MICROFINANCE SUMMIT 2010 NEPAL

ROLE OF STATE FOR THE DEVELOPMENT OF MICROFINANCE SECTOR

(Draft for Discussion)

Nara Hari Dhakal
Project Coordinator/Rural Finance Sector Specialist
Rural Finance Sector Development Cluster Programme I
Ministry of Finance
Singha Darbar,
Kathmandu, Nepal

January 2010

Abstract

This paper discusses the role of state on developing microfinance sector to enhance access to financial services to a majority of un-served and under-served poor and low-income households with emphasis on two aspects: sustainable financial services and enhancing access to financial services to un-reached. In this paper, a review of different schools of thoughts on this subject is done and state's role are discussed considering country context, realities and environment within which existing financial market operates. Further, this paper emphasizes sustainability and mass outreach at the outset in cognizance of significance of the debate for financial sector development and the fact that often policy makers' concerned on providing services to poor tend to ignore issues relating to permanency of services.

The paper documented that there are three school thoughts namely: laissez-faire school, interventionist school and moderate interventionist school, concerning the role of state in developing microfinance sector and state's involvement in microfinance sector is the function of macroeconomic instability, maturity of banking system, stage of development and structure of microfinance sector, size of the potential microfinance market and rural infrastructure.

The paper uncovered that states' involvement on developing microfinance sector in Nepal dates back to mid fifties when government supported the cooperative movement. The involvement if the state gained momentum with the implementation of Intensive Banking Scheme in 1974, Small Farmers' Development Project in 1975 and Production Credit Project for Women in 1981 and further intensified with its engagement on promoting five Grameen Bikas Banks (GBBs), with one GBB in each region, during early and mid 1990s. Further, state has funded and/or has been funding a plethora of new projects such as Biseshwor with the Poor, Jagriti, Youth Employment Programme, etc. at the retail level and result of such efforts has been rather not encouraging. The paper concluded that the outcome of involvement of the state on developing microfinance sector is mixed and suggested optimal roles state can play to foster permanent financial access for the poor and recommend that the states' role should be confined as an enabler and not as a direct provider of financial services.

The paper has identified the three broader roles: protectors' role, providers' role and promotional role that state can have on developing microfinance sector and has synthesized the menu of policy interventions for supporting inclusive financial access under each role. The paper concluded that state should play an important role in setting a supportive policy environment that stimulates expansion of financial services in remote areas while protecting poor people's savings and suggest that the states involvement should concentrate at maintaining macroeconomic stability, avoiding interest-rate caps, and refraining from distorting market with unsustainable subsidized and high-delinquency loan programs. State can also support financial services for the poor by improving business environment for entrepreneurs, clamping down on corruption and improving access to markets and infrastructure. At the most, in a very much specialized situation, state funding for sound and independent microfinance institutions in remote areas may be warranted when other funds are lacking and where enhancing access to financial services is one of the challenges for improved livelihood situation of the poor and disadvantaged groups.

Table of Content

1. Introduction

Nepal has developed considerable history in providing microfinance services which is evidenced by emergence and growth of a large number of microfinance institutions (MFIs) and microfinance programmes over time. Microfinance institutions (MFIs) allow thousands of households, usually excluded from the commercial and development banking sector, to access financial services and thereby address poverty problems. Role of the state[1] in financial market development is one of the long-standing and unresolved debates that have engaged economists around the world (Joseph Stiglitz 1993, p.19). Ironically, much of the literatures on this subject are lopsided on addressing issues related to commercial finance and there have been limited discussions on issues related to financial services for the poor. The enormity of poor people's demand for a variety of financial services and potentials of sustainable financial institutions to meet such demand is a relatively new area of concern in microfinance literature. It is in this context that the role of the state in developing microfinance sector has received attention in recent years. This subject has added significance in view that proper state interventions influence involvement of stakeholders, social welfare (Gonzalez Vega, 1997) and lay foundations for a sound microfinancial system while making a positive contribution to industry growth. In contrast, inappropriate government interventions jeopardize sustainable development of microfinance as happened in case of agricultural finance during 1960s-1980s in most developing countries (World Bank, 1989; Meyer and Nagarajan, 2001).

Literatures on role of the state in developing microfinance sector generally provide a standard list of measures that state should do to promote microfinance. These recommendations, among other, include improving enabling policy environment; developing a legal, regulatory and supervisory framework, and eliminating provision of directed credit at subsidized interest rates. Such policy prescriptions have limited significance to both policy makers and practitioners as they need to be tailored consistent to country context and realities. Further, mostly these recommendations are based primarily on negative experiences of agricultural finance and new paradigms on formal financial sector development and are back by sound theoretical foundation.

Within above context, this paper discusses the role of state on developing microfinance sector to enhance access to financial services to a majority of un-served and under-served poor and low-income households with emphasis on two aspects: sustainable financial services and enhancing access to financial services to unreached. In this paper, a review of different schools of thoughts on this subject is done and state's role are discussed considering country context, realities and environment within which existing financial market operates. Further, this paper emphasizes sustainability and mass outreach at the outset in cognizance of significance of the debate for financial sector development and the fact that often policy makers' concerned on providing services to poor tend to ignore issues relating to permanency of services. The information required for this paper is gathered from secondary sources through a review of available literature on enhancing access to financial services for the poor and disadvantaged groups.

This report is organized into four sections. After this introductory section, section two reviews the relevant literatures in microfinance that pertains to the role of the state in microfinance sector. Section three outlines the results and discussions on the role of state in developing microfinance sector while conclusions and recommendations are provided in section four.

[1] In this paper, government relates to domestic public actors that play a role to promote access to finance fall into three broad categories viz. (i) representatives of national and local executive branches (e.g., financial policy regulators and supervisors, telecommunications regulators, line ministry staff, heads of state-owned financial institutions, provincial governors, and other appointed officials), national and local legislative representatives (e.g., parliamentarians, mayors, and other elected officials) and members of unions, political parties, and other socioeconomic political organizations.

2. Review of Literature

Available literatures on the role of the state on developing microfinance sector are reviewed and findings of the review are synthesized to include: (i) different schools of thoughts on role of state and (ii) fundamentals considerations to define the role of state in developing microfinance sector.

2.1 School of Thoughts

Close scrutiny and synthesis of available literatures reveals that there are at least three different schools of thought on role of the state on developing microfinance sector.

Laissez-faire School
This school of thought emphasizes that the state should maintain macroeconomic stability and entrust the private and non-government sector with the responsibility to enhance access to financial services and sustainable microfinance development. This school of thought underlines that the more state will involve on microfinance sector, the less it will contribute to sustainable development. According to this view, state's main contribution to microfinance sector would be to stay out of the way by closing the state-owned commercial, development and microfinance banks and avoiding directives.

Interventionist School
This school holds the notion that involvement of the state to enhance access to financial services and microfinance development is a must due to market failure. A majority of the poor are out of the frontier of formal finance owing to failure of financial market. The state has a major role to play in expanding frontier including provision of services by different types of government-owned organizations owing to realities that traditional commercial banks are not interested in microfinance market for various reasons including high transaction cost and credit risk and private risk capital is unlikely to flow in those areas because of difficulties to achieve essential triangles of microfinance (outreach, sustainability and impact) is these areas. While experts in this camp admit the possibilities of "state failure", they believe on the potential positive contributions of the state on expanding frontier of financial services.

Moderate Interventionist School
This school of thought combines fundamentals of laissez-faire school and interventionist school. Believer of this school of thought emphasize that the state should not only maintain macroeconomic stability but also provide enabling policy environment and essential financial infrastructure. However, this school does not support direct interventions by the state in providing financial services.

To sum-up, three school of thoughts emphasize that state has definite role to play for developing microfinance sector, however, exact type and magnitude of roles varies depending on the complexities involved in financial development and level of maturity of the microfinance industry. Further, it implies that the role of state varies depending on context and realities on microfinance markets and other country-specific conditions.

2.2 Fundamentals Considerations

Fundamental considerations that determines the role of state include, but are not limited to level of macroeconomic stability; stage of development of banking system; stage of development of microfinance sector; size of potential microfinance market; geographical diversity; and population density. These fundamentals are discussed hereunder.

Macroeconomic Instability
Ensuring macroeconomic stability is one of the most important tasks for the state. Macroeconomic instability adversely affects overall economic growth and limits

productive economic opportunities and potential for expanding sustainable access to financial services. High inflation in particular erodes capital of financial institutions and makes it difficult to mobilize resources to expand services. As a matter of fact, macroeconomic instability increases volatility of interest rates, exchange rates and relative prices and imposes additional costs and risks on financial institutions and their existing and potential clients. High inflation creates difficulties to harness full benefits of supportive measures and state must be accountable on controlling inflation.

Banking System

Growth and development of microfinance sector essentially depends on stages of banking system development. If banking system in less developed, state should focus on developing a sound banking system to provide traditional banking services prior to establishing a formal microfinance industry. Basic banking services are essential for developing sustainable microfinance although traditional banking institutions may not provide microfinance services directly. On the absence of sound banking system, MFIs experience difficulties in selecting a safe place to park their deposits and manage loanable fund for on-lending to their clients. MFIs will lack confidence on security for their deposits in poorly managed and performing banks where they also have to incur high transaction costs in withdrawing deposits. A less developed banking system also makes it difficult and more costly for MFIs to access funds from banking system, while a more developed banking system can be a significant source of support. Thus, state has a paramount role on developing efficient banking system to facilitate development of microfinance sector.

Stage of Development and Structure of Microfinance Sector

Stage of development and structure of microfinance sector determines the role of state on developing microfinance sector. State has to play crucial role if the microfinance sector is matured and complex to ensure prudent growth and development of sector. Given the industry structure, the state can play an important role by introducing an environment – both policy and legal – for the growth and development of microfinance sector (Charitonenko and Rahman, 2002, p.42).

Regulation and supervision of MFIs has received much attention in recent years in the literature. Some organizations have warned about rush to regulate because premature and inappropriate regulation can have significant adverse impact as far as growth of microfinance industry is concerned (Christen and Rosenberg, 2000). Rhyne (2001, p.206) notes that "banking authorities should define regulations for MFIs in advance of their development, thereby risking and choking off potentially crucial innovations and adaptations."

The microfinance industry has a relatively large potential market and is characterized by too many small-scale suppliers[2]. Although institutional diversity is generally an important characteristic of a robust microfinance industry, institutional proliferation cannot necessarily be considered good for healthy growth and development of microfinance industry. A majority of small-scale service providers are unable to diversify their risks adequately across space and activities that they finance. They also run greater risks of being subject to liquidity problems that in turn affect their service quality and reliability (Fernando, 2001). Most of these small operators have neither adequate capital nor human resources to use new information and communication technologies (ICT) to expand their operations to realize economies of scale. Considering these context and realities, state should provide incentives for consolidation of small-scale institutions while preserving institutional diversity. Such incentives may include, for example, more attractive time-bound tax exemptions for the consolidated institutions (Charitonenko and Rahman, 2002, p.44).

[2] For example, in Nepal there are 15 microfinance development banks, 45 FI-NGOs, over 6000 SCCs and 229 SFCLs operate in Nepal.

Size of the potential microfinance market

The size of the potential market matters in defining appropriate role for the state in developing microfinance sector. Geographical aspects and population density influences the size of potential market and significantly determines the role of the state. Enhancing access to sustainable microfinance services is a complex proposition in remote areas with difficult terrain and low population density where prospects for commercial operations are questionable with available financial technology. In such areas, state can promote either community based operations through NGOs or even offer smart-subsidies for example either on auctioned basis or on the basis of the number of clients reached to commercially oriented suppliers to operate in those areas (Dhakal 2007).

Rural infrastructure

Access to rural infrastructure plays an importance role for developing microfinance sector. Microfinance sector grow better quantitatively and qualitatively if basic rural infrastructure deficiencies such as better rural roads, bridges, irrigation facilities, market facilities, primary health care and education facilities are addressed and economic opportunities for rural population are increased and basic financial services are productively used. Such infrastructure also reduces potential risks and transaction costs for financial institutions and provides incentives for innovations, diversification and expansion of microfinance operation (Meyer, R.L. and G. Nagarajan 2001).

3. Findings and Discussions

3.1 State and Microfinance Nexus

The Microfinance industry in Nepal has evolved through strategies implemented by the Government of Nepal, the bilateral and multilateral development partners, and private sector. Today the industry reaches around 1.2 m clients mainly in Tarai regions and accessible hills. The diversity of retail MFIs is a key feature of Nepalese microfinance industry. Regulated microfinance development banks, cooperatives, financial NGOs, and community-based savings groups provide a wide range of micro finance services (Dhakal 2007).

History of microfinance is relatively short but eventful in Nepal marked by costly process of trial and errors. Access to financial services is regarded as one of the essential services to address poverty problems in Nepal since the advent of planned development efforts in mid fifties. The cooperative movement became the first vehicle of Nepalese microfinance industry as 13 cooperatives provided access to financial services to flood victims resettled in Chitwan district. Following the success of these self-help concepts, more societies were promoted in other parts of the country. In parallel, rural finance institutions were established such as the Agricultural Development Bank of Nepal (ADBN), which aimed at providing credit and marketing support to agriculture modernization and development (AsDB, Manila and NRB, Kathmandu. 1994).

In 1974, the two state-owned commercial banks, Nepal Bank Ltd (NBL) and Rastriya Banijya Bank (RBB) were directed by NRB to invest at least a portion (first 5% to increase as high as 12%) of their deposit liabilities in the 'small sector'. This marked the beginning of the directed credit system in Nepal. In 1976, the scope of the small sector was broadened to include agriculture, cottage industry and services, and has since then been called the 'priority sector'. The credit didn't reach the poor, as only influential and well-connected people, with collateral, were able to access financial services linked to these programme. This led to the development of targeted initiatives, such as the Intensive Banking Programme (IBP) in 1981, initiated by government and NRB, through partnerships with commercial banks. Under this approach, group guarantee for loan repayment were used instead of physical collateral (AsDB, Manila and NRB, Kathmandu. 1994).

Starting in 1975, the Small Farmers' Development Programme (SFDP), implemented by the ADBN, mobilised farmers groups using a credit plus approach, and as a first experience of group-based lending. Unfortunately, it failed due to political pressure for a fast expansion, overemphasis on credit, high delinquency levels and the overall not satisfactory performance of the system (AsDB, Manila and NRB, Kathmandu. 1994).

In 1982, the Cottage and Small Industries (CSI) Project and the Production Credit for Rural Women (PCRW) provided new directions to priority sector lending, focusing on project viability rather than collateral, and therefore provided a financing window to the poor through commercial banks collaborating with local development organisations. The commercial banks perceived this programme as more of an obligation towards the NRB than a business interest (AsDB, Manila and NRB, Kathmandu. 1994).

In 1990, the government of Nepal established Rural Self Reliance Fund (RSRF), with the objective of providing wholesale loans to NGOs, cooperatives and financial intermediaries for on lending to the poor. The Microfinance Department of Nepal Rastra Bank (NRB) acted as the secretariat of the RSRF and management committee headed by the NRB deputy governor oversees the fund (Sinha S. 2000).

In 1992, the government of Nepal, following a recommendation from the NRB, established Regional Grameen Bikas Banks (RGBBs) in each of the five development regions of Nepal, modelled on the Grameen Bank methodology. The majority of the ownership of the RGBBs is in the hands of government, NRB and public commercial banks, while other private commercial banks have small equity stakes. During the same period, private initiatives led by NGOs, such as Nirdhan and the Centre for Self-help Development, also used the Grameen Bank methodology, resulting in a generally more efficient and successful replication. Other NGOs also gradually opted their participation and involvement in microfinance sector (Sinha S. 2000).

In the 1990s, with technical assistance from GTZ, local branches of the ADB/N under the SFDP, started to be reorganised into federations of small farmers groups and transformation of SFDB sub-project offices (SPs) at VDC level into Small Farmers' Cooperative Limited (SFCL); each operating as an autonomous cooperative (Sinha S. 2000).

With the promulgation of Development Bank Act in 1995, Nirdhan was the first NGO (1998) to transfer its microfinance portfolio into an autonomous microfinance rural bank namely Nirdhan Utthan Development Bank. Since 2000, three other microfinance rural banks were created through the same process first initiated by Nirdhan, with DEPROSC Development Bank (DDB) in 2000, Swabalamban Bikas Bank (SBB) Ltd and Chhimek Bikas Bank (CBB) in 2001. Acknowledging poor performance of RRDBs under public ownership, NRB started a restructuring program. As of December 2009, four of the five RGGs located in eastern, central, western and mid-western development regions are privatized. The post privatization performance of these RGBBs is yet to be seen (Dhakal 2007).

With a view to provide a source of wholesale fund to regulated MFIs (MFIs), government facilitated the establishment of the Rural Microfinance Development Centre (RMSC) which later on opened its lending to other microfinance service providers. Further, in order to create assured financing window to SFCLs, the government further facilitated the establishment of the Sana Kisan Bikas Bank (SKBB) under the Development Bank Act. The SKBB provide wholesale funds to SFCLs (Dhakal 2007).

Thus the government's direct and indirect interventions supported by donor assisted projects promoted the evolution of the industry. Lessons learned from each initiative were used as a base when designing subsequent strategies (Sharma S. R. and V. Nepal.

1997, Dhakal 2007). Important initiatives in the microfinance sector implemented by the Government are:

- Credit co-operatives established in the 1950s.
- Co-operative bank established in 1963.
- SFDP established under ADB/N (1975).
- Commercial banks required following priority sector lending directives (1974).
- The IBP involved commercial banks in micro-credit (1981).
- Gender based micro-credit – Production Credit for Rural Women (1982).
- Setting up of Rural Self Reliance Fund (1991).
- Gender programs refined involving NGOs – Microcredit Project for Women (1994).
- Replication of Grameen banking model (1992).
- Co-operative act promulgated to support the credit cooperatives (1992).
- Government-run MF programs - banking with the poor, Bisheswor with the Poor, Jagriti, Youth Self Employment, etc.

Microfinance regulation is mainly under the Banking and Finance Institutions Act (BAFIA) and the Financial Intermediary Act. MFIs are categorized as 'D' type financial institutions under BAFIA and the prudential norms are designed in line with normal financial institutions. Capital requirement is lower for MFIs. 13 microfinance banks, 2 wholesale MFIs and 16 credit co-operatives are regulated under this Act. The Financial Intermediary Act is designed to accommodate non-government organizations under regulation. Even though prudential norms have been designed, follow-up procedures are very weak. The Nepal Rastra Bank has not taken any action for non-submission of reports or non-compliance of regulations and 45 financial NGO's are licensed under the Act (Dhakal 2007).

Government of Nepal announced National Microfinance policy 2064 on May 4, 2008 and prior to that there was no formal policy as such. But informally or in scattered way government and NRB used to have various policy that governs microfinance operation such as Deprived Sector Lending (DSL) promoting MF by government itself by way of establishing Grameen Banks or emphasis on co-operative development, etc. The policy seeks to assist in poverty reduction through sustainable, simplified and access oriented microfinance services. The objectives of the policy are: increase the access of microfinance services for poor and weak financial status family and women group and conducting income generating and employment generation work, make microfinance service reliable and accessible through MFIs, help microfinance service supplying organizations to develop required capacity to be established in sustainable and self capable manner, formulate required law related to microfinance, and develop appropriate institutional mechanism to increase the microfinance service and to make such service disciplined (Dhakal 2007).

Microfinance providers have faced major challenges in extending their services to remote areas. Outreach of microfinance services has been stagnated in recent years as their expansion has been impeded among other by security concerns and lack of proven micro-lending methodologies (Dhakal 2007).

3.2 Role of the Government

State can have different roles for developing the microfinance sector. Because all roles are not equally effective and some roles may actually harm financial inclusion by discouraging private-sector delivery of services, state need to be well informed of risks and benefits of specific interventions and tailor their use to specific barriers that impede permanent financial services for the poor. For simplicity and proper analysis, their roles are broadly grouped into three: protector role, provider role and promotional role. A discussion on each of these roles follows hereunder.

Protector Role

State should play a protective role for developing microfinance sector. Legal and regulatory environment is the main tool for the state to demonstrate the protective role. Regulation becomes a necessity with development of microfinance sector in order to protect savers, allow MFIs to mobilize external resources and offer them an official recognition against their informal and sometimes unfair competitors. Regulation must strengthen microfinance movement and should not impede its development with rigid rules. Regulation should encourage innovation providing flexibility for institutional forms. Compared to commercial banks, transparency in financial accounting and objectives of sustainability should be the same among MFIs, but some aspects like liquidity requirements may be stricter given the seasonality of demand, dependency on donors' funds or short-term liabilities. Further, some rules may be more flexible such as recognizing concept of solidarity group as a guarantee and approval of uncollateralized loans. Furthermore, regulation of MFIs requires specific skills and more resources in order that traditional supervisory agencies can enforce prudential regulations. State has limited capacity to regulate mushrooming MFIs and there is a need to consider alternative form of regulators or promote forms of self-regulation, apex institution or third-party.

Proper functioning of the protector role of the state is most essential, because it builds trust and addresses imbalances between customers and financial institutions. Regulatory authorities have an important mission of developing appropriate prudential regulations or adapting existing banking regulations to protect solvency of large institutions that collect deposits from poor people, to protect their savings and build confidence on clients. However, regulatory ambitions must be balanced with available capacity to supervise, especially when determining which organizations should face prudential supervision.

The protection role of the state will be more challenging with the introduction of new products and services such as home mortgages, consumer loans, etc., delivery channels such as branchless banking, and players such as nonbank finance companies, telecommunication companies, retailers, etc. Protective regulation must be proportionate or appropriately "light touch" if it is to protect consumers against serious abuse while not prematurely impeding access or innovation. Other examples of effective protection include regulation to increase transparency in the sector.

Provider Role

In certain circumstances state should be engaged as a Provider of financial services to the poor and disadvantaged groups. Given that the performance of state-owned financial institutions and programs varies, there are cases where state has engaged as a direct Provider of financial services, especially subsidized credit, as one of the least efficient policy interventions for sustainable access. Such a role combines both financial and policy objectives. Although state owned microfinance services providers typically are expected to at least break even, they often do not because of policy objective challenges. Such institution tends to perform relatively better on outreach than profitability. They require massive periodic recapitalizations, demanding extensive public funding that could have served other policy purposes such as health or education or created incentives and support for private institutions to deliver pro-poor finance. Those institutions with stronger outreach often performed better financially. Having the state act as provider of financial services also may create unfair competition by offering subsidized credit and erode payment culture if collections are more relaxed. The state backed institutions can play a more positive role in providing payment or savings services than subsidized credit.

Where an extensive network of financial institutions already exists, role of the state could be to efficiently transform and restructure public institutions to strengthen structure of financial system. Likewise, when no rural banking network exists, there is an important role of the state in creating a minimum banking structure by developing public branches or incentive for commercial banks, where the private sector fails to adequately address demand of specific poorer segments of the population.

Promotional Role

State has many options to serve as promoter of financial inclusion. The model of integration of microfinance within public sector enables expansion of outreach among rural population. The development of MFIs as an alternative to deficient role of the state and market incurs lots of constraints that may limit their outreach. Under such circumstances, role of the state can be to invest in network building: a minimum banking structure can facilitate development of a rural financial system where complementarity between institutions increases outreach and sustainability. In terms of depth of outreach, neither integrated/complementary, nor alternative model of microfinance vis-à-vis the public sector adequately reach the poorest of the poor. This may arise from inherent limitations of microfinance as a tool to reduce extreme poverty. In this case, financial interventions are just part of a range of choices for development assistance seeking to reduce poverty.

For adopting innovations, model that integrates microfinance within public sector can help support its adoption as a public good. The state could play a role in implementing innovations such as microfinance services to agriculture or insurance services. Further, a balance of power must be created between state, local authorities and financial institutions through external control to avoid political intrusion while ensuring a dynamic adoption of innovation and sound financial practices.

Global best practices indicate that MFIs requires subsidies for start-up investment and network building and for other innovations such as micro-insurance schemes. Further, addressing extreme poverty requires complementary services such as infrastructure, education, health, etc. that can be offered through NGOs or state services, but independently from financial services.

Hence, the promotional role of the state can be both direct and indirect. The indirect promotion tools include policies and investments that benefit microfinance industry while not focusing exclusively on promoting fair competition, strengthening payment system, etc. State also may promote microfinance sector more directly by developing a national microfinance strategy, establishing local wholesale facilities that provide MFIs with financial and technical assistance or by supporting so-called deprived sector lending in the selected un-served remote areas.

3.3 State's Priorities in Microfinance Sector

In the context of developing Nepalese microfinance sector, state can play the protector, provider and promotional roles on a priority basis. A discussion on some of the priorities of the state on developing microfinance sector follows hereunder.

Complete phase-out of directed credit programs

While it is generally assumed that the old directed credit paradigm is out and the new paradigm of financial system development is dominant and widely accepted, Nepal continue to have significant directed credit programs or have re-introduced in one form or other (Youth Employment Program) to channel credit on sectors considered important for addressing poverty problems. Budgetary funds are used and part of the deprived sector lending resources is diverted on such purposes. Since, these programs insist on loan disbursement and are not very serious about loan recoveries, there is likelihood that the scheme may weaken financial institutions. They also damage potential for sustainable development of microfinance market primarily through weakening of financial discipline among borrowers and reducing incentives for operations by commercially oriented service providers. Therefore, it is essential for the governments to phase out such programs where they exist and stay away from those in future as a policy. The rush to substitute short-cuts for building sustainable microfinance systems is most likely to reduce social welfare of the poor in the long-term.

Support ICT development in rural areas

State's interventions are needed to support use of new information and communication technology (ICT) in rural areas because these can not only expand size of potential markets but also reduce transaction costs and risks for both clients and service providers. This is not only an "appropriate government intervention" but also "a more promising way to encourage sustainable rural finance than the old paradigm policies to induce more lending in rural areas" (Meyer and Nagarajan Vol. 3, p. 53). Supportive policies by governments are required to deal with emerging "digital divide" between urban and rural areas and enable rural financial institutions to take advantage of ICTs.

Allow more room for foreign equity participation

The state can also make a significant contribution to microfinance industry by liberalizing foreign investments in the industry. In general, most Nepalese MFIs still do not have a capacity to bear foreign exchange risk associated with borrowing in foreign currency. On the other hand many social investors are interested in investing their funds in microfinance industry but are unable to make equity investments in MFIs because of restrictions imposed by the state. For example, foreign equity participation is not permitted in rural banks although these banks suffer from inadequate capital for expansion and have potential to become dominant players in microfinance market. If governments can initially allow and facilitate equity investments by foreign social investors, this market could be more dynamic. The experience of equity investments of such social investors may be used to determine whether microfinance market liberalization should be deepened to include commercial investors.

Reform state-owned rural financial institutions

Nepal has taken effective measures to reform state-owned rural financial institutions and contributed significantly to sustainable development of microfinance industry. A notable example is the Agriculture Development Bank, two state-owned commercial banks (NBL and RBB), SKBB and GGBBs. Notwithstanding these, Nepal continue to rely on state-owned rural financial institutions that adopt old paradigm of subsidized credit and continue to undermine potential for sustainable microfinance. There is a need to take a fresh look at these institutions with a view to either reforming or liquidating them. Emerging evidence appears to suggest that their physical infrastructure can be effectively used to provide financial services for rural population including the poor, provided that state is willing and committed to introduce and implement essential reforms. The state has mobilized financial and technical support for such reforms from multilateral financial institutions such as Asian Development Bank, World Bank, etc.

Design Approaches to Microfinance Service Delivery

Only MFIs providing specialised and full cost priced financial products and services can provide sustainable financial services to the poor. Yet there has been great debate on approaches to microfinance programme design on aspects like (i) minimalist or integrated (i.e. financial services versus complete business development services) and designed under (ii) welfare or institutional development framework. Debate exist on whether MFIs should offer only financial intermediation (i.e. minimalist) or both financial intermediation and other services. Through MFIs adopting both *minimalist* and *integrated* approaches to microfinance service delivery coexists among MFIs, those MFIs using *minimalist* approach offer only financial intermediation and very much limited social intermediation services. Minimalist bases their approach on the premise that there is a single 'missing piece' for enterprise growth, usually considered to be lack of affordable, accessible short-term credit, which MFI can offer. Historically, micro-credit interventions started in Nepal mid 50s under governments' and donors' support with the objective to reach the greatest number of poor people and to provide them with financial services at a low cost. Initially the modality took a "welfarist approach" or "directed credit approach" in cognizance to wide believe that the key determinant of the poor demand for credit has been is costs and notion that poor lack ability to pay full cost services. The approach played counterproductive to growth and development of microfinance sector in Nepal and led to the evolution of a new approach commonly known as an "institutionalist approach" or "financial market approach" characterized by the will to liberalize financial markets; has strongly influenced financial reforms and emphasized that subsidies led to a worse allocation of financial resources, and to unsustainable institutions. The proponents of this approach seek to establish institutions offering microfinance services on sustainable and commercial bases. Programme seeking to work under this approach work only with the MFI with proven evidence of viability. Such MFIs are characterized by financial self-reliance, viability, charging high interest rates and reach large numbers of poor. The case of RMDC is the example to cite with. The welfarist approach and institutional approach still co-exist in Nepalese microfinance sector. While those implemented under welfare approaches (SFDP, PCRW, MCPW, etc.) are almost collapsed, those implemented under institutional approaches (RMDC, MDBs, SKBB, FI-NGOs, etc.) are performing better and possess prospects for viability. Those programme started under institutional approach struggle on improving their performance thereby find new sources of external funding to increase their loan portfolio in order ensure their financial viability; and providing services to low-income and poor people to reconcile their economic and social objectives. Hence, available evidence indicates that only those microfinance programmes started under institutional approaches are viable.

Microfinance and Poverty Reduction

There has been substantial progress over the last three decades or so in design and delivery of financial services to the poor on a sustainable basis. The clients' loan repayment capacity is a pre-requisite for any microfinance services to implement well. Clients must have the capacity to repay the loan under the terms by which it is provided. Otherwise, clients may not be able to benefit from credit and rather it will risk them being pushed into debt problems. This sounds obvious, but microcredit is viewed by some as "one size fits all". Instead, microcredit should be carefully evaluated against the alternatives when choosing the most appropriate intervention tool for a specific situation. In general, microfinance services assist the poor to break the vicious cycle of poverty. However, there exist evidences that microcredit is an inappropriate intervention in situations where conditions pose severe challenges to standard microcredit methodologies. In Populations that are geographically dispersed or nomadic; with a high incidence of debilitating illnesses (e.g., HIV/AIDS), depending on a single economic activity or single agricultural crop or reliance on barter rather than cash transactions, etc. are not suitable microfinance candidates. The presence of hyperinflation or absence of law and order may stress the ability of microfinance to operate. Microcredit is also much more difficult when laws and regulations create significant barriers (e.g. by mandating interest-rate caps) to sustainability of MFIs. Only the strong and innovative MFIs are able to operate even in extremely challenging circumstances. These providers uphold two prerequisites of successful microcredit: discipline both for clients (timely repayment) and institutions (business practices that lead to sustainability); and no subsidization of interest rates. There could be some alternatives to micro-credit that can assist poor to break the poverty trap.

Role of Regulation and Supervision in Microfinance

All the commercial MFIs are regulated to protect their depositors and prevent risks to financial system. Best practices principles has been that credit-only MFIs do not take deposits from public and are too small to pose much risk for financial system, hence, should not be regulated. Regulation by financial authorities is needed for MFIs that do take deposits. In effect, only the savings-based financial cooperatives or credit-based MFIs that want to start taking deposits to finance their growth are to be regulated. This is not the cases. In Nepal all the registered MFIs have been brought under the preview of regulations and supervision. As matter of fact, MFIs that do not take deposits do not need intensive regulation and supervision, but they do need a certain minimum regulatory structure in order to operate.

Donor Support on Microfinance Sector

Donors who support financial services for the poor are advised to search out MFIs that are committed to financial self-sufficiency. Sustainability is a cornerstone of sound microfinance. Financially sustainable MFIs can become a permanent part of financial system because they can stay in business when grants or soft loans are no longer available. To promote sustainable providers of financial services to the poor, donors' role has been to build the capacity of the microfinance programming. Donors should acknowledge that many small MFIs require institution-strengthening grants and technical assistance before they can reach the operational and financial self-sufficiency needed to sustain large-scale growth and they should not come forward with their own agenda to promote microfinance.

Capacity building is very much time-intensive and should include designing and implementing a MIS; cultivating strategic and human resource management; developing financial forecasting capability; instituting transparent financial reporting, internal controls, and audit practices; and implementing a product development process. For NGOs seeking to transform into regulated financial institutions, it also means creating a shareholder organization, attracting equity investment, and forming a strong board of directors.

Tendency of the donors to funding strong MFIs that already have access to commercial and quasi-commercial banks and investments from socially responsible investors (SRIs) need to be discouraged. The principal task of donors should be to identify and bet on promising but riskier MFIs, leaving the known winners to commercial investors. Country-level programming should be adjusted to facilitate funding of global or multi-country MFI networks. These networks provide much-needed technical assistance to their members while supporting industry-wide measures such as performance standards and transparency in financial reporting.

4. Summary and Conclusion

The status of the microfinance market clearly shows that the state has an important role to play in developing a sustainable microfinance industry. However, what precisely is the role of the state depends on context and realities under which microfinance operates. In view of this, the precise role for the state, therefore, needs to be defined based on thorough analysis of macroeconomic aspects, overall financial system and its performance, structure and performance of the microfinance industry, the stage at which industry operates at a given time and the environment within which it operates.

There are three school thoughts namely: laissez-faire school, interventionist school and moderate interventionist school, concerning the role of state in developing microfinance sector and state's involvement in microfinance sector is the function of macroeconomic instability, maturity of banking system, stage of development and structure of microfinance sector, size of the potential microfinance market and rural infrastructure.

The states' involvement on developing microfinance sector in Nepal dates back to mid fifties when government supported the cooperative movement. The involvement if the state gained momentum with the implementation of Intensive Banking Scheme in 1974, Small Farmers' Development Project in 1975 and Production Credit Project for Women in 1981 and further intensified with its engagement on promoting five Grameen Bikas

Banks (GBBs), with one GBB in each region, during early and mid 1990s. Further, state has funded and/or has been funding a plethora of new projects such as Biseshwor with the Poor, Jagriti, Youth Employment Programme, etc. at the retail level and result of such efforts has been rather not encouraging. The paper concluded that the outcome of involvement of the state on developing microfinance sector is mixed and suggested optimal roles state can play to foster permanent financial access for the poor and recommend that the states' role should be confined as an enabler and not as a direct provider of financial services.

State could have three broader roles: protectors' role, providers' role and promotional role that state can have on developing microfinance sector and has synthesized the menu of policy interventions for supporting inclusive financial access under each role. International practice highlights protector role of state as most consistently useful for developing permanent access to finance. The prerequisites for successful provider roles by state demand deeper analysis as government is quite keen to work in this capacity. Because state want to do more than protecting clients, it is useful for all stakeholders to consider further which promoter roles might be useful and effective. State could develop a vision of integrating microfinance into broader financial sector and articulating complementarity between private and public roles in building inclusive access to finance. The vision being developed could explore ways to promote expanded access to commercial financing. Such a vision should be anchored in a solid understanding of the stage of financial-sector development and key access gaps and obstacles, so that state can tailor interventions accordingly. A good diagnostic assessment that identifies barriers and institutional capacity should always precede selection of appropriate interventions.

State should play an important role in setting a supportive policy environment that stimulates expansion of financial services in remote areas while protecting poor people's savings and suggest that the states involvement should concentrate at maintaining macroeconomic stability, avoiding interest-rate caps, and refraining from distorting market with unsustainable subsidized and high-delinquency loan programs. State can also support financial services for the poor by improving business environment for entrepreneurs, clamping down on corruption and improving access to markets and infrastructure. At the most, in a very much specialized situation, state funding for sound and independent microfinance institutions in remote areas may be warranted when other funds are lacking and where enhancing access to financial services is one of the challenges for improved livelihood situation of the poor and disadvantaged groups.

References

ADB. 2000. "Finance for the Poor: Microfinance Development Strategy". Available at http://www.adb.org

AsDB, Manila and NRB, Kathmandu. 1994. "Nepal Rural Credit Review Final Report Volume 1 (Summary Report)", Kathmandu.

Charitonenko, S. and S.M. Rahman. 2002. '*Commercialization of Microfinance: Bangladesh',* Manila: Asian Development Bank. September.

Charitonenko, S. and D. de Silva. 2002. '*Commercialization of Microfinance: Sri Lanka (Draft)*', Manila: Asian Development Bank. December.

Christen R.P. and R. Rosenberg. 2002. '*The Rush to Regulate: Legal Framework for Microfinance*', CGAP Occasional Paper No. 4, Washington D.C.

Development Project Service Center, Nepal and J. Ledgerwood. 1997. "Critical Issues in Nepalese Microfinance Circumstances" IRIS Center, Maryland.

Dhakal, N. H. 2007. "*Towards Expanding the Frontier of Microfinance Services in Nepal*" a paper presented in an International Conference on Rural Finance Research: Bringing Research into Policy and Practices, organized jointly by FAO, IFAD and Ford Foundation during 19-21 March 2007 in FAO Head Quarter in Rome, Italy.

Dingcong, C.G. and L.M. Joyas. 1998. '*Profile of Philippine Microfinance NGOs: A Nationwide Survey*', Microfinance Coalition for Standards, Manila. August.

Fernando, N.A. 2001, *'Proliferation of Microfinance Institutions',* Finance for the Poor, Vol. 2. No. 3. Asian Development Bank, Manila. September.

Gonzales-Vega 1997. '*The New Development Finance*', Economics and Sociology Occasional Paper No. 2398, The Ohio State University. October.

Long, M. 1999. '*A 1999 Perspective on Finance and Development: Development Report 1989',* a presentation made at the Third Annual Seminar on new Development Finance at Frankfurt, Germany. September.

Meyer, R.L. and G. Nagarajan. 2001 '*Rural Financial Markets in Asia: Policies, Paradigms, and Performance'*, Oxford University Press, Hong Kong.

Rhyne, E. 2001. '*Mainstreaming Microfinance: How Lending to the Poor Began, Grew, and Came of Age in Bolivia'*, West Hartford, Connecticut: Kumarian Press.

Robinson, M.S. 2001. *The Microfinance Revolution. Sustainable Finance for the Poor*. The World Bank, Washington D.C.

_________ 2002. *The Microfinance Revolution. Vol-2, Lesson From Indonesia*. Washington DC: The World Bank & Open Society Institute.

Sharma S. R. and V. Nepal. 1997. "Strengthening of Credit Institutions / Programmes for Rural Poverty Alleviation in Nepal" ESCAP, Bangkok.

Sinha S. 2000. "Nepal Country Study in Asian Development Bank 2000" published in the Role of Central banks in Microfinance in Asia and the Pacific, ADB: Manila, 2000.

Stiglitz, J.E. 1993. '*The Role of the State in Financial Markets*', Proceedings of the World Bank Annual Conference on Development Economics, Washington D.C.: The World Bank.

The World Bank 1989. '*The World Development Report 1989'*, Washington D.C.: The World Bank.