

SUMMARY STRATEGIES FOR EXPANDING MICROFINANCE SERVICES IN HILLS AND MOUNTAINS

(Nepal: Rural Finance Sector Development Cluster Program [Subprogram 2])

A. Background and Rationale

1. In Nepal, the total estimated outreach of rural finance is approximately 1 million households against 2.7 households that require credit. There is an acute shortage of financial services in rural Nepal. Access to finance is especially limited in the hills and mountains. It is estimated that only 20% households in the hills and mountains receive credits from formal financial or semi-formal institutions,¹ and the rest of the households have no access to credit or can rely only on informal sources of finance such as money lenders, friends and relatives.

2. According to a study by the National Savings and Credit Development Program in Nepal, a community-based cooperative model is a cost-effective and sustainable approach to providing financial services to areas with no access to formal financial services. Empirical evidence suggests that microfinance services through cooperatives can be operated sustainably and are highly responsive to local needs. Most cooperatives have very low operating costs and charge affordable interest rates. However, cooperatives have limited outreach and require outside support and funding to increase their capacity and expand their outreach. Besides cooperatives, microfinance nongovernment organizations (NGOs), and self-help groups (SHGs) also serve the hills and mountains, but are limited as well in scale and outreach. External support is required to enable these institutions to bring viable microfinance services to the hills and mountain areas.

3. The Small Farmers Development Bank (SFDB) was established by transforming the Small Farmers Development Program of the Agricultural Development Bank of Nepal in 1987 under the institutional development program funded by GTZ. The key function of SFDB is to provide wholesale lending to Small Farmers Cooperative Limited (SFCL). SFCLs are the federations of the small farmer cooperatives, which are registered under the Cooperative Act (1992).

4. SFCLs have a three-tiered structure of small farmer groups, inter-groups and a main committee. Small farmer groups comprise 5–12 members and are the basic units of SFCLs. Small farmer groups collect savings from individual members every month and access credit needs of members. From each small farmer group within a defined area, one representative joins the inter-group. The main function of the inter-group is to recommend loans to the main committee and ensure timely recovery from members. The main committee approves loans for small farmer groups.

5. SFDB currently has 219 partner SFCLs for onlending. Of which, 50 SFCLs are operating in the hills and mountains. As a pioneer institution for wholesale lending to cooperatives, SFDB envisages expanding financial service outreach in the hills and mountains by further strengthening its partner SFCLs as well as extending to support other microfinance NGOs and self-help groups in those areas.

¹ Formal financial institutions include banks, development banks, micro-credit development banks, finance companies, microfinance NGOs and cooperatives that are licensed and supervised by the Nepal Rastra Bank, the central bank. Semi-formal institutions refer to microfinance NGOs and cooperatives that are registered under various non-financial legislation and not supervised by the Nepal Rastra Bank.

B. Strategies for Expanding Microfinance Services in Hills and Mountains

6. **Goal.** The goal is to make microfinance services more accessible to the poor in the selected hill and mountain districts and thereby reduce poverty.

7. **Objectives.** The objectives are to (i) improve the financial sustainability and outreach of microfinance institutions serving in the hills and mountain areas; (ii) raise the socioeconomic status of clients, especially women; and (iii) strengthen links to social development services.

8. **Activities.** The following activities will be undertaken to improve access to microfinance services in the hills and mountains:

- (i) **Selection of districts from the hills and mountains for the first phase of the program.** Hills and mountains districts, cooperatives, and microfinance NGOs will be selected on the basis of defined criteria. With the lessons and experiences gained in the first phase, the activity will be extended to other hills and mountains districts.
- (ii) **Mapping of cooperatives and nongovernment organizations operating in the selected districts.** The selected districts will be mapped and a detailed profile of microfinance institutions will be prepared. The profile for each institution will contain its name, address, contact number, date of establishment, date of operation, a short profile of its board and executive members and staff, the number of its members and clients, the name of the microfinance program implemented by village district committees, and 2-year audited financial statements. Data for the mapping will be collected from secondary sources (cooperative department, promoting agencies, NGOs, etc.). Mapping will also capture data on the number of SHGs and other informal groups, technical service providers in microfinance, vocational training, and income generation activities in the districts.
- (iii) **Institutional assessment and rating of microfinance institutions and identification of training and technical assistance needs.** On the basis of the information gathered through mapping, the potential districts and microfinance institutions will be selected for the institutional assessment. The assessment will establish the baseline data; analyze strengths, weaknesses, opportunities, and threats (SWOT) and identify the training and technical assistance (TA) needed to expand the outreach and improve the financial health of the microfinance institutions. The institutional assessment will cover: (a) vision, mission, goals, and objectives of the cooperative, as well as its annual action plan, financial plan, and long-term plan; (b) membership distribution, size, growth rate, and dropout rate, disaggregated according to gender; (c) products offered; (d) governance system; (e) bookkeeping and management information system; and (f) financial performance (repayment rate, delinquency rate, loan tracking system, operational, and financial self-sufficiency).
- (iv) **Design of training and technical assistance tools and capacity building of microfinance institutions.** The institutional assessment will allow the identification of training and TA needs and the design of tools and training to upgrade the capacity of the selected microfinance institutions. The experience of the SFDB and other agencies indicates that microfinance institutions may require TA to develop business plans, monitoring and evaluation systems, bookkeeping and management information systems, and training in member education, management and leadership development, SHG merger, and financial and

- delinquency management. Microfinance institutions will be assisted in applying the principles of community-based organization management.
- (v) **Wholesale lending.** Once the microfinance institutions have adopted appropriate accounting and record-keeping systems, microfinance operating policies and procedures, and business plans, and have trained their boards and staff to implement the program, SFDB will extend wholesale credit. The amount of the wholesale credit will not exceed internally generated resources (shares, savings, and other funds).
- (vi) **Development planning for microfinance institutions, and progress monitoring and reporting.** Cooperative development plans will be developed. Experience in promoting and strengthening cooperatives in Nepal has shown that it will generally take 3–5 years to turn microfinance institutions into sustainable community-based organizations. A model development plan is in Table 1.

Table 1: Model Cooperative and Microfinance NGO Development Plan

Stage 1: Year 1	Stage 2: Year 2	Stage 3: Year 3
Institutional assessment of microfinance institutions conducted; training and technical assistance needs identified	Business plan in place	New savings, loan, and insurance products developed to meet members' needs
Board and staff trained to manage a microfinance institution	Yearly review against the targets set in the business plan	Good financial management practices in place
Policies and procedure in place	Ratios and other financial management tools used to manage and evaluate progress	Wholesale credit provided on the basis of performance
Bookkeeping and management information systems in place to monitor progress	Wholesale credit extended	Business expansion (at least 20% growth in membership and internal resources)
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Source: Small Farmers Development Bank.

C. Wholesale Lending Eligibility Criteria

9. To be eligible for wholesale lending from SFDB, microfinance institutions should
- (i) have been rated by SFDB as category A or B institutions in accordance with SFDB's assessment criteria;
 - (ii) operate under a satisfactory business plan for rolling 3- to 5-year periods;
 - (iii) have satisfactory governance and internal control policies and procedures that clearly demonstrate their ability to manage and account for their financial intermediation operations;
 - (iv) not have outstanding delinquent loans to members of their boards of directors or staff, or to the families of directors and staff; and
 - (v) have shown satisfactory operational experience and financial performance in accordance with the indicators given in Table 2 for at least 2 years in each case as defined by the Nepal Rastra Bank (the central bank) or as commonly understood in generally accepted banking practice.
10. Wholesale lending from SFDB will be provided to those microfinance institutions that meet the specific financial and governance indicators (Tables 2 and 3). Microfinance institutions with insufficient financial and governance capacity will be supported with TA and training.

Table 2: Minimum Financial Eligibility Criteria for Wholesale Lending

Indicator	Minimum Level
Core capital ratio	≥2 %
Capital adequacy ratio	≥5 %
Ratio of internally generated funds to outstanding loans	≥30 %
Net worth	Positive
Operational self-sufficiency ratio	≥100 %
Financial self-sufficiency ratio	≥90%
Annual repayment rate on outstanding loans	≥90%
Number of active client members	≥300
Percentage of female client members	≥40%
Return on equity	≥1 %
Ratio of operational expenses to outstanding loans	≤ 5 %

Source: Small Farmers Development Bank.

Table 3: Minimum Governance Eligibility Criteria for Wholesale Lending

- (i) Business plan (3–5 years)
- (ii) Activities carried out to achieve the targets set in the business plan
- (iii) Up-to-date accounting and record-keeping systems
- (iv) No outstanding delinquent loans to board of directors, staff, and their family members
- (v) At least 2 years of successful operation of microfinance services in the hills and mountains

Source: Small Farmers Development Bank.

11. **Subborrower eligibility criteria.** A credit line from wholesale lending will be onlent to members of eligible borrower microfinance institutions. To be eligible for onlending, member subborrowers must

- (i) have been a member of the eligible microfinance institution for at least 6 months;
- (ii) have a track record of regular savings, participation in membership meetings of the eligible microfinance institution concerned, and a solid loan repayment history; and
- (iii) demonstrate the capacity and capability to undertake the activities for which the subloan will be extended.

12. **Subborrower lending limit.** Only one member of each household will be eligible for a loan. The loan limit per borrower will not exceed NRs60,000 for microfinance and NRs150,000 for microenterprise (the limits defined by the Nepal Rastra Bank). The wholesale lending will have the standard features and procedures shown in Table 4.

Table 4: Key Features and Procedures of Wholesale Loan

Name of loan	Wholesale loan for expanding microfinance services in the hills and mountains
Purpose of loan	To expand microfinance services to low-income households in the hills and mountains
Maximum loan amount	NRs5,000,000 or 10 times the amount of equity, whichever is less
Interest rate	An annual market-based interest rate, payable monthly, on the outstanding principal amount of each loan
Loan term	Maximum allowed: 24 months
No. of installments	Maximum allowed: Eight quarterly installments
Repayment schedule	No grace period; interest to be paid monthly and principal to be paid quarterly
Guarantee	(i) Institutional rating (only Small Farmer Cooperative Limited [SFCL]) cooperatives and nongovernment organizations that meet the financial and governance indicators in section C: Wholesale Lending Eligibility Criteria will be eligible for loans) (ii) Guarantee paper signed by the board of directors committing themselves to pay the outstanding principal and interest in case of the microfinance institutions' failure to pay (iii) Regular loan recovery procedures of the Small Farmers Development Bank (SFDB)
Client selection criteria for SFCLs/cooperatives	(i) Members with regular savings and good repayment history (ii) Low-income households (iii) Loans must be used to finance working capital, purchase of productive assets, and income-generating activities (iv) Loan limit per borrower will not exceed NRs150,000 (defined by the Nepal Rastra Bank as the maximum loan limit for microfinance clients)
Lending procedure	(i) The loan application must have been completed properly and signed by the concerned authority of the microfinance institutions applying for the loan. (ii) SFDB assesses the applicant microfinance institution to make sure that it meets the eligibility criteria. (iii) If the microfinance institution meets the eligibility criteria, then SFDB prepares the loan contract and disburses the loan. (iv) Loan utilization is regularly monitored and followed up. (v) Principal and interest amounts are collected according to the repayment schedule.

Source: Small Farmers Development Bank.

D. Expected Results

13. Table 5 shows the expected results of the program, including both small farmer cooperatives and other microfinance institutions.

Table 5: Expected Results

Indicator	Year		
	1 (base year)	2	3
Number of microfinance institutions	16	28	40
Total members and clients	10,105	20,125	30,250
Female members	60,000	12,500	19,000
Repayment rate (%)	>85	>90	>95
Operational self-sufficiency (%)	100	105	110
Outstanding loans (NRs million)	215	455	660
Lending from Small Farmers Development Bank (NRs million)	101	144	113

Source: Small Farmers Development Bank.