CEGS

DISCUSSION　PAPER　SERIES

No. 2015-CEGS-02

Policy Sector and Currnent Challenges of Microfinance in Nepal

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2016 年 3 月

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Current Challenges of Microfinance and its Policy Sector in Nepal

Abstract

This research describes the analytical picture of microfinance in Nepal by explaining the development process, modalities of microfinance institutions (MFIs) and various microfinance regulations. Furthermore, this research explores the current challenges of microfinance emerging in Nepal, and claims that institutional governance is the effective method to overcome most of those obstacles. Institutional governance is probably a new concept for microfinance in Nepal. It simply means the exercise of managing the political, social and economic matters and human interaction. Institutional governance helps to interact between different institutions—public and private, and contributes to put values on formal and informal rules which can finally contribute in order to address the current challenges that this research has identified. With a point of view of institutional governance, Nepalese microfinance sector needs clear vision and policy according to the heterogeneous modalities of microfinance institutions, and coordination between the Government of Nepal (GoN) and microfinance institutions to create the healthy environment of microfinance in order to contribute in poverty reduction in Nepal.

Keywords: Microfinance, Microfinance Institution (MFI), Nepal, Poverty Reduction, Government of Nepal (GoN), Nepal Rastra Bank (NRB), Regulations, Microfinance Development Banks (MFDBs)

Introduction

This research describes the analytical picture of microfinance in Nepal and observes the recent obstacles in microfinance in Nepal. As most of us know microfinance has been recognized as one of the effective tools of poverty reduction. Nepal also experienced the development of microfinance over the past two decades. The earliest initiatives for establishing microfinance in Nepal date back to the 1950's when the cooperatives were established to provide agriculture credit for the rural poor. However, the institutional development started in 1981 when the central bank of Nepal (Nepal Rastra Bank, NRB) introduced the intensive Banking Program and made commercial banks to allocate 3 percent of finance to the priority sector. In 1992, the Regional Rural Development Banks (RRDBs) was initiated by the Government of Nepal (GoN) and expanded throughout the country by establishing five RRB in five development regions of Nepal. So the period of two decades from 1990s is the milestone time for the development of microfinance in Nepal. Nepal is heterogeneous in terms of population density, per capita income, economic structure, economic and social development. Microfinance has also developed according to those heterogeneous socio-economic conditions. Now, according to the data of ADB 2010, 18 Microfinance Development Banks (MFDBs), 16 Savings and Credit Cooperatives (SACCOs) and 45 Microfinance NGOs (FINGOs) are providing microfinance services to the poor as formal microfinance institutions (MFIs) in Nepal. Simultaneously, there are several obstacles and challenges have emerged with the development of microfinance. This research focuses on those challenges and proposes a new idea of institutional governance to cope with those challenges such as lack of national data on microfinance, complicated policy related to microfinance, government's unnecessary interference, lack of fund, high interest on deprived sector loan, high tax rate, public deposit, complicated geographical environment, lack of commercial orientation, weak technical capacity, inadequate financial infrastructure, controlled legislative framework, weak coordination, lack of savings, voice is ignored, unhealthy competition, etc. This research has proved that institutional governance is one of the effective approaches to address these challenges properly in time.

Background to the Research

Definition of Microfinance

There are several ways in which to explain the definition of microfinance. The International Encyclopedia of the Social Sciences (2008) expresses microfinance as "Microfinance, also termed microcredit, refers primarily to small, development-oriented loans made to low-income borrowers with the aim of helping them to develop commercial activities or start businesses". The World Bank in its Microfinance Handbook has defined microfinance as "the provision of financial services to low-income clients including self-employees, includes both financial and social intermediation. It is not simply banking, it is development tool" (Ledgerwood, 2000).

The National Bank for Agriculture and Rural Development (NABARD) in India has defined microfinance as "provision of thrift, credit, and other financial services and products of very small amounts to the poor in rural, semi–urban, or urban areas for enabling them to raise their income levels and improve living standards" (Bashyal, 2008).

In simple words, microfinance is termed as the financial services rendered to the deprived groups of the people and small entrepreneurs in savings, credit, remittance, rural insurance, etc. to help them in developing self–employment opportunities and various income generating activities. Small size of loan, group savings, small-scale entrepreneurs, diversified utilization and simple and flexible terms on credit (without collateral) are the determining characteristics of microfinance.

The concept of microfinance mainly related to rural development and target group focused programs specially that of lending to agricultural and related business with an objective of attaining growth with social justice. People who normally live below poverty line demand such credit (Bashyal, 2008).

Microfinance has been particularly recognized as an effective development intervention for basic 3 reasons: (I) The services provided through microfinance can be targeted specifically at the poor and the poorest of the poor (II) These services can make a significant contribution to the socio–economic status of the targeted community and (III) The institutions that deliver these services can develop within few years, into sustainable organizations with steady growing outreach. Moreover, the purposes of microfinance can be distinguished in four ways: (a) Poverty Alleviation, (b) Promoting Agricultural Production, (c) Investing in Small Entrepreneurs, and (d) Empowerment of Women.

Development of Microfinance in Nepal

Nepal is one of the least developed countries in the world having US$ 426.48 GDP per capita (World Bank, 2014). The Nepalese economy is predominantly an agricultural economy. Around 80 percent of the population lives in the rural area of the country engaging in the agricultural sector. The average GDP growth rate of the agricultural sector is 1.0 percent (ADB, 2007). Although more than 80% of the population is involved in agricultural sector, the growth rate is comparatively low. By the end of Tenth Year Development Plan, in 2007, about 31 percent of the population was found to be living below the poverty line which was 42 percent before the Ninth Year Development Plan (Sigdel, 2007). At the declaration of Microfinance Summit Nepal 2010, the average number of the poor people has come around 25 percent. But it could not be distinguished as the real aspect of the poverty reduction, it might also the result of the income gap between the rich and poor people in Nepal.

Nepal has been witnessing planned development efforts since the last more than five decades. The objectives envisaged in most of the plans aim at reducing poverty since the Sixth Five Year Development Plan in 1980. However, the intensity of poverty in the country calls for massive and genuine efforts. Microfinance is one of the effective tools for poverty reduction.

The microfinance sector in Nepal has expanded considerably in recent years. The earliest initiatives for establishing microfinance services in Nepal can be dated back to the early 1960s when the first credit cooperatives were established and primarily intended to provide credit to the agricultural sector (Sinha, 2001). So the cooperative movement became the first vehicle of microfinance in Nepal, as 13 cooperatives provided flood victims access to financial services adapted to their specific needs. In parallel, rural finance institutions were established such as the Agricultural Development Bank Limited (ADBL)[1], which aimed at providing credit and marketing support to agriculture.

In 1974, the two state-owned commercial banks, Nepal Bank Ltd. and Rastriya Banijya Bank were

[1] The former name of ADBL is Agricultural Development Bank of Nepal (ADBN). ADBN has converted to ADBL after it was distinguished as Class ‘A’ financial institution according to the Bank and Financial Institutions Act (BAFIA), 2006.

directed by the central bank, Nepal Rastra Bank, to invest at least a portion (first 5 percent to increase as high as 12 percent) 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 the program. This led to the development of targeted initiatives, such as the Intensive Banking Program (IBP) in 1981, initiated by the government and the central bank, through partnerships with commercial banks. Under this approach, group guarantee for loan repayment were used instead of physical collateral.

Starting in 1975, the Small Farmers Development Program, implemented by the Agricultural Development Bank of Nepal, mobilized farmers groups using a credit plus approach, and was the first experience of group-based lending in Nepal. 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.

In 1982, the Cottage and Small Industries Project and the Production Credit for Rural Women all 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 organizations. The commercial banks perceived this program as more of an obligation towards the central bank than a business interest.

In 1990, the GoN established the Rural Self–Reliance Fund (RSRF), with the objective of providing wholesale loans to NGOs, cooperatives and other financial intermediaries for on lending to the poor. The Microfinance Department of NRB acts as the secretariat of the RSRF and management committee headed by the NRB deputy governor oversees the fund.

In 1992, the GoN, following a recommendation from the NRB, established Regional Rural Development Banks (RRDBs) in each of the five development regions of Nepal, modelled on the Grameen Bank methodology. It is called Grameen Bikash Bank (GBB). The majority of the ownership is in the hands of government, Nepal Rastra Bank (the central bank) 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 Center for Self-help Development, also used the Grameen Bank methodology, resulting in a generally more efficient and successful replication. In the 1990s, with technical assistance from GTZ, local branches of ADBL under the Small Farmer Development Program, started to be reorganized into federations of small farmers groups, the 'Small Farmer Cooperatives Limited (SFCL); each operating as an autonomous cooperative.

With the promulgation of the Development Bank Act in 1995, Nirdhan was the first NGO (1998) to transfer its microfinance portfolio into an autonomous microfinance rural bank (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 in 2000, Swabalamban Bikas Bank Ltd and Chhimek Bikas Bank in 2001. Acknowledging the poor performance of the GBBs under public ownership, the central bank started a restructuring program, which will lead ultimately to the privatization of the five GBBs.

With the view of providing a source of wholesale fund to regulated microfinance institutions (MFIs), the Rural Microfinance Development Center (RMDC) was established in 1998, and later on opened its lending to other MFIs. In 2001, the Small Farmer Development Bank (SFDB) was established under the Development Bank Act to provide wholesale funds to Small Farmer Cooperatives Ltd. (SFCLs), which were formed after the transformation of Small Farmers Development Projects, promoted under the Small Farmers Development Project, into cooperatives. SFDB is owned by ADBL, the Ministry of Finance, two commercial banks, and a group of SFCLs. It is envisaged that SFCLs majority ownership will grow over time.

Generally, the MFIs in Nepal can be divided into two types: i) Community Based MFIs, such as SACCOs and SFCLs; ii) Commercial Oriented MFIs, such as MFDBs, GBBs, FINGOs, etc. So there are several modalities of MFIs in Nepal.

Modalities of Microfinance Institutions in Nepal

There are several models of MFIs that exist in Nepal. Every model has important contribution in the financial sector of Nepal.

1. Small Farmer Cooperatives Limited

   Previously it was the Small Farmer Development Project under ADBL, which has been transferred to the local community under the Cooperative Act, 1991.

2. Priority Sector and Deprived Sector Credit Programs

   There is the mandatory provision for all commercial banks to disburse 2% and 3% of the total loan portfolio to priority and deprived sector credit program respectively. By mid-July 2007, the priority sector credit program phased out.

3. Rural Microfinance Development Banks

   To provide the banking facilities for the socio-economic upliftment of the deprived people in the rural areas, 5 regional rural development banks (GBBs) were established with the initiative of the government (CBN) and some other financial institutions. Later, 4 private sector MF development banks (Nirdhan, Swabalamban, Deprosc and Chhimek) were also established.

4. Financial Intermediary Non-government Organizations (FINGOs)

   Out of about 10,000, only 47 NGOs are licensed by CBN for financial intermediary. They usually form the groups and collect deposit through MFIs as well as they obtain wholesale credit from MFIs and disburse it to the group members.

5. Savings and Credit Co-operatives

   The cooperatives have been introduced in Nepal since 1956. About 8000 cooperatives are registered in Cooperative Department of the Government of Nepal. Some near about 2600 cooperatives are involved with the savings and credit programs. Of them, only 19 cooperatives are licensed by CBN for limited banking transaction and 199 cooperatives are associated with RSRF (Rural Self Reliance Fund).

6. Wholesale Microfinance Institutions

   RSRF: To increase the income and render employment opportunity for the deprived people in the rural areas, GoN has established the Rural Self Reliance Fund (RSRF) in 1991 with the seed capital fund of Rs. 20 million and added another Rs. 20 million in 2004/05.CBN has provided a total amount of Rs. 253.40 million from its profit in this fund in different periods. In F.Y. 2006/07, the Government of Nepal is injecting the amount of Rs. 50 million in the fund. RSRF provides the wholesale credit for on-lending purpose to the deprived people through MFIs, cooperatives and NGOs and long-term loan to the sector like tea, cardamom and cold storage through ADBL.

   RMDC: To provide the wholesale loan to MFIs, Rural Microfinance Development Centre (RMDC) is established in 2000.

   SKBBL: To provide the wholesale loan to Small Farmer Cooperative Limited (SFCL), Sana Kisan Bikas Bank Ltd. (SKBBL) is established in 2002.

7. Donor Sponsored Microfinance Programs

   There are 6major donor funded MF programs those are running in the country of which are now in inactive stage. They are PCRW, MCPW, TLDP, PAPWT, RMP and CGISP. All these programs are focused to reduce poverty and have contributed to the facilitation of MF to the targeted groups and assisted in capacity building.

   PCRW: To improve the socio-economic status of rural women by accessing them to institutional loan for their productivity, the project Production Credit for Rural Women (PCRW) was launched in 30 November, 1982.

   MCPW: To increase the economic status of the rural and urban women by providing micro-credit for their micro business, the project Micro-Credit Project for Women (MCPW) was launched in 15 December 1993.

   TLDP: To increase the income and employment of the rural poor by engaging them in livestock management and productivity, the project Third Livestock Development Project (TLDP) was launched in 1997.

   PAPWT: To increase participation of the deprived poor in Western Terai for their socio-economic upliftment, the project Poverty Alleviation Project in Western Terai (PAPWT) was launched in 1998.

RMP: To increase the socio-economic status of rural poor, the project Rural Microfinance Project (RMP) was launched in 1998.

CGISP: To increase the agriculture productivity by providing the irrigation facilities to the deprived community's farmer for the poverty alleviation program, the project Community Ground Water Irrigation Sector Project (CGISP) was launched in March, 1999.

There are different opinions about the typology of microfinance institutions. Some scholars say two types: formal and informal MFIs; and some say three kinds of MFIs: formal, semi-formal and informal. In recent days, some practitioners distinguish MFIs in 2 types: (1). Community Based: SACCOs, SFCLs, and (2). Commercial Oriented: MFDBs, GBBs, FINGOs. This research will mainly distinguish the MFIs of Nepal in three types 1) Formal MFIs: Government/NRB mandated models and rural development banks, 2) Semiformal MFIs: NGO and Savings and Credit model with external fund and, indigenous model, SACCOs, Microfinance Development Banks, National Cooperative Development Bank, and 3) Informal MFIs: landlords, friends, relatives.

Policies and Regulations Related with Microfinance in Nepal

Microfinance is an effective tool for reducing poverty, and for making microfinance effective, appropriate microfinance policy is needed. Furthermore, it is also important to cover the demand of microfinance at the local level, and make it easy to access for the poor. There is no single statement by the government addressing this challenge; statements by industry associations or by the central bank which can also include Nepal's national microfinance policy. Policy is the statement and commitment made by the broader stakeholders who provide direction, regulation, promote best practices and also makes provision of supervision. In the Nepalese case, those stakeholders could be:

- The government
- Central bank of Nepal
- The donors
- The industry groups such as Nepal Microfinance Banker's Association (NMBA), National Federation of Saving and Credit Cooperatives (NEFSCUN), Microfinance Association of Nepal (MIFAN)

The Development Bank Act- 1995 and Financial Intermediary Act- 1998 were the instances of some regulation related to MF sector. The prudential regulation for MF development banks came into existence in 2003. This regulation became effective from January 2004 with some amendments. Followingly, BAFIA- 2006 permits to run MF business while 1st Amendment of Financial Intermediary Act (1998)- 2002 facilitates FINGOs for doing limited financial intermediation as small savings, group savings, micro-credit and agent banking.

a. Nepal Rastra Bank Act, 2002

b. Bank and Financial Institutions Act (BAFIA), 2006

c. Cooperative Societies Act, 1992

d. Financial Intermediaries Act, 1998

e. NRB Directives for Microfinance Institutions, 2003

a. Nepal Rastra Bank Act, 2002

This Act defines the role of NRB in formulating effective policies, developing secure, healthy and efficient payment system, regulating, supervising and inspecting banking and financial institutions and promoting and striving of a credible banking and financial system. It prohibits NRB to buy share of CBs or financial institutions. NRB, however, plays a developmental role through a special fund, the Rural Self-Reliance Fund (RSRF), which operates with and interest rate below market rates. NRB's financing role through RSRF undermines the steady development of other apex institutions in rural and microfinance sectors. The justification for continued operation of RSRF is based on the need for serving weak institutions that cannot meet the eligibility criteria of criteria of other wholesale lending institutions.

b. Bank and Financial Institutions Act (BAFIA), 2006

This umbrella Act, “Bank and Financial Institutions Act” (BAFIA) came into force in 2006 and it replaced the Bank and Financial Institutions Ordinance (BAFIO) of 2004. All the commercial banks, development banks, finance companies, microfinance development banks are regulated under this umbrella act as Class A, Class B, Class C and Class D institutions, respectively. A small Microfinance Development Bank (MFDB) can be established with a paid up capital of Rs. 10 million to operate in three districts outside Kathmandu valley. For operating in 4-10 districts outside Kathmandu, the MFDB has to have paid up capital of Rs. 20 million and for a national level MFDB the paid up capital must be at least Rs. 100 million. MFDB can increase the number of districts if it could increase paid up capital. For an adjoining additional district, it requires to increase paid up capital by Rs. 2.5 million. The promoters can retain 70% of the share capital and they must float the remaining 30% share to the general public. An MFDB operating in 10 districts with a capital of Rs. 20 million can operate in other five districts in the hills without any additional capital. This umbrella Act has a provision for even a foreign bank or financial institution, in joint collaboration with a Nepalese organization or citizen or through its subsidiary organization having its full share, can provide microfinance services in the country with the permission from NRB and the Government of Nepal. Under this act, NRB has the responsibility to supervise, warn the Board of Directors and even take over management in case some wrong things happen to a bank and also initiate actions for liquidation if required by circumstances.

c. Cooperative Societies Act, 1992

The Cooperative Societies Act was introduced in Nepal in 1992. Under this Act, cooperatives can be formed with 25 persons as its members. These autonomous institutions are entitled to formulate their own bylaws or operational procedures through their General Assembly (GA) meetings. Each cooperative will have a Board of Directors and an Accounts Committee (AC) consisting of members duly elected by the members through General Assembly using one-man one vote principle. The term of Board members and members of Account Committee (AC) is also determined by the GA but not exceeding 5 years. The Board appoints a management team or prescribes other body that carries out the day-to-day activities of a cooperative. The AC is responsible for internal audit and accountable to General Assembly for accounting and financial operations. Under the act, the Department of Cooperatives is fully authorized to register, supervise, appoint auditor, take necessary actions for improvements and reforms and liquidate all types of cooperative societies.

d. Financial Intermediaries Act, 1998

In 1998, NRB introduced the Financial Intermediaries Act in order to regulate the financial intermediary NGOs carrying out microfinance activities. This was claimed to be a significant step in boosting up NGOs to undertake microfinance activities for the poor. However, this Act did not permit FINGOs to accept savings deposits from their clients, which is considered to be a vital aspect for sustainable operation of microfinance services. Consequently in 2001, this act was amended allowing FINGOs also to accept saving deposits from their members. According to this Act, an NGO intending to carry out microfinance activities is required to obtain license from NRB. The FINGOs need to maintain a minimum of Rs. 100,000 as their capital to get license. After receiving license from NRB, they can apply for funds from the wholesale lending institutions, such as RSRF, RMDC and Commercial Banks. The FINGOs are required to renew their license every two years. The NRB is responsible for supervision of the FINGOs to ensure that they are performing well to the interest of the target groups and the institutions that provide them financial support.

e. Nepal Rastra Bank (NRB) Directives related to Microfinance Institutions

NRB issued ‘Directives’ for the microfinance institutions with the objective of promoting healthy, organized, transparent and standard operation of microfinance banks. The main features of the ‘Directives’ are summarized under the following headings:

Minimum capital adequacy requirement:

• 4% primary capital (paid up capital, share premium, general reserve, retained earning loss)

• 8% primary and supplementary capital (loan loss provision, asset revaluation reserve and other reserve)

Fund mobilization:

• It can mobilize fund up to 30 times of core capital through group savings, borrowing and debentures.

Compulsory reserve and liquid assets:

• It is required to maintain compulsory minimum reserve of 0.5% of total borrowed fund with NRB or any other Class A Commercial Bank.

• It is also required to maintain liquid assets of 2.5% of individual, group and special saving of members. The liquid assets are defined as cash reserve at hand, investment in government bonds, investment in NRB bonds and deposit in commercial banks.

Expansion of Branch and Geographical Area

• MFDBs must take permission from NRB prior to expanding branches and geographical areas.

Norms of Corporate Good Governance

• MFDBs should clearly spell out rules for the appointment of Board of Directors and CEO and specify their functions and job responsibilities.

Loan Limit to Individual Group Member

• Extension of loan up to NRs. 60,000 per member without collateral security.

• Extension of loan up to NRs. 150,000 to individual member for starting microenterprise with collateral security.

Interest Rate and Service Charge

• MFDBs are given freedom to fix interest rate on deposit and loans and advances, service charge and penalty interest rate for overdue loans.

Reporting Requirement

MFDBs, FINGOs and Cooperatives licensed by NRB are required to report to the Financial Institutions Regulation Department and Bank and the Financial Institutions Regulations Department according to the Unified Directives and other directives related to MFIs. If they fail to comply with the prudential norms of reporting or reporting late, they are penalized according to the Bank and Financial Institutions Act (BAFIA), 2006. Non Bank Financial Institution Supervision Department of NRB is supposed to monitor and supervise the operations of the MFDBs and other forms of MFIs. However, owing to the lack of adequate manpower and trained staff it has not been able to discharge these responsibilities effectively and many MFIs are short of complying with the requirements of the NRB Directives.

f. Financial Intermediaries Regulation 1999

After the promulgation of Financial Intermediary Act 1998, the Nepal Rastra Bank introduced Financial Intermediary Regulation in 1999, which was amended in 2003. The regulation has specified the documents to be submitted by an NGO to the NRB for obtaining a Financial Intermediary license along with Rs. 25 as license fee. As per the regulation, it has to be renewed every two years by paying Rs.100 as renewal fee. The FINGO has to classify outstanding and overdue loans in four categories such as good, sub-standard, doubtful and bad, and create a reserve for loan loss provision. There is no need to make provisions for good loans (0-3 months) however for the other categories, the rate of loan loss provision should be 10% for substandard loans (3-6 months), 50% for doubtful (6 months to 1 Year) and 100% for bad loans (above one year) at the end of the fiscal year. The regulation has restricted the FINGOs to purchasing shares and debentures without NRB permission taking loan by board members and their family members and purchasing fixed or movable property for commercial purpose.

Analytical Framework of the Research

Recently, governance related issues and inclusive microfinance are hot topics in Nepal. The practitioners of microfinance say that the role of the government is much more important to develop the microfinance sector effectively. Traditionally, the term "governance" was used in reference to governments and large companies; the term governance is now applied to microfinance among other areas. Governance in microfinance sector generally refers corporate governance. Governance is defined broadly as the system of people and processes that keep an organization on track and guides major decisions. Governing bodies define and uphold the organization's goals and mission, guide major strategic directions, manage risks, maintain an organization's health over time, and ensure accountability throughout the organization (CGAP, 2010).

According to OECD (1999), corporate governance is typically defined as a system, or a set of mechanisms, by which an organization is directed and controlled. However, corporate governance is insufficient to cover diversified development of microfinance and heterogeneous MFIs. So this research has proposed a new concept of governance, institutional governance by which all kinds of MFIs and policy and governance related with GoN as policy maker and MFIs as practitioners. Concept of institutional governance covers the public and private aspect of governance. In public aspect, governance represents as policy maker and control the MFIs. In other hand, in private aspect, governance represents MFIs which operate through the policy made by public aspect and control internal management of private aspect. The concept of institutional governance is the coordination of these public and private aspects of governance which still lack in the sector of microfinance in Nepal. Before discussing the concept of institutional governance in detail, this research has observed the current challenges of microfinance in Nepal.

Current Challenges of Microfinance in Nepal

As this research describes the background with analytical observation of the development of microfinance in Nepal and, modalities and regulations of MFIs, this research has found several challenges emerging in the current situation of Nepalese microfinance sector.

Lack of National Level Data on Microfinance

The national level of data and survey on the microfinance sector has not been available yet. Furthermore, the study, research and the informative aspects are weak in microfinance sector. Without these progressive phenomena, it is difficult for the microfinance institutions to achieve the objective of poverty reduction, one of the top priorities of the GoN.

Complicated Policy Related to Microfinance

As described before, microfinance institutions run under different Acts such as Bank and Financial Institutions Act (BAFIA), Co-operative Societies Act, Financial Intermediaries Act, etc. Hence, it is confusing and complicated for the institutions as well as for the users too. The GoN should come up with a single legal framework of microfinance to cope with the complexity of the policy.

Government's Unnecessary Interference

The GoN sometimes announces some policies which disturbs the financial activities of MFIs. The government arbitrarily announced the policy considering the poor people such as exemption of loan, Biseshwor with the Poor, Jagriti, Youth Employment Programme, etc., which do not encourage the MFIs and affect their management system.

Lack of Fund

According to the direction of NRB, commercial banks, development banks and finance companies have to provide deprived sector loan by 3, 2 and 1.5 percent of their transactions to microfinance institutions (MFIs) respectively. However, credit on micro hydro, hospital, youth for employment & small housing is countable in microfinance which is almost half of the resource altered for MFIs from last year. MFIs are expanding areas in villages, and unreached districts but resources are limited. The NRB and the government should deeply initiate availing at least 3 percent of deprived sector loan to the MFIs.

High Interest on Deprived Sector Loan

As formal microfinance regulator of the country, the Central Bank of Nepal, NRB has set the policy of deprived sector loan for the resources of fund to the MFIs. According to this policy, every commercial bank, development bank and financial companies have to provide 3, 2 and 1.5 percent of their transactions in low interest rate (3-5%) respectively. However, in recent days, according to the interview of the related persons from the MFIs, those banks have raised their deprived sector lending rate (6-9 percent) which is the higher rate for the microfinance institutions. Due to high interest rate, cost of funds has increased, has had negative impact on poverty reduction and makes it difficult for MFIs to their microfinance services. So the government of Nepal should take effective steps to reduce deprived sector lending rate to strengthen the microfinance institutions in their quest for broader service areas.

High Tax Rate

As it is mentioned before, according to the Bank and Financial Institutions Act (BAFIA), 2006, all financial institutions are divided into four categories by the NRB. MFIs lie in category "D". In these categories there are different types of rules for their establishment, but the corporate tax is same as for other commercial banks. The profit of MFI's is lower than other banks and financial companies. The GoN charges a corporate tax rate of 30 percent which is a maximum higher rate for MFIs. If the Nepalese government exempted corporate tax for MFIs, the rebate amount of tax would be used to expand services to poor families, institutional strengthening and capacity building of its staff as well as client too.

Public Deposit

The BAFIA 2006 has a provision that microfinance institutions can accept public deposit with the approval of the NRB. It has been essential that public deposit be opened to maintain the fund scarcity. However, the NRB is positive. It has collected some deposit from the members in small amounts and is learning the banking transaction to the poor. In other South Asian countries like Bangladesh, public deposits have been continuously and successfully permitted. Hence, Nepal should follow other countries' good examples.

Complicated Geographical Environment

Nepal is a geographically diversified country. The southern part of the country, Terai is a plain area which covers approximately 20 percent of the country, and the rest are mountainous and hilly regions. While lack of cultivatable land is the biggest challenge for the hilly and the mountainous regions, the difficulty of constructing infrastructure constrains economic development. In particular, the lack of adequate transportation has hindered area development projects. In contrast, projects in the more easily accessible parts of the hilly region and the Terai region have met with success. The microfinance program is no exception.

Lack of Commercial Orientation

One of the significant challenges is the orientation of commercialization. Through the case study, it was clear that neither the MFI staff nor the customers have commercial thoughts towards microfinance activities. By observing through the monthly center meeting, nearly one third of the members were absent and so other members paid for them. Center meeting is important for the users, for paying their installment and getting approved or the new loan. In contrast, bank staff was not so persuasive by including the absent members. They claim it is difficult for them to control the discipline of the meeting.

Weak Technical Capacity

Another burning challenge is the weak technical capacity. The operating system is done mostly by hand. Thus, it is inefficient, time-labor consuming and an expensive operating cost. To cope with this problem, it is inevitable to have a skilled staff, which is also helpful for the capacity development of the users.

Inadequate Financial Infrastructure

Financial viability[2] refers to the capacity of MFIs to provide continued access to financial services in the long-term. To do this, MFIs must ensure that the savings and credit services provided meet the needs of their clients and do so in a financially sustainable manner. To reach financial viability, effective financial management is required including: ensuring that there are enough capital funds to meet credit demand; generating adequate revenue to cover operating costs (financial self-sufficiency); and maintaining useful and accurate financial reports (financial reporting). Continued reliance on subsidies impedes ability of an MFI to reach financial viability. Mostly, MFIs in Nepal have access to adequate capital funds. The main exceptions are indigenous NGOs / SACCOs and those organizations providing financial services in more remote areas. To be financially self-sufficient, an MFI must generate enough revenue to cover all of its costs and earn enough excess revenue to increase its capital base (retained earnings) in order to provide services to a growing client base with increased financial needs. Expenses of the MFIs include: operating costs; financial costs; loan losses and the cost of capital. The primary source of funds to cover these expenses is interest revenue generated by loan portfolio. At present, most Nepalese MFIs are not financially self-sufficient. The inability of the Nepalese MFI to reach financial viability is primarily attributable to low rates on loans, high loan losses, lack of well-trained staff and small client base. To achieve financial self-sufficiency, MFIs must reduce their loan losses, develop more efficient operating procedures and increase their outreach. In addition, interest rates should be increased to a level where they will cover all costs based on the most efficient delivery of services[3].

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2 Financial viability refers to the capacity of the MFIs to provide continued access to financial services in the long-term.

3 During the initial stages in the development of a microfinance institution, costs will be greater than revenue. Clients should not be expected to pay interest rates high enough to cover these initial costs i.e. the first three to five years, nor should they be expected to cover the costs of inefficient operations.

Controlled Legislative Framework

The policy framework for inclusive finance is fragmented. The legislative and regulatory requirements are extended even to very small providers of financial services to members. There is even a debate on whether Savings and Credit groups at village level should be registered and supervised to receive external credit. While consolidation and stream-lining is taking place under the reform projects and the limited supervision capacity of the Central Bank is recognized, the new Microfinance and Co-operative Ordinance appears to remove the supervisory responsibility for MFIs and SACCOs from the Central Bank, counter to their integration in an inclusive financial sector.

Weak Coordination

The financial service providers have not coordinated their efforts to any large extent, neither in terms of outreach (mapping, expansion planning) nor performance (no industry performance monitoring takes place). The top-down regulatory environment does not encourage lateral collaboration and protectionism and to some extent competition has been seen to hinder the sharing of experience for mutual benefit. The microfinance network, Microfinance Association Nepal (MIFAN)[4] established in 2001, failed after a couple of years, mainly due to a lack of clear vision, commitment and funding. At present, there is no network of Financial Services Providers (FSPs) serving the Bottom of the Pyramid (BOP) – the poor and the low-income population. Limited coordination extends outside of the industry; coordination among donor agencies, with and within the government is also weak. Overall consensus among all stakeholders and adherence to performance-based, results-oriented good practices in a sector approach to the development of an inclusive financial sector has yet to be attained.

Lack of Savings

MFIs provide credit to the poor who invest in the formal or informal sectors to generate income. A good indicator of a successful investment is the savings generated. Microfinance programs in Nepal have largely failed to help the borrowers manage their savings. The MFIs researched for the case study, have comparatively low savings than loans by observing their progress figure.

Ignored Voices

Sometimes the voice of MFIs is ignored by the government. Especially, when the customers of MFIs want to get some skill training, the MFIs hardly achieve the cooperation from the government.

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[4] Microfinance Association Nepal (MIFAN) is reorganized at 2007 with the participation of 10 FINGOs. This organization mainly focused on expanding memberships to all NGOs as financial intermediaries (FINGOs) as soon as possible, and to cordially invite all financial NGOs to join the association.

Unhealthy Competition

As ascertained before, microfinance focus especially in Terai region breeds the challenge of unhealthy competition among the MFIs and severe duplication. Some customers get the loan from various MFIs. MFIs are only focusing to increase the outreach and forget the real objective of microfinance. This exacerbates the problem.

Institutional Governance

As stated before, Institutional governance is the exercise of managing the political, social and economic human interaction. There are few scholars who defined the institutional governance. The definition of Dahal (1996) on governance also supports the definition above to some extent. He stated that "Governance applies to the exercise of power in a variety of institutional contexts, the objects of which is to direct, control, and regulate activities in the interests of people as citizens, voters and workers"(Dahal, 1996: p.5).

As described before, the general concept of governance is state-focused, and corporate governance is firm (corporation)-focused. However, each concept ignores what has been developed by the other. In order to discuss the institutional governance of MFIs, the linkage of the state and each financial institution is important. So the concept of institutional governance should include two dimensions; the public dimension as a government policy on microfinance, and the private dimension as MFIs' internal rules and management. The linkage of the indicators of institutional governance will be discussed later.

Institutional governance is applicable for various institutions including social norms and human relations. Rules and regulations are created to be obeyed. However, some informal elements such as culture, life-style, geographical variations, and informal rules of society are difficult to measure the extent of being followed since they exist exogenously. Institutional governance is inevitable for putting value in sharing and co-operating those informal rules. So it needs the mechanism of informal rules, discipline and interest for functioning the formal policies, rules and regulation. In this regard, institutional governance is important for the different sizes of MFIs, which corporate governance lacks. As a supportive factor for the above explanation, Canadian International Development Agency (CIDA) explains that governance encompasses the values, rules, institutions, and process through which people and organizations attempt to work towards common objectives, make decisions, generate authority and legitimacy and exercise power.

Indifferent from this definition, the concept of corporate governance in microfinance seems to provide a benchmark for strategic planning and control (i.e., the objectives), and it provides a specific benchmark for each institution rather than "a standard for the industry" (Labie and Mersland, 2011). As there are several types of financial institutions, as well as MFIs with various objectives, it is difficult to deal with the development of MFIs by the general governance theory. Furthermore, the theory of corporate governance is also insufficient to handle the challenges of MFIs, as it is quite obvious that microfinance is practiced by a wide variety of organizations, not all of whom have the same priorities. So the concept of institutional governance is appropriate to gain the main objective of microfinance institutions—achieving financial sustainability and financial self-sufficiency in order to address several challenges that have emerged in current microfinance sector in Nepal.

Conclusion and Recommendation

There is no doubt that microfinance is one of the effective tools for poverty reduction in Nepal. As this research shows Nepal has witnessed tremendous development of microfinance within two decades since 1990s. However, the development of microfinance has also created several obstacles and challenges that this research has shown in detail. As the hot discussion of governance and concept of inclusion microfinance, it is nearly impossible by ignoring the concept of institutional governance. Every MFI operates internal rules, regulations and management by itself whether NRB also draws up microfinance acts and policies without particular consultation from MFIs, and lack of coordination between MFI and the GoN often occurs. Unless these two aspects link each other, sound development of microfinance should be difficult in Nepal.

The governance of microfinance also has been addressed in two aspects; general governance and cooperate governance. However, each concept is insufficient to tackle the issues in MFIs because of the MFIs' unique features (Kayastha, 2012). The main objective of MFIs is reducing poverty but they also pursue profits as financial institutions. These two goals seem incompatible, but by improving the institutional governance, both goals can be achieved. Institutional governance is a very wide concept which has public aspect and private aspect but the concept contributes to the link between the government and MFIs by addressing both aspects.

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