EMERGING ISSUES IN NEPALESE MICROFINANCE SECTOR

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Abstract

This paper explores emerging issues on microfinance in Nepal and strategies towards developing a sustainable microfinance sector through a review of the state of the art on developing Nepalese micro-finance sector. The paper has concluded that historically Nepal witness microfinance as an anti-poverty and development tools and demonstrated a significant paradigm shift on the sector beginning late 1990's and it forward departure as an industry, which benefit thousand of the poor people, poor women, micro-entrepreneurs and peasant farmers and anticipate that the industry should transform further as a lucrative business providing financial services for the poor. In order that all these changes will happen the paper has identified emerging issues such as policy on macro-economy and financial system stability, regulation and supervision of microfinance sector, institutional capacity building, expanding the frontier of microfinance services in remote areas, introduction of ICT, encroachment or unfair competition and financial viability and uncovered the clear need to address these issues properly and in time.

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. Formal microfinance in Nepal emerged in 1956 with the emergence of cooperatives that started providing savings and micro-credit services to their shareholders. Government also recognized potential role of microfinance services on addressing poverty problems and in 1974 Nepal Rastra Bank (NRB), the central bank, directed the then two state-owned commercial banks to invest at least five percent[2] of their total deposits in small-scale finance. In 1975, the Agriculture Development Bank of Nepal (ADBN) launched Small Farmers Development Project (SFDP), as a first project to introduce the concept of group guarantee as a substitute to physical collateral for microlending[3].

The official policy that recognized importance of microfinance sector on poverty reduction came in the Sixth Plan (1980/1 - 1984/5) and then-after both government and nongovernmental sector developed and implemented number of programs to ensure access to formal credit to the poor; particularly to poor women. The microfinance sector gained momentum after 1990s wherein number of microfinance service providers (MSPs) increased exponentially with the entry of local NGOs and microfinance development banks (MDBs) in the market.

At present, four major types of MFIs namely Savings and Credit Cooperatives (SCCs), Small Farmers' Cooperatives Limited (SFCLs), Financial Intermediary NGOs (FI-NGOs) and MDBs; and large numbers of SCGs are active in Nepalese microfinance sector. In addition to these MFIs, there are over dozen of rural development programmes with credit component to provide financial services to the poor. Thus, over last two decades,

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[2] Currently NRB requires commercial banks to invest three percent of their total deposits in deprived sector.

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

Nepal witnessed a significant development of microfinance initiatives. This rapid proliferation is a result of success story of microfinance in providing financial services to a large number of poor clients who do not have access to formal financial institutions in rural areas. As a development tool, microfinance is considered as one of the important financial resources for poor people to conduct household economic and income generating activities, which can reduce their vulnerability and allow them to accumulate capital and hold valuable assets. In another perspective, microfinance also means of helping micro-entrepreneurs to expand their businesses to the point of becoming viable business and eligible for credit from commercial banks. However, it is irony that microfinance services are confined to a greater extent among small relatively less poor segment of rural population living in accessible districts and large number of poor and vulnerable poor living in remote hills and mountain districts are yet to be serviced through microfinance services.

This paper explores emerging issues on microfinance in Nepal and strategies towards developing a sustainable microfinance sector. The paper is organized into five sections as: introduction, the development of microfinance, microfinance as a part of financial mainstream; emerging issues and conclusions.

2. The Development of Microfinance

Nepalese microfinance is gradually building out of a lesson learned from the mistaken policies in the past. The initial development of microfinance (popular term was rural finance) was highlighted by supply-leading finance paradigm which emphasized on subsidized credit program for supporting peasant farmers in rural areas and massive donor-funding for alleviating chronic poverty. The approach has been gradually shifted into market-driven which focuses more on providing financial services including voluntary saving products to economically active poor and micro-entrepreneurs.

2.1 Supply Leading and Poverty Lending Approach

Rural development issues have been intensively discussed since mid 1950s. Economic development experts recognized that a critical element of development strategy was to stimulate food cultivation, rural development, rural incomes and rural employment. Therefore, the economic development program should encourage adoption of modern technology in agricultural activities and use of production inputs such as seeds, fertilizers and pesticides. Moreover, to enhance economy growth in the rural areas, the farmers needed credit to attain the production inputs. Supply-leading approach assumes farmers either lacks of capital and/or did not have enough access to financial sources, if any they were charged high interest rate by informal sources to obtain production inputs therefore there should be a system that was available to supply loans and inputs required to cultivate improved varieties of crops at subsidized interest rate. In doing so, rural financial institutions like Agricultural Development Bank, credit cooperatives, Intensive Banking Programme, Production Credit for Rural Women, Microcredit Project for Women, etc. were designed and implemented with primarily orientation in the provision of credit to farmers and was tied to specific agricultural packets or technologies. However, the supply-leading strategy had temporarily succeeded in disbursing credit to the target groups but it failed to achieve objectives to serve the rural poor and to be sustainable credit institutions.

With a similar perspective to combat chronic poverty, international donors and development institutions have developed anti-poverty initiatives pioneered by Professor Muhammad Yunus through Grameen Bank in Bangladesh. The poverty lending approach focuses on reducing poverty, through providing micro-credit and other complementary services to the poorest of the poor particularly women at very low cost (subsidized). The Grameen Bank model has been replicated and used in many developing countries but their sustainability has been questioned because they much rely on funding and grants

from donors which is relatively limited. In addition, the interest rates on micro lending are too low to achieve cost recovery and thereby requiring frequent recapitalization for long-term operation.

2.2 Demand Driven and Financial System Approach

Various empirical studies have uncovered that repressive financial system and subsidized loan approach for rural development had actually been counterproductive thereby demanding for a new approach derived from market-based concept. The financial system approach focuses on demand of commercial financial services of the poor borrowers and savers. The transformation of NGOs into commercial microfinance institution (Nirdhan, CSD, DEPROSC, Chhemek, and many financial intermediary NGOs) is the foremost examples of the financial system model that is currently active in Nepal. These institutions provide easy access to credit at reasonable interest rate to economically active poor and micro-entrepreneurs and offers convenient and safe saving services to them that want to store cash and to gain positive interest rate on their investment. Generally, loan portfolios are financed by savings, profits and commercial lending, in some cases only limited funds come from donors. This model is geared towards enabling MFIs reach financial self-sufficiency and expands outreach of services to low-income clients profitably. However, there is a growing critic on this approach particularly on its roles in serving bottom layer of the poor and expanding services to inaccessible hills and mountains.

3. Microfinance in Financial Mainstream

Inevitably, microfinance industry is becoming mature and more dynamic, associated with market changes. Recently, microfinance sector has changed radically and will continue to develop over the next several years as there are millions of poor demanding financial services for livelihoods. To challenge their needs, microfinance industry must move beyond from credit oriented to be more variety products and services such as deposit facilities for accumulating capital and investment, payments services, money transfer and foreign exchange transactions. In addition, there is a concern of other financial services such as micro leasing as an alternative for business financing and micro insurance for coping with risk. Furthermore, Marguerite Robinson in her book The Microfinance Revolution, Sustainable Finance for the Poor also states "The microfinance revolution is a commercial revolution, based on new financial technology and greatly accelerated by information revolution that developed concurrently". This implies that there is a need to combine advance financial technology and the rapid development of information and communication technology (ICT) to driven microfinance industry to be part of modern financial mainstream.

3.1 Balancing between Credits and Savings

The root of microfinance was micro-credit which most of discussions, initiatives and activities focused on how to deliver credit and how to assure money safe in the hands of poor people. Moreover, as microfinance sector has become mature at the one end and because of growing needs of deposit services by clients at the other end, many experts, practitioners and donors starting to put their interest on deposits (voluntary savings) mobilization.

From the perspective of a MFI, savings mean source of funds that can be lent to borrowers. In this context, higher saving rate will increase MFI's flexibility to expand its loan portfolio, which can lead to higher profitability. In reverse, lower savings capacity will diminish MFI's ability to increase business as well as profitability. Savings is cheaper funds if deposit services are priced properly. There are ample international examples (e.g. BRI-Unit and Credit Unions in Latin America) showing that the cost of fund of saving tends to be lower than interest rate in money market. In other words, higher

savings will allow MFI to set up competitive interest rate on lending and reasonable profit margins. Introducing savings facilities may improve outreach and expanding new services and products. A stable savings can liberate MFI from donor and government aids in order to achieve self-reliance financing for long-term operation as well as lower liquidity risk. Saving can maintain balanced governance. The presence of net savers will create a pressure on management of MFI to conduct a prudent operation that can lead to public confidence and stability of the institution.

There are several critical issues that should be addressed in establishing savings mobilization. First, savings mobilization can't gain momentum on the absence of sound macro-economy and financial sector environment including an appropriate legal, and regulatory and supervision framework. Second, this requires strong governance, ownership, and institutional structures demonstrating good management. Third, it does not function well on the absence of advance financial management capabilities that focus on liquidity and risk management practice. Fourth, there is a need to introduce market-oriented products and mechanisms that fit preferences of poor clients. Finally, human resource empowerment through capacity building program as well as incentive system on staff performance is very important.

3.2 The Role of ICT

There is no doubt, that ICT has rapidly transformed the way of human life and provided huge opportunities and advantages including for microfinance industry. Recent ICT developments have allowed MFI to increase outreach and operational coverage, lower overhead cost and provide more affordable and flexible financial products and services to more poor clients.

Like other financial sectors, information is part of microfinance industry. MFIs, whether manually or computerized, deal with large amounts of important business data and information, such as client information, financial transactions, portfolio statistics and so forth which of those must be maintained, manipulated and managed for making sound management decisions. Management information system (MIS) is a critical factor for the success of MFI. Through a good MIS, MFI will be able to access and analyze information more efficiently and to streamline and shorten flow of information and in time decision-making process.

In addition, the forces of ICT development allow MFIs to create better products and services with more options. One of good example is smart card with embedded microchip allows MFI shorten transaction times and to track consumer information as well as to overcome limitation of online network. The development of Internet, mobile phones and wireless communication technology have been instrumental to transform MFI to provide services, and communicate with clients, among themselves and to the world. Indeed, ICT is a powerful tool but also source of problems if it does not properly designed and implemented. In addition, lack of internal controls, poor staff morale and inadequate infrastructure will generate potential trouble for microfinance institutions. However, Nepalese MFIs are at the stage of infancy on using the ICT.

4. Emerging Issues

Microfinance has been regarded as one of the key vehicles in achieving the "The Millennium Development Goals" by 2015. All the key stakeholders of the microfinance movement both nationally and internationally have focused their attention to strengthen microfinance industry and provide sustainable access of poor people and micro-entrepreneurs to financial services. in order to support the achievement of this global movement, future of Nepalese microfinance should focus on establishing a policy environment conducive to microfinance, developing regulatory and supervision framework, institutional capacity building, expanding services to remote areas,

introduction of ICT on microfinance sector, and addressing issues of encroachment/unfair competition and attaining financial viability.

4.1 Policy on Macro Economy and Financial System Stability

Stabile macro economy and financial sector are the pre-requisites for developing sustainable microfinance industry. In view that success of microfinance depends on state of development of other sectors; the government policy should focus, among other, on provision of infrastructures, education and skill development and job creation. The governments also put more attention on how to control inflation rate and establish appropriate regulations that focus on interest rate reforms particularly on credit and savings. In addition, it is also important to educate bureaucracy and the public about microfinance and its importance for the economy and for development.

4.2 Regulation and Supervision

The regulation and supervision function should focus on maximizing the functions of the industry in providing financial services for poor clients. This requires that the regulatory and supervisory framework is flexible and provide incentive both for clients and service providers. First, the regulation and supervision system should balance a number of objectives and interest of different parties. It should protect the financial system from unsound practices that can have domino effect on whole financial system particularly MFI which heavily rely on funds from commercial banks or other financial institutions. Second, it should protect and provide legal support to small depositors that save their money at MFI. Third, it should promote industry in which regulation and supervision may attract more deposits from public and may be able to obtain financing at lower cost. Finally, it should protect public funds in case liabilities of MFI are covered blanket guarantee from government or by public deposit insurance.

4.3 Institutional Capacity Building

Strengthening institutional capacity is one of key issues for sustainability of microfinance sector. Strong institutions together with good governance will be able to provide good quality financial services to poor, increase their outreach significantly and achieve financial self-sufficiency. Some of the issues to be addressed on institutional capacity building includes: improvement on management capacity which more autonomous and adapting sound governance practices and operation and procedures that focus on increasing efficiency, lowering transaction cost, improving client satisfaction, and ensuring that earned income covers operating and financial expenses; enhance management information systems and accounting policy; strengthen internal supervisory system and audit capacity that is integrated with daily operation and routines; develop risk management framework with a comprehensive strategy for arrears and fraud prevention; develop human resources though career development, training and corporate culture incorporated with promotion/incentive system to motivate employees; provide adequate physical infrastructure, convenient offices close to customers so that they can access the services relatively easily; and products development suitable to the market and offers incentive to customers.

4.4 Expanding the Frontier of Microfinance Services to Remote Areas

Nepalese microfinance sector is reaching 37% of its potential market with access concentrated in accessible areas and virtually no or limited access in inaccessible hills and mountains and concluded that expansion of microfinance services to a large number of un-served and under-served micro-entrepreneurs and poor households living in remote districts is yet a challenge. While commercial MFIs are quite successful to penetrate their services in urban and densely populated peri-urban areas, community based MFIs have comparatively better penetration in relatively inaccessible areas.

Further, there are over 100,000 SCGs throughout Nepal, irrespective of remoteness, yet to be used at their full potential.

Existing service delivery cost structure is a barrier to commercial MSPs to expand their services in remote areas; while such impediment either does not exist or are at minimum among community based MSPs. Innovation to reduce operating cost is one of the prerequisites to expand microfinance services of existing MSPs in inaccessible hills and mountains. Further, products and service delivery methodologies deter commercial MSPs to expand their services in inaccessible hills and mountains, while capacity and resource constraints undermine potential of community based MSPs to intensify their services in their working areas and expand their services in more remote areas. Business linkages of commercial MSPs with large number of informal SCGs that even exist in inaccessible hills and mountains areas as well as partnership of apex institutions with community based MSPs on capacity enhancement and access to loanable fund is most effective and efficient alternatives to expand microfinance services in these areas. Such an effort will be instrumental to promoting inclusive financial services in Nepal.

4.5 Introduction of ICT in Nepalese Microfinance Sector

Use of ICT is very much limited in Nepalese microfinance sector due to lack of capacity and affordability. As a result of this there is problem on portfolio tracking, introduce and comply with best practice reporting standard as per international best practices. Accurate and timely information assist MFI to know their status in time and start the corrective action in time. These is greater need to introduce portfolio tracking system and proper use of internet, mobile phones and wireless communication technology to properly for the operational decision making on microfinance operation. It should be mentioned that lack of proper use of ICT will eventually turn into a problem to the MFI. Any MFIs choosing to automate their services should provide extra focus on appropriate use of ICT.

4.6 Encroachment or Unfair Competition

Encroachment[4] is gradually emerging as an issue in most accessible areas of the Terai where numerous MFIs operate and compete for very few existing clients. It is further exacerbated by political interference encouraging loan disbursement to people who may not be appropriate clients for services being offered. Most suggest the creation of a central body to designate specific areas to specific MFIs so as to address the issue of encroachment. However, this may not work properly in most cases.

The most prudent measures could be - in any given area, there is a range of microfinance clients requiring varying products and services. Most specifically, loan sizes will vary depending on borrowers' activity and their level of income. The demand for financial services amongst the poor is substantial, providing a significant number of clients for all MFIs. Provided MFIs clearly identify the target markets and design their products and services accordingly, allowing clients to freely choose the best provider, there should be no encroachment problems. This however, requires a marketplace which is free of distortions/imperfect conditions.

In order to address the issues of encroachment and unfair competition, there is a need to develop a means of information sharing amongst MFIs whereby lists of clients/members of each MFI are shared among each other and allow MFIs to determine their most appropriate target market and corresponding products and services.

[4]Encroachment is defined as the attempt by one MFI to capture borrowers from, or disseminate false information about, another MFI.

4.7 Financial Viability

Financial viability[5] refers to the capacity of MFIs to provide continued access to financial services in the long-term. In order to do this they 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 a MFI to reach financial viability. For the most part, MFIs in Nepal have access to adequate capital funds. Main exceptions are indigenous NGOs / SCCs and those organizations providing financial services in the more remote areas.

To be financially self-sufficient, a 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 and/or clients 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 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[6].

Interest rates charged by most MFIs are below existing market rates. Given the relatively small volume of loans, it is infeasible that a MFI could cover its costs with below market rates. In fact, most successful MFIs around the world charge significantly higher than market rates and are able to maintain significant outreach and sustainability. There is a need to increase interest rates charged by MFIs without any loss of outreach.

The inability of many MFIs to reduce their loan losses is partly attributable to a lack of credit discipline and a lack of "ownership" felt by clients. Clients that do not expect continued access to financial services often fail to repay their loans. This not only results in high loan losses, but also reduces interest revenue. Loan losses should be kept to a minimum of 2% in order to reach financial self-sufficiency.

Dedicated and qualified staff is also important factor in achieving self-sufficiency. Appropriate training, compensation and accountability are imperative to the success of MFIs. Committed staff providing valued services which meet the needs of their clients is the best way to ensure self-sufficiency of MFIs. There is a need in Nepal for greater commitment to a "business approach" to microfinance rather than a "social banking approach".

As the client base of a MFI increases, financial self-sufficiency becomes easier to achieve as economies of scale are reached. However, the growth of a MFI should be gradual, as the organization develops its products and delivery mechanisms to suit the clients. Sustained growth will only be achieved as MFI accurately assess the needs of the market and manage their activities accordingly. As MFIs grow, they will require increased access

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

[6]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.

to capital funding. With financial self-sufficiency comes increased access to capital sources through commercial banks[7], allowing for continued expansion of services.

5. Conclusions

Historically Nepal witness microfinance as an anti-poverty and development tools. There is a significant paradigm shift on microfinance sector beginning late 1990's and it witness the movement forward as an industry, which benefit thousand of the poor people, poor women, micro-entrepreneurs and peasant farmers. In the future, microfinance industry will transform further as a lucrative business providing financial services for the poor. This realization requires that emerging issues such as policy on macro-economy and financial system stability, regulation and supervision of microfinance sector, institutional capacity building, expanding the frontier of microfinance services in remote areas, introduction of ICT, encroachment or unfair competition and financial viability is addressed identified in this paper is properly and timely addressed.

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[7]Commercial sources will lend to financially self-sufficient microfinance organizations as the risk is of non-payment is reduced in a self-sufficient organization.