Bank. Other partner organisations of RMDC are also emerging as learning centres, such as FORWARD, Jeevan Bikas Samaj, Batabaran Multipurpose Cooperative and Boudh Savings and Credit Cooperative.

RMDC also undertakes close monitoring and supervision of its partner organisations to ensure that they operate in a sound manner so that they might achieve high portfolio quality, efficiency and profitability as well as create desired impacts on clients and their households. Due to this supervision, RMDC's partners have high portfolio qualities (over 95% loan repayment rate) and have attained over

125% operational self-sufficiency. Furthermore, RMDC has a strong relationship with the central bank and has played a vital role in developing a conducive legal and regulatory environment for the microfinance sector in the country. For example, RMDC played a proactive role in the amendment of the 'Financial Intermediary Act, 1998' and in preparing the plan for restructuring of RRDBs.

Rural Finance Nepal

Rural Finance Nepal (RUFIN), a joint Nepali-German project, provides technical assistance to the Agriculture Development Bank for the transformation of its credit groups organised under the Small Farmers Development Program into sustainable Small Farmers Cooperative Limiteds (SFCLs). The Project also provided assistance to establish the Sana Kisan Bikas Bank Ltd. (SKBBL) in 2001 with the purpose of providing funds to SFCLs.

Centre for Microfinance

The Centre for Microfinance (CMF), a non-profit company, was established in 2000 with external support (such as CIDA, Ford Foundation) to conduct training and research on microfinance. Each year, CMF conducts class-room based training programs on microfinance using local professionals as resource persons. In the past, it has conducted research and consultancies mainly related to cooperatives. It was also involved in a micro-insurance pilot scheme as a facilitator, linking the ultimate clients to an insurance company. CMF currently partners with ImpAct, an international project focusing on the social impact of microfinance, funded by the Ford Foundation and implemented by three UK universities.

National Federation of Savings and Credit Union Nepal

Established in 1988, the National Federation of Savings and Credit Union Nepal (NEFSCUN) is an apex organisation for savings and credit cooperatives in the country. It has around 350 member cooperatives in 46 districts. The average number of members of the member cooperatives is 110. NEFSCUN offers capacity building support and funds to a few of its members. It mainly serves as a forum for its member cooperatives to share experiences and lobby for issues related to their operations.

Credit Information Bureau Limited

The Credit Information Bureau Limited (CIB) was established in 1989 as an initiative of the NRB. It was registered as a company in September 2004 and started its operations in March 2005. CIB is the central organisation in the country acting as the repository of credit information of the customers and commercial borrowers of all banks and financial institutions. It collects credit information from banks and financial institutions and disseminates to them on demand. The NRB, banks and other financial institutions own the CIB. As of mid-July 2007, there were 2,235 borrowers blacklisted by CIB at the request of banks and financial institutions. CIB keeps records of those borrowers, who have loans over Rs 1 million.

Networks and Ratings Agencies

Over the years, local microfinance networks have been formed, such as the Microfinance Association of Nepal (MIFAN), the Grameen Network Nepal (GNN) and Nepal Microfinance Bankers Association (NMBA). However, they have not been active enough to promote and safeguard the interests of the industry.

There is no separate rating agency in the country, like MCRIL or CRESEL in India. Wholesale lending organisations (like RMDC, SKBBL) appraise their applicant institutions themselves before making approval of a loan. Staff of these institutions are trained for this purpose.

Box 1: RMDC's Operational Approaches for Promotion of MFIs

Potential institutions (NGOs, cooperatives, banks) are identified based on their institutional profile, experience and commitment;

An exposure visit program is organized for executive committee members of the potential organisations to allow them to do self-study and observe best practices of microfinance;

After the visit, the participating members are invited to take part in a 3-day interaction program, which includes sharing of experiences from participants, discussions on the major issues, essentials of microfinance and steps of implementing microfinance programs, and factors affecting viability and sustainability of MFIs, and setting appropriate interest rate, and so on;

a few field staff of the interested institutions are provided with 2-month long on-site practical training on operational systems at field offices of a successful MFI;

The institutions' staff are also trained on PRA/PWR methodologies, which they can use to assess problems and potentialities for implementing microfinance programs in an area, and to identify poor households;

A few officials of the institutions are provided with on-site guidance on preparing their institutions' 3-year business plans;

The institutions are given on-site consultancies on establishing appropriate operating systems (e.g. accounting, MIS, reporting, monitoring and supervision, internal control, etc.) and on conducting pre-group training and center meeting;

- Regular off-site and on-site monitoring and supervision to the borrowing institutions are undertaken;
- Special on-site technical assistance is also given to an MFI as per its need and demand.

5. Funding Sources

The sources of funds for microfinance programs in the country consist of the Deprived Sector Credit funds from commercial banks, wholesale lending organisations and a few international donors.

CBs contribute to the microfinance industry as wholesalers and equity investors in MFDBs. These banks are required to disburse at least three percent of their total loan outstanding to the Deprived Sector. They have been the major sources of external funds for retail MFIs as well as wholesale lending organisations, like RMDC and SKBBL. NRB has also directed development banks and finance companies to disburse some of their loan funds to the deprived sector.

RMDC is the largest wholesale lending organisation in the country. It provides wholesale funds to all types of institutions which are legally allowed to undertake microfinance operations, such as MFDBs, FINGOs, SCCs, SFCLs. It has also disbursed funds to development banks (DBs) for financing micro-enterprises under the Community Livestock Development Project funded by the ADB. As of December 2007, RMDC has disbursed Rs 2,901 million to the poor through its 60 partner organisations, which comprised six development banks lending for agriculture and livestock-based enterprises, 7 MFDBs, 24 FINGOs and 23 cooperatives. Its loan outstanding stood at Rs 1,189.9 million with zero non-performing assets. RMDC's partner organisations have also maintained over 98% repayment rates. These retail organisations have served over 563,009 poor families. Most of its partner organisations have crossed in to the operational self-sufficiency level.

Any institution meeting a few basic criteria (Box 2), committed to following best practices, maintaining financial discipline and practicing good governance with professional management can apply for a loan to RMDC. If necessary, RMDC provides necessary training and technical support before providing loans in order to make sure that the institution has the minimum skills to keep records and operate a microfinance portfolio with a small number of clients. RMDC supports institutions until they establish proper accounting, operating procedures and systems, good governance and professional management, skilled human resources, effective monitoring and supervision and internal control mechanisms. All of RMDC's partner organisations have been able to attain the level of operational self-sufficiency within 2-3 years of partnership.

RMDC has successfully implemented a number of projects funded by international agencies. It completed a US$20 million ADB project-Rural Microfinance Project in mid-July 2007. In the early stages of this project, RMDC faced difficulties in disbursing the allocated funds due to the arrangement of interest rates higher than the market rate and an inadequate single borrower loan limit in the loan agreement between the Government of Nepal and ADB. There were also a very limited number of capable MFIs in the country. This led to the decision of RMDC creating new MFIs and working to create a conductive policy environment for the project through continuous dialogue with the Government and ADB.

SKBBL is a special wholesale lending organisation for financing SFCLs. Its authorized capital is Rs 240 million and paid-up capital Rs 120 million. The major owners of the organisation are ADBN (67%) and the Government of Nepal (19%). It has disbursed loans to 219 SFCLs, which serve 129,000 individual clients in 24 districts. The outstanding loan of SKBBL granted to 219 SFCLs was Rs 1.33 billion in mid-July 2007. Commercial banks and ADBN are the major sources of funds for SKBBL for lending to the SFCLs.

The Rural Self Reliance Fund (RSRF), managed by the Microfinance Department of the Central Bank of Nepal, offers a small amount of wholesale funds (up to Rs 2.5 million) to primary level NGOs and cooperatives for a three year term at an annual interest rate of 8%, of which 75% is returned to the borrowing institution if it repays the loan on time. RSRF was established in 1991, as a deliberate poverty reduction strategy, with seed money of Rs 20 million from the government. The government contributed another Rs 70 million during 2005-07 and the central bank added Rs 253.4 million from its profit to avoid the dearth in microcredit facility in rural areas. In this way, the fund has Rs 343.4 million for providing wholesale micro-credit in rural areas. The fund has also been providing funds to MFDBs and ADBN since fiscal year 2002-03 to support programs like tea and cardamom cultivation and cold storage construction. The fund provided a total line of credit of Rs 40 million (Rs 10 million each) to Eastern Rural Development Bank, Central Rural Development Bank, Mid-Western Rural Development Bank and SKBBL as of mid-July 2007. ADBN was also provided Rs 119.2 million as a long-term line of credit. As of mid-July 2007, RSRF had disbursed Rs 132.6 million through 277 institutions (52 NGOs and 225 SCCs). At this time, its loan outstanding to these institutions was Rs 54.1 million. These 277 institutions have served a total of 12,228 households in 48 districts, 77% of them below the poverty line. The loan overdue rate of the credit program is 8.5%[14].

The National Cooperative Development Bank (NCDB) also provides funds to its member cooperatives. In December 2007, its loan outstanding with its 59 cooperatives was Rs 123.3 million.

14 Nepal Rastra Bank (2007). *Economic Report, 2006/07*, page 84 (http://red.nrb.org.np/publications/economic-reports/Economic_Reports_2006_07.NEW.pdf)

Box 2: RMDC's Eligibility Criteria for Lending

Institutions willing to borrow credit from RMDC should fulfill the following requirements.

An organisation should

i. have registered under an appropriate act and received a license for microfinance operation;

ii. have minimum of one year experience in operating microfinance activities;

iii. have savings balance at least 5% of the loan outstanding in the 1st year, 10% in the 2nd year, 15% in the 3rd year, and 20% in the 4th year and onward;

iv. have attained minimum 90% loan recovery rate;

v. have committed and dynamic executive committee;

vi. have active and professional management;

vii. have appropriate management information system;

viii. have an appropriate business plan;

ix. have adopted modern accounting system;

x. have appropriate policies and procedures for implementing and monitoring its credit program;

xi. have at least 50 active borrowers;

xii. have at least 25% female borrowers;

xiii. have minimum financial resources Rs 250,000;

xiv. have minimum net-worth of Rs 100,000;

xv. have a trend towards self-sufficiency as per the last three years' financial position; and

xvi. have audited in time.

6. Impact of Microfinance Activities

Three studies have been undertaken on the impact of microcredit in the country in recent years:

1) *Impact of micro-credit program on poverty reduction*, **funded by the National Planning Commission in 2004;**

In 2004, the National Planning Commission of Nepal, through a research firm (Centre for Policy Studies and Rural Development, Kathmandu) conducted a study on the impact of microfinance on poverty reduction [15]. The study examined (i) the outreach of microfinance programs and coverage of the poor, (ii) socio-economic impact on beneficiary households, (iii) gender empowerment and (iv) the sustainability of microfinance institutions. The study was based on secondary as well as primary data. Primary data was collected from a sample of 479 microfinance clients from six districts (three hills and three Terai). Both government and non-government microfinance institutions were included in the study sample. The major findings of the study were as follows:

- Total outreach of the microfinance institutions was estimated to be 35.25%. The outreach was not totally confined to the poorest of the poor, as the proportion of the poorest of the poor to the total microfinance borrowers was estimated to be 68.6%;
- A large majority of households (84.1%) reported profit from the first loan. The proportion of households reporting profit decreases in successive loans;
- Only a small proportion of households (24.4%) felt an improvement in their socio-economic conditions after participation in microfinance programs;
- There was a change in the composition of the principal occupation of respondents, particularly in the form of a shift from agriculture to petty trade. Dependence on agriculture declined from 56 to 48 percent, while that on petty trade increased from 11.1 to 32.2 percent;
- Respondents witnessed some changes in their wealth status after participation in microfinance programs. The proportion of households possessing items such as better roofed houses, radio, television, bicycles, hand-pumps increased;
- Respondents witnessed an improvement in their food self-sufficiency status after participation in the program;
- Literacy rates of respondents increased from 52 to 89.8 percent because of program initiatives to make the participants capable of, at a minimum, writing their names;
- The proportion of households sending sons to school increased somewhat (from 80.1 to 84.1 percent) but the proportion of households sending daughters to schools remained unchanged (76.4%);
- The frequency of consumption of nutritious foods, such as fruits, meat, fish and eggs increased;
- The proportion of respondents knowing about HIV/AIDS and its mode of transmission increased. Similarly, a large proportion of households were aware of the importance of seeking health services at the locally available health facilities;
- Certain household chores, which are perceived to be exclusively women's domain, are now performed by both males and females;
- The proportion of women reporting increased control over their income increased from 13.3 to 19.1 percent, while those reporting the need to submit their income to husband/in-laws decreased from 31.4 to 20.1 percent; and
- On the whole, the impact of microfinance programs on reducing the poverty level of the clients was found to be low.

15 Center for Policy Studies and Rural Development, 2004. *Impact Evaluation of Microfinance Programs on Poverty Reduction*, a study report submitted to the National Planning Commission, Kathmandu.

2) *Impact of microfinance*, funded by SAP-Nepal in 2006

INAFI SAP-Nepal, in 2004, conducted a thematic research study on the impact of microfinance services on poverty reduction in Nepal[16]. The main objective of the study was to find out the overall impact of microfinance services on poverty reduction in the country. The study focused on (i) outreach of microfinance, (ii) access, use and contribution of microfinance, (iii) micro-enterprise development, (iv) managing risks and vulnerabilities by clients, (v) empowerment of women, and (vi) poverty reduction. Both primary and secondary data were collected for the analysis. In the study, both 'before and after' and 'with and without' approaches were used. The major findings of the study were as follows:

- There was a positive impact of microfinance on poverty reduction. Microfinance enabled the poor to enhance their access to financing for income growth and welfare improvement through micro-enterprise development and increased ability to address vulnerability and economic empowerment;
- Microcredit was used both for production (66%) and consumption (36%) purposes. Microfinance contributed to reduce poverty in client households and 56% of the respondents increased their incomes after participation in the microfinance programs;
- Microfinance beneficiaries have built slightly more financial, physical and human capital than non-clients;
- Microcredit has served to lessen their dependency on moneylenders, reducing the average interest rate burden especially for the poor;
- Microcredit has promoted micro-enterprise activities, which in turn have increased wage and self-employment opportunities for the beneficiaries and the community people;

16 INAFI SAP-Nepal, 2005. *Impact of Microfinance Services on Poverty Reduction in Nepal.*

- There is a clear link between access to microfinance services to the poorest of the poor and poverty reduction. Microfinance services enable client households to increase income and build more financial, physical and human capital; and
- Other impacts of microfinance are improved nutrition, better food intake, better clothing and better housing.

3) *Impact of microfinance on the clients of RMDC's partner organisation*s, August 2007, funded by RMDC.

In 2007, RMDC carried out a study on the impact of microfinance on the livelihoods of the clients[17]. The study focused on the impacts of microfinance on (i) loan transactions from various loan sources, (ii) investments, income and savings, (iii) creation of assets, (iv) food availability, nutrition and clothing and housing, (v) health care measures and education, and (vi) women's empowerment. The before and after approach was used in the study to assess changes on the above matters with clients who had joined MFIs more than three years before the sample of study. The study reported that there had been remarkable improvement in the socio-economic conditions of the households participating in the microfinance program. The major findings of the study were as follows:

- After three or more years of participation in a microfinance program, the reliance on moneylenders and relatives has decreased by 68% and 65%, respectively;
- The participating households were found to have increased their investment by 219%, income received by 250% and savings by 286%;
- Holdings of living and non-living assets increased remarkably. For instance, participating households have increased their holding of goats, buffaloes and cows by 161%, 78% and 120%, respectively;

17 Rural Microfinance Development Center Ltd., 2007. *Impact of Microfinance Services on the Clients of RMDC's Partner Organisations*

- The number of thatched houses decreased by 65%, while the tile and corrugated houses increased by 10% and 153%, respectively;
- Land holding of the participating households increased by 61%;
- The level of food self-sufficiency for 12 months through self-production and income-generation improved from 31% of all households to 85% of all households after participation for three or more years;
- Involvement in community work among the beneficiary households increased by 129%; and
- There were significant changes observed in the use of safe drinking water, sanitary toilets, DPT, polio, vitamin A and number of visits to doctor.

7. Opportunities and Challenges

Nepal has both opportunities and challenges for the growth and success of the microfinance industry. Some of them are as follows:

7.1 Opportunities

- The Government of Nepal has issued 'National Microfinance Policy, 2007' which aims to facilitate the creation of a conducive legal environment and the necessary financial infrastructure for further development of the microfinance industry in the country;
- Laws have been in place for operating microfinance under different institutional frameworks. For operating microfinance on a wider scale, a microfinance bank might be established as a joint-stock company with a larger size of capital under the umbrella act "BFIA, 2006'. The central bank has nominated the development this type of bank as a priority. Recently, microfinance banks have also been allowed to expand operations in an additional five hill districts without increasing share capital. NGOs can undertake microfinance activities after being formally registered under the 'Financial Intermediaries Act, 1998 (amended in 2002)'. Similarly, local CBOs or self-help groups can be converted to legal financial organisations, registered as savings and credit cooperatives under the 'Cooperative Act, 1991';
- A number of quality retail microfinance institutions with sufficient institutional capacity and professional management have developed in the last few years due to the adoption of best practices and the development of their human resources to attain institutional and financial sustainability of their institutions;
- The establishment of wholesale lending organisations (such as RMDC, SKBBL, RSRF, NCDB) have bolstered the supply of funds to retail microfinance institutions;
- A substantial amount of funds for microcredit programs are available from domestic sources (the commercial banks) under the mandatory Deprived Sector Credit Program;
- New products, such as micro-insurance products, have been introduced through a partnership between microfinance providers and a large insurance company. A number of self-managed micro-insurance schemes at an institutional level (without linking with an insurance company) have also been practiced in Nepal for more than a decade. New MFIs can replicate the scheme.
- The decade long conflict due to the Maoist insurgency, which has severely constrained the implementation of microfinance programs particularly in the hills and mountains, is now over, and this has created a positive environment for microfinance operation in the remote regions.
- Commercial banks, which had closed their rural branches, have started reopening branches in the rural areas. The central bank has also directed them to do so to increase financial services in these areas;
- At present, a good number of MFIs are operating in a professional manner in the country, from which the upcoming microfinance leaders and practitioners can learn valuable best practices and good experiences of microfinance;
- A large number of poor households (around 40% of the total poor population) are still deprived of institutional microfinance services, which provide a good market for the microfinance institutions to scale up their operations.

7.2 Challenges

- Difficulties in expanding microfinance programming into the hills and mountains of Nepal has been one of the major challenges in the country due to the lack of local financial institutions and the unwillingness of large MFIs to expand their operations in those areas. The few existing local cooperatives do not have adequate institutional capacity or governance to expand outreach considerably;

- An overlapping of MFIs operating in densely populated areas poses a threat to the maintenance of quality operations, resulting in unhealthy competition. The NRB, has not been able to upgrade its capacity to adequately supervise the MFIs and solve this issue;
- Rural and remote areas, where most of the poor population reside, have limited physical infrastructure and economic opportunities for the people. Microfinance operations cannot flourish in such areas. The government should get involved to actively develop the basic infrastructure required for improving agriculture and local economy.
- A large number of people from rural and remote areas migrate to towns and urban areas for seasonal employment. They need access to microcredit, but MFIs are hesitant to extend services to them due to their temporary nature of stay in the program areas;
- Most political parties and leaders are unaware of the basics of microfinance and the need of institutional sustainability of MFIs, seeing microfinance programs as charity. Occasionally, they have argued for lower interest rates and loan waivers.
- The ultra-poor, the marginalized castes (*dalits and janjatis*) and the destitute are still excluded by the existing microfinance programs even in the Tarai regions where microfinance programs are concentrated. MFIs need to focus on their services to these vulnerable groups urgently;
- Highly subsidised microcredit programs are still being operated in most parts of the country, which have been threatening the financial discipline and basic norms of microfinance systems.
- Even though the Maoist insurgency is over, insecurity still prevails in the Eastern Tarai region due to the activities of a few political groups in the area. The criminal groups operating in the Nepal-India border areas are benefiting from this situation.

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