FRONTIER OF MICROFINANCE SERVICES IN NEPAL

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ABSTRACT

This study uncovered that 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[1] 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 microfinance institutions (MFIs) are quite successful to penetrate their services in urban and densely populated peri-urban areas, the community based MFIs have comparatively better penetration in relatively inaccessible areas. On the other hand, over 55,000 Savings and Credit Groups (SCGs) promoted by government and non-government sectors exist throughout Nepal irrespective of remoteness, but not fully used up to the potential level.

Existing service delivery cost structure is a barrier to commercial MFIs to expand their services in remote areas; while such impediment either does not exist or are at minimum among community based MFIs. Innovation to reduce operating cost is one of the pre-requisites to expand microfinance services of existing MFIs in inaccessible hills and mountains. Further, products and service delivery methodologies deter commercial MFIs to expand their services in inaccessible hills and mountains, while the capacity and resource constraints undermine potential of community based MFIs to intensify their services in their working areas and expand their emergence and growth in more remote areas. Business linkages of commercial MFIs 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 MFIs 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.

1. INTRODUCTION

Nepal has developed considerable history in the provision of 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 microcredit 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

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

(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 non-governmental 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 MFIs 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. Despite significant innovations to extend financial services to the poor and excluded, microfinance services has been 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.

After documenting the context and realities on microfinance operation and landscape of MFIs, this research reviews product and service delivery methodologies, outreach, cost structure, efficiency and productivity and portfolio quality of leading MFIs and assesses their comparative advantages to expand the frontier of microfinance services in inaccessible hills and mountain areas.

This research is based on information collected from both primary and secondary sources. Secondary sources of information includes both published and unpublished information obtained from NRB, MFIs and microfinance programmes while primary information are collected through consultations with key stakeholders and survey of microfinance service delivery units (MFIs) - 48 SCGs, 14 SCCs, 7 SFCLs, 4 MDBs and 3 FI-NGOs - from 16 districts[4] representing mountains, inaccessible hills, accessible hills and Tarai using criteria such as age of operation, products, services, operational policies, pricing, leadership and management capabilities to ensure homogeneity and make appropriate comparision.

Information collected from secondary sources was used to map breadth of outreach of microfinance services and analyze distribution of microfinance services across geographical regions. Product and service delivery methodologies, outreach, cost structure, efficiency, productivity and portfolio quality of five different were modalities computed to assess their comparative advantages to expand the boundaries of microfinance services in remote areas.

This report is divided into five sections: Introduction; Context and Realities on Microfinance Operation; Landscape of Financial Service Providers; Assessment of Microfinance Operation; Constraints and Opportunities to Expand the Frontier; and Conclusions.

[3]AsDB and NRB. 1994. "Nepal Rural Credit Review Final Report Volume 1 (Summary Report)", Kathmandu.
[4]These districts are: Jumla, Rasuwa, Taplejung , Dolakha (mountains), Myagdi, Bhojpur, Lamjung and Dailekh (inaccessible hills), Dhading, Kavre, Makawanpur and Baglung (accessible hills) and Jhapa, Sunsari, Rupandehi and Kailali (Tarai).

2. CONTEXT AND REALITIES FOR MICROFINANCE OPERATION

Nepal is one of the 14 Least Developed Countries of the Asia Pacific region and one of the poorest countries (per capita GNI is $260) in South Asia. Nepal endorsed the Millennium Development Goals and set a target to reduce absolute poverty to 21% by 2015 from 42% in 1996[5]. Poverty incidence decreased from 42% in 1996 to 31% in 2004[6] indicating significant progress on poverty reduction in the recent years. The difficult topology, the feudal history, and inequality in income[7] and human development by-passed rural populations in remote areas and excluded the indigenous and occupational groups from access to basic services. Over 90% of the poor[8] live in rural areas and a majority of them live in inaccessible hills and mountainous areas. Microfinance is one of the targeted programmes experimented by the government for poverty reduction. The Poverty Reduction Strategy Paper/the 10th Plan focuses on accelerating income and employment opportunities in rural areas and address the issue of social, economic and financial inclusion.

With approximately 25.6 million populations in 2006, administratively Nepal is divided into 5 development regions, 14 zones, 75 districts, 3915 village development committees (VDCs) and 58 municipalities. Based on state of development as well as environment, people, economy, customs, culture and access, Nepal can be divided into four almost parallel regions viz. mountains, inaccessible hills, accessible hills and mountains.

There exist great variations across geographic regions with Tarai the most potential and mountains the least. Tarai and accessible hills have comparative advantage on microfinance operation due to dense population, good transport network, high quality and existence of high per capita high quality cultivated land. Limited infrastructure and market access, remoteness, sparse population, climatic conditions, less arable land and limited but specialized economic potentialities complicated provision of microfinance services in remote areas where demand for microfinance services is higher than in Tarai and accessible hills due to poverty and deprivation.

Table 1: Key Features of Geographic Regions in Nepal 2004

S.N.	Geographic Regions	Districts (NO)	Population (%)	Land Area (%)	Population Density (People/Km^2)	Cultivated Land (%)	Income Index	Human Poverty Index
1	Mountains	16	6.8	35.2	29.8	1.7	0.402	49.8
2	Inaccessible hills	17	14.0	18.4	117.9	9.8	0.437	43.2
3	Accessible hills	22	30.1	23.3	200.2	19.5	0.471	36.7
4	Tarai	20	49.1	23.1	329.2	70.0	0.420	39.6
	Total	75	100.0	100.0	155.0	100.0	0.429	39.6

Source: Nepal Human Development Report 2004 and Central Bureau of Statistics, 2005.

Nepal is the eleventh poorest country in the world and it is one of the least developed counties among South Asian countries[9] in terms of key indicators of well being. Incidence of poverty is characterized by limited entitlements, access to assets, education, health facilities, economic infrastructure, savings, and access to paid employment. It is predominately agrarian and rural economy, with over 66% population depending on agriculture sector for livelihood,

[5]GON and UNCT. 2002. "Progress Report 2002: Millennium Development Goals, Nepal" Kathmandu.
[6]GON NPC and the UN: "Nepal Millennium Development Goals (MDG) Progress Report", September 2005.
[7]The Gini coefficient increased to 41.4 in 2004 from 34.2 in 1996.
[8]GON: National Living Standards Survey 2004
[9]World Bank. 2000. "World Development report 2000/01: Attacking Poverty" World Bank, Washington.

which contributes over 39% in the GDP[10]. Most people are subsistence farmers, managing to grow enough to feed their families and sell a small surplus, which buys a few necessities like salt, tea, and cloth. Rice, maize, mustard and wheat are grown in Tarai and accessible hills and millet, barley and potatoes are grown in more remote districts. The rural economy is characterized by stranglehold of low income, low savings and low investment where the infusion of credit can be a major key to break this structure[11]. However provision of microfinance services embodied by different challenges is not straightforward in rural areas.

Table 2: Well-being Indicator in 2004

Particulars	Unit	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Life expectancy	Years	64.9	63.3	62.2	63.9	74
Adult literacy	%	49.2	61	48	53	92.5
Poverty Incidence	%	40.9	26.1	30.8	23.9	22.7
GDP growth	%	3.7	5.4	1.6	3.9	4.8
Per capita GNI in PPP	$	1980	3347	1470	2160	4000
Per capita GNP	$	440	620	260	736	1025
Population growth	%	1.7	1.5	2.2	2.0	1.3
Foreign debt	Million $	18778	113467	3253	38345	10238

Source: SARAAC Poverty Profile 2005 http://www.saarc-sec.org/data/pubs/rpp2005/ and World Development Report 2006 www.worldbank.org/wdr/ .

Nepal faces considerable development problems and challenges. Agricultural productivity is low and declining due to population pressure on marginal land. Nepal's limited resource base, rapid population growth, environmental degradation, low level of social development and widespread poverty reinforce development challenges. The ability to expand cultivable land for sustainable crop production, often at the cost of forest resources, is gradually diminishing. Opportunities in non-agricultural sector remain largely unexploited due to lack of resources. Access to financial services is limited, more so among women and further hindered by geographic limitations in remote areas. Improvements in infrastructure, markets, communication facilities, skills training, information, and financial services are required to increase the benefits of microfinance services, allowing microentrepreneurs, particularly women, to improve their economic status in those remote areas.

3. LANDSCAPE OF FINANCIAL SERVICE PROVIDERS

This section defines scope of microfinance operation as they relates to landscape to financial service providers with a brief discussion of informal financial sector, followed by an overview of formal financial sector as it pertains to provision of microfinance services and a 'snapshot' of microfinance sector.

3.1 Informal Financial Sector

Nepalese informal financial sector includes either individual lenders such as landlords, merchants, farmer-lenders, goldsmiths, pawnbrokers, friends, and relatives or group informal institutions like dhikuti, dharam bhakari, and guthi.

[10]MOF, GON. 2006. "Economic Survey 2005/06" Singhadarbar, Kathmandu, Nepal
[11]AsDB and NRB. 1994. "Nepal Rural Credit Review Final Report Volume 1 (Summary Report)", Kathmandu

Informal lenders provide credit without procedural complexities and have flexibility regarding repayments and collateral, which does not exist in formal sector[12]. Moneylenders are often landholders and exist in almost all the villages. They lend either with collateral (gold or silver) or without collateral albeit linked with labor and/or land transaction as security. The interest charged by moneylenders is generally very high, ranging between 36% and over 100% per annum. In addition, they often receive either labor services or other small gifts as part of the loan request. Owing to high effective interest rate, loans from moneylenders are generally used mainly for emergency purposes such as medical crises or socio-cultural obligations like weddings and funerals.

Traditional rotating credit groups such as dhikuties, dharam, bhakari, guthies, etc. are well established and widespread in Nepal and represent a truly local and indigenous response to credit needs. Savings mobilized and credit delivered through informal rotating credit mechanisms like dhikuties represent an enormous level of financial activity[13], indicating that the resources are not yet fully tapped by formal and semi-formal sectors[14].

3.2 Formal Financial Sector

The formal financial sector in Nepal includes the following institutions: NRB, commercial banks, development banks, finance companies, SCCs and NGOs licensed by NRB. The NRB was established in 1956 and is Nepal's central bank and is responsible for regulating and supervising country's formal financial sector. NRB also mandates commercial banks (CBs) to lend directly to microentrepreneurs through the Intensive Banking Programme (IBP) and Deprived Sector Lending (DSL).

As of July 2006, there are 18 commercial banks (A grade) of which two (two state-owned) namely Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) were involved in microfinance sector since 1974 under priority sector lending programme, renamed as IBP in 1981. They were also implementers of large government microfinance programmes[15]. Initially NRB imposed lending requirement to commercial banks on priority sector at 5% in 1974, which increased to 7% in 1976 and to 12% in 1990. Also NRB directed commercial banks to allocate at least 25% of these priority sector loans or 3% of the total portfolio to hardcore poor under DSL. These schemes were undertaken by all the commercial banks as mandatory requirements or pay the penalties for non-compliance. Recently, NRB has decided to phase out priority sector credit policy by 2007 withholding 3% investment in deprived sectors. The outreach of microfinance services through IBP/DSL once reached in almost all the 75 districts of Nepal decreased gradually owing to poor portfolio quality, deteriorating security situation and management problems.

There are 32 and 71 financial institutions respectively of B grade and C grade with limited role to provide microfinance services, while there are 11 financial institutions (D grade) working as MDBs, of which two are wholesale lenders and nine are retail lenders. Of the nine retail lending MDBs, five are Regional Grameen Bikas Bank (RGBB)[16] promoted by

[12]ADB and NRB (1994) estimate proportion of households borrowing from informal sources at 34% and there is no latest updates.
[13]For details, please refer Development Project Service Center, Nepal and J. Ledgerwood. 1997. "Critical Issues in Nepalese Microfinance Circumstances" IRIS Center, Maryland and CMF. 2003. "A Directory of MFIs in Nepal" Kathmandu, Nepal..
[14]CECI. 1996. "Community Based Savings and Credit Organizations in Nepal: Current Status and Future Prospects", Kathmandu.
[15]they are Production Credit for Rural Women (PCRW), Microcredit Project for Women (MCPW) and DSL scheme.
[16]GON established two RRDBs in 1992, two more in 1995 and fifth one in 1996.

government in each of the development regions to replicate the Grameen Bank model of Bangladesh to provide microfinance services to rural poor (mainly women) and remaining four are outcome of commercialisation of leading NGOs into MFIs.

Table 3: Banks and Non-financial Institutions in Nepal as of October 15, 2006

S.N.	Type of institutions	Number of institutions by location		
		Kathmandu	Outside	Total
1	Commercial Banks (A grade)	13	5	18
2	Financial Institutions (B grade)	8	24	32
3	Financial Institutions (C grade) – Finance Companies	48	23	71
4	Financial Institutions (D grade) – MDBs	2	9	11
5	Savings and Credit Cooperatives – limited Banking operation	7	12	19
6	NGOs – involved in microfinance operation	13	34	47
	Total	91	107	198

Source: Nepal Rastra Bank, Nepal 2006

There are thousands of NGOs active in the microfinance sector as promoters and practitioners. In their roles as promoters, these NGOs facilitate group formation of poor and disadvantaged people that generate internal resources through members' savings and use the fund for on-lending to members. NGOs occasionally provide seed money to groups. The groups often disintegrate when NGO programs come to an end and cease to provide technical support. NGOs have also supported to transform some promising groups are into SCCs. Recently, some NGOs transformed into financial intermediary obtaining license from NRB to involve as practitioners MFIs and as of July 2006 there are 47 FI-NGOs active in Nepalese microfinance sector.

Most of the activities in formal financial sector are commercial in nature, resulting in large loan sizes concentrated in industrial productive activities. The vast majority of loans are made to men, as women are not normally involved in larger businesses[17].

3.3 Microfinance Sector

Microfinance sector generally target to poor and excluded groups, focus to address poverty problems and comprises of MFIs and microfinance programmes.

3.3.1. Regulations in Microfinance

Nepalese microfinance sector is governed by Bank and Financial Institutions Act 2006, Cooperative Act 1991 and Act for NGOs involved in Financial Intermediation 1998.

Bank and Financial Institutions Act 2006 aims to protect and safeguard the rights of depositors by enhancing credibility of all banking and financial systems; provide quality and reliable banking and financial intermediary services to people through healthy competition among banks and finance institutions; lessen risks in banking and financial sectors; strengthen the economy through liberalization of banking and financial sectors; and amend

[17]ADB and NRB (1994) estimates proportion of rural households reporting borrowing from formal sources during 1991/92 at 8%. Across regions, proportions are 4%, 8% and 9% for the Mountains, the Hills and the Terai regions respectively."

and regulate current laws related to entry, operation and exit of bank and financial institutions while completely subsiding NRB Ordinance for Bank and Financial Institution 2003 that was promulgated on 31 January 2005 that primarily dismissed the Finance Company Act, 1985 and Development Bank Act, 1996. The act provisioned all financial institutions to operate under it.

NRB sets out rules and regulations for entry, operation and exit of MFIs. In the past, it imposed priority sector lending to CBs to ensure flow of institutional credit to rural sector that obliged them to lend directly to individuals or self-help groups or provide wholesale funds or equity to MFIs. NRB has decided to phase out its priority sector credit policy by the end of 2007 while withholding 3% investment in deprived sector.

Chapter 6, Clause 26 (2) of Cooperative Act 1992 has provisioned the engagement of cooperative in other banking business including accepting small savings, supplying loans from members and issuing checks. Cooperative has to obtain license from NRB to engage in such banking activities. They should have paid-up capital between NRs. 1-10 million depending on their core area of operation and access.

NRB introduced Act for NGOs involved in Financial Intermediation 1998 to bring the microfinance activities of the NGO within the ambit of prudential regulation and supervision. The act upon amendment in 2002 permits NGOs to accept savings deposit from their clients.

3.3.2. Microfinance Institutions

Nepalese MFIs comprise of MDBs, FI-NGOs, SCCs, and SFCLs. Further, there are three refinancing organizations supporting the MFIs. First, the Rural Self Reliance Fund (RSRF) established in 1991 by the government with secretariat in NRB to provide wholesale loan to SCCs and NGOs. Second, the Rural Microfinance Development Centre Ltd (RMDC) established in 1998 to provide wholesale funding to regulated MFIs. Finally, the Sana Kisan Bikas Bank (SKBB) established in 2001 to outsource the wholesale funding to SFCLs and similar institutions. Number of MFIs increased from 9 MDBs, 43 FI-NGOs, 2300 SCCs and 161 SFCLs in July 16, 2004 to 9 MDBs, 47 FI-NGOs, 2957 SCCs and 205 SFCLs in July 16, 2006. Based on their ownership and nature of operations, these MFIs can be broadly grouped into two categories such as commercial oriented and community based. The former includes CBs, MDBs and FI-NGOs while SCCs, SFCLs and SCGs falls on later category.

CBs are involved in providing microfinance service through their obligation to meet DSL requirements. In general, CBs meet the DSL requirements imposed by NRB either providing block loans or investment as share capital to MFIs or pay penalties or a combination of all three. Some CBs like ADBN, RBB and NBL have extended microfinance services through their branches in all 75 districts. In cognizance to emerging distortions, NRB has a policy to phase out priority sector credit policy in 2007 while continuing DSL requirements.

The nine MDBs providing microfinance services are replicating grameen model either as such or through some modification. While five RRDBs were government owned established during 1992-1997, remaining four are private MDBs with operational history back to early 1990, receiving MDB status between 1998 and 2001 (one in 1998, two in 2001 and one in 2002). All these MDBs share basic objectives to improve access of microfinance services to women for promoting income-generating activities.

First FI-NGO was registered in 2001 and of the 47 FI-NGOs, 25 are involved as practitioner to provide microfinance services. FI-NGOs mobilize savings and borrow loanable fund from two apexes - RSRF and RMDC[18] - and DSL window of the commercial banks.

Cooperatives are formal body characterized by democratic and highly participatory decision-making process. The SCCs are community based organizations either self emerged or promoted by I/NGOs and have a history back to 1954. The cooperative sector gained momentum in 1990s with the enactment of a new Cooperative Act 1991 that focused on capturing the spirit of cooperative norms and values. SCCs have largest presence (i.e. 69 out of 75 districts) and there are only six mountain districts without SCCs. In contrast, SFCLs are member-owned and controlled multi-service cooperative agency promoted under external influence to deliver both financial and non-financial services. It consists of three-tiered organization[19] and plays an important role in the rural civil society, by pooling joint resources to meet basic needs and to defend members' interests. Formation of SFCLs started in 1993 and compared to SCCs, SFCLs are characterised by improved cohesion and communication within shareholders. Establishment of the SKBB, as an **apex body** has been quite innovative to provide wholesale funds to SFCLs.

3.3.3. Microfinance Programmes

Since mid 1970s Government and NRB implemented at least 17 rural development programmes with credit component to extend group approach to financial services delivery to un-served poor and dis-advantaged communities. These programmes focus to organize target people into SCGs with savings collection and loan operation as one of the key activities and are highly deep-rooted with hardly any clusters or villages in rural areas without SCGs. There are cases where member of the households have participated in more than one SCGs supported by different programmes.

Table 4: Savings and Credit Groups in Nepal as of July 2006

S.N.	Particulars	Unit	Value
1	Rural Development Programmes	No	16
2	SCGs	No	55,742
	Male only	No	15,681
	Female only	No	21,705
	Mixed	No	18,356
3	Members	No	1261,309
	Male	No	602,049
	Female	No	659,260
4	Savings mobilization	Rs. '000	1,203,951

Sources: Institutional Survey, Oct.- Dec. 2006.

SCGs are promoted either targeting among households below poverty line or using holistic approaches covering over 80% HHs in a settlement. Mainly SCGs are promoted adopting homogeneity and joint liability principles at village or settlement level. Numbers of member per SHG ranges between 9 and 60 with an average of 23 members. SCGs act as financial and non-financial MFI of the most rural development programme. In most cases, SCGs are the

[18]RSRF was established in 1991 and managed by NRB that provides wholesale loans up to NRs. 2.0 millions to SCCs/FI-NGOs while RMDC was established in 1998, owned by NRB and Nepalese banking sector that can on-lend up to NRs. 200.0 millions to MFIs.

[19]This includes solidarity groups at village level, inter-groups at ward level and main committees at VDC level. Main committee is registered as cooperatives under Cooperative Act 1990.

body for the members to start their loan application process, pool monthly individual and other compulsory savings and carry out other activities viz. marketing, farming and community development.

As of July 16, 2006, there over 55,742 SCGs with over 1261,309 members, all of which mobilize members' financial savings and use them for lending to promote income generation, asset creation and social/economic development[20], however, these are one of the infrastructures yet to be properly used in Nepalese microfinance sector.

3.3.4. Technology in Programmes

MFIs have attempted to introduce technology into their operations under the support different donors. However, these interventions have not been integrative and holistic. Most MFI are currently at verge of expanding their in high hills and mountains and this requires more than traditional microfinance approaches to doing business. It may require technological approaches that have the potential to bring financial services to those that MFIs have found difficult to reach. But current state of technology use is minimum.

4. ASSESSMENT OF MICROFINANCE OPERATION

This section examines current microfinance operation in terms of products and service delivery methodologies; outreach; cost structure; efficiency and productivity; and portfolio quality. Throughout the discussion, comparative advantages of products / services delivery methodology adopted by particular MFIs to expand boundary of microfinance services are identified, leading to identification of challenges and opportunities to expand the frontier of microfinance services in remote areas in next section.

4.1 Product and Service Delivery Methodologies

Initially microfinance sector started with the provision of access to microcredit to clients (men or women) of the households below poverty line with savings as an integral part of their operation. Since the beginning of new millennium, scope of microfinance extended to include activities such as micro-insurance and money transfer. MFIs and microfinance programmes have chosen a specific micro-lending methodology to fit the needs of target client group and conditions in local environment (economic, social, political, and legal) consistent to program goals.

Table 5: Product and Service Delivery Methodologies of Microfinance Service Providers

Key Elements	Commercial Oriented			Community Based		
	CBs	MDBs	FI-NGOs	SCCs	SFCLs	SCGs
Model	Solidarity group	Grameen replication or some modification	Grameen replication or some modification	Credit Union	Federation of solidarity groups	Village Bank type
Clients	Men and women below poverty line	Women only	Women – 90% Men – 10%	Men and women	Men and women	Men and Women
Size (members)	6-20	5	5	25-7000	250-1200	10-60
Targeting technique	Income and / or land criteria	PWR and income criteria	PWR and income criteria	No targeting, cooperative principle,	Income and / or land criteria	Non targeting Area / Settlement

[20]For details, see the literatures in the Bibliography.

Key Elements	Commercial Oriented			Community Based		
	CBs	MDBs	FI-NGOs	SCCs	SFCLs	SCGs
						approach
Service delivery outlet	Branch office	Group and center	Group and center	Office	Office	Group meeting
Institutional structure	Decentralized	Decentralized	Decentralized	Centralized	Centralized	Centralized
Operational arrangements	Centralized	Centralized	Centralized	Decentralized	Decentralized	Decentralized
Services	Savings and loan	Savings and loan	Savings and loan	Savings and loan	Savings and loan	Savings and loan
Linkages to external capital	Yes	Yes	Yes	Yes (few)	Yes	No
Savings as liability	No	Yes	Yes	Yes	Yes	Yes
Interest on savings	NA	6-8% p.a.	6-8% p.a.	6-8% p.a. + bonus	6-8% p.a. + bonus	No interest but bonus
Frequency of savings	Monthly	Weekly, Fortnightly, Monthly	Weekly, Fortnightly, Monthly	Monthly	Monthly	Fortnightly, Monthly
Loan terms (years)	1-3	Max. 1 year	Max. 1 year	0.5 – 3 yrs	0.5 – 3 yrs	0.5 – 1 yrs
Repayment term	Quarterly, Bi-annual, Annual, Balloon,	Weekly, Fortnightly, Monthly	Weekly, Fortnightly, Monthly.	Monthly, Quarterly, Bi-annual	Monthly, Quarterly, Bi-annual	Monthly, Balloon
Grace period	Case by case	No	No	Case by case	Case by case	No
Interest type	Declining	Flat – majority Declining – few	Flat – majority Declining – few	Declining	Declining	Declining
Interest on loan	11-15%	10-12% flat 18-24 % declining balance	10-12% flat 18-24 % declining balance	14-18% declining balance	14-18% declining balance	18-36% declining balance
Clients per staff	< 200	200-600	300-500	< 200	400-500	NA
Suitable settlement	Any type	Dense	Dense	Any type, dense preferred	Any type, dense preferred	Any type,

Source: Institutional Survey, Sept.– Nov. 2006

All the SCGs, SFCLs and most SCCs and FI-NGOs operate from head-office only while all CBs and MDBs and few SCGs and FI-NGOs work through a network of head-office and branch offices. As of July 2006, there are a total of 4001 Service delivery units (MFIs) of MFIs and their distribution is skewed in favor of Tarai and accessible hills against remte areas. Number of MFIs is more in case of SCCs (2957) followed by CBs (539), MDBs (240), SFCLs (190), and FI-NGOs (75).

Table 6: Distribution of Households and Service Delivery Unit of Financial Service Providers (No) as of July 2006

S.N.	Areas	Potential Clients (HHs)	Community Based (No)			Commercial (No)				Total
			SCCs	SFCLs	Total	CBs	MDBs	FI-NGOs	Total	
1	Mountains	296403	185	0	185	44	0	0	44	229
2	Inaccessible hills	485267	326	5	331	63	5	1	69	400
3	Accessible hills	750220	1363	54	1417	181	41	15	237	1654
4	Tarai	873999	1083	131	1214	251	194	59	504	1718
	Total	2405889	2957	190	3147	539	240	75	854	4001

Source: Institutional Survey, Sept.– Nov. 2006
Note: Office networks relate to number of or service delivery outlet (branch offices) of the microfinance service providers.

MFI of MDBs, FI-NGOs and SFCLs are concentrated in Tarai and accessible hills; very few branches exist in inaccessible hills and there are no MFI in mountains. In contrast, there are SCCs in all the four geographic regions. Though CBs are distributed in all 75 districts, they have limited role to extend microfinance services and they are primarily meant to support the fiscal management effort of the government.

Table 7: Clients per Service Delivery Units of Microfinance Service Providers (No) of July 2006

S.N.	Areas	Total (Average)	Average Clients (NO)						
			Community Based (No)			Commercial (No)			
			SCCs	SFCLs	Total	CBs	MDBs	FI-NGOs	Total
1	Mountains	77	72	0	72	99	0	0	99
2	Inaccessible hills	119	94	280	97	176	650	1191	225
3	Accessible hills	178	118	497	132	218	1109	1466	451
4	Tarai	447	171	679	226	289	1572	1972	980
	Total	282	132	617	161	236	1474	1860	727

Source: Institutional Survey, Sept.– Nov. 2006 and Field Survey, May-Aug. 2006

Average number of clients per MFIs is 282: highest (1860) in case of FI-NGOs and lowest (132) in case of SCCs. In general, number of clients per MFIs is lower among community based MFIs compared to their commercial counterparts. Average numbers of clients per operating units is highest in Tarai (447), followed by accessible hills (178), inaccessible hills (119) and mountains (77). This indicates that markets potential as well as product and service delivery methodologies have implications on reaching the required number of clients per MFI. In the context that existence of MFI is a necessary to extend microfinance services, community based MFIs (i.e. SCCs) are in comparatively better position to extend their services in remote areas compared to their commercial counterparts. Inability to reach minimum number of clients per MFI due to low population density and high poverty incidence is one the reasons for low market penetration in remote areas.

4.2 Breadth of Outreach

There exist MFIs of the MFIs in all the 75 districts. Almost all types of MFIs exist in Tarai while very few mountain districts have MFIs. While branches of CBs and SCGs exist in all the 75 districts, there are SCCs, MDBs, SFCLs and FI-NGOs respectively in 69, 42, 39 and 20 districts. Thus in terms of distribution of MFIs, CBs and SCGs have largest existence while FI-NGOs have the lowest.

Table 8: Distribution of Service Delivery Unit of Microfinance Service Providers across Districts as of July 2006

S.N.	Areas	Total Districts (No)	Number of Districts with MFI of MFIs							SCG
			Community Based			Commercial				
			SCCs	SFCLs	Total	CBs	MDBs	FI-NGOs	Total	
1	Mountains	16	11	0	11	16	0	0	16	16
2	Inaccessible hills	17	16	4	16	17	4	1	17	17
3	Accessible hills	22	22	15	22	22	18	8	22	22
4	Tarai	20	20	20	20	20	20	11	20	20
	Total	75	69	39	69	75	42	20	75	75

Source: Institutional Survey, Sept.– Nov. 2006

At present there are hardly any clusters or villages in rural Nepal without SCGs. There are cases where household members have participated in more than one such group.

Total number of clients served by these MFIs through different MFIs is estimated at 1127,229 savings clients and 892,188 loan clients. This estimate, however, does not take into accounts the issue of duplication and microfinance services through SCGs. For instance, using the same Grameen Bank methodology, the private MDBs and FI-NGOs compete with RGBBs and there are areas in Tarai where market is highly competitive and almost saturated. Intensity of duplication is estimated at 21% and 18% for savings clients and loan clients respectively. Duplication is high in Tarai, followed by accessible hills, inaccessible hills and mountains. With adjustment on duplication, it gives effective numbers of HHs served by existing MFIs to be 886,003 savings clients and 729,869 loan clients.

Table 9: Distribution of Outreach of Microfinance Services - Savings Clients (No) as of July 2006

S.N.	Areas	Total Savings clients	Community Based (No)			Commercial (No)				Total Savings Clients (adjusted)
			SCCs	SFCLs	Total	CBs	MDBs	FI-NGOs	Total	
1	Mountains	17676	13320	0	13320	4356	0	0	4356	16792
2	Inaccessible hills	47716	30789	1400	32189	11088	3248	1191	15527	43422
3	Accessible hills	294119	160347	26838	187185	39458	45486	21990	106934	250001
4	Tarai	767718	184883	88947	273830	72557	304985	116346	493888	575789
	Total	1127229	389339	117185	506524	127459	353719	139527	620705	886003

Source: Institutional Survey, Sept.– Nov. 2006
Note: Total savings clients (adjusted) relates to adjustment for duplication which is estimated at 21% (5% in mountains, 9% in inaccessible hills, 15% in accessible hills and 25%.in Tarai.)

A more dis-aggregated assessment of the outreach of microfinance services reveals that MDBs are the largest MFIs followed by SCCs, CBs, SFCLs and FI-NGOs. Despite significant outreach, operation of both SCCs and SFCLs are criticized on their viability; quality and depth of outreach; and institutional stability. While FI-NGOs are gradually making their presence in Nepalese microfinance sector, role of CBs as MFI is decreasing overtime.

Table 10: Distribution of Outreach of Microfinance Services – Loan Clients (No) as of July 2006

S.N.	Areas	Total Savings clients	Community Based (No)			Commercial (No)				Total Loan Clients (adjusted)
			SCCs	SFCLs	Total	CBs	MDBs	FI-NGOs	Total	
1	Mountains	12681	8325	0	8325	4356	0	0	4356	12174
2	Inaccessible hills	35083	18908	1400	20308	11088	2740	947	14775	32978
3	Accessible hills	220283	98136	26838	124974	39458	38076	17775	95309	191646
4	Tarai	624141	113750	88947	202697	72557	254841	94046	421444	493071
	Total	892188	239119	117185	356304	127459	295657	112768	535884	729869

Source: Institutional Survey, Sept.– Nov. 2006
Note: Total loan clients (adjusted) relates to adjustment for duplication which is estimated at 18% (4% in mountains, 6% in inaccessible hills, 13% in accessible hills and 21%.in Tarai.)

The outreach of microfinance services is still low and market for micro and rural financial services appears to be huge, if only services could be delivered in a sustainable manner. On the assumption that one member from one households borrows from MFIs, as of July 2006 there are 886,003 HHs with access to microfinance services. According to latest estimates, market for microfinance services is still huge with 50% of the total population being poor and vulnerable (boarder line) poor in demand for microfinance services. Based on this assumption, market for microfinance is estimated at 2405,889 HHs with market penetration of savings services at 37% and loan services at 30%.

In relative term, market for microfinance services is more in mountains (89%), followed by inaccessible hills (69%), accessible hills (48%) and Tarai (39%) regions while a reverse trend[21] prevails in terms of market penetration.

Table 11: Market for Microfinance and Market Penetration as of July 2006

S.N.	Areas	Market for Microfinance			Total Clients Served (adjusted for Duplication)		Market Penetration (%)	
		Total HHs	HHs potential for MF services	% of potential HHs	Savings clients	Loan clients	Savings Services	Loan Services
1	Mountains	331918	296403	89.3	16792	12174	5.7	4.1
2	Inaccessible hills	702268	485267	69.1	43422	32978	8.9	6.8
3	Accessible hills	1551644	750220	48.4	250001	191646	33.3	25.5
4	Tarai	2254900	873999	38.8	575789	493071	65.9	56.4
	Total	4840730	2405889	49.7	886003	729869	36.8	30.3

Source: Institutional Survey, Sept.– Nov. 2006 and Field Survey, May-Aug. 2006

The foregoing assessment implies that despite huge market for microfinance the outreach of microfinance services is still low and ensuring the access to microfinance services to people living in remote areas is yet a challenge in Nepal.

4.3 Cost Structure

An assessment of the cost structure of the existing MFIs provides better understanding on their capability to continue serving people tomorrow as well as today. Cost structure of the selected MFIs across geographical regions is analyzed using ratios such as return on performing assets, total operating expenses and operating self-sufficiency.

Table 12: Return on Performing Assets (%) across Service Delivery Units

S.N.	Areas	SCGs	SCCs	SFCLs	MDBs	FI-NGOs
1	Mountains	17.5	16.2	-	-	-
2	Inaccessible hills	17.7	17.1	12.1	13.2	13.4
3	Accessible hills	17.2	16.6	13.8	15.1	15.3
4	Tarai	17.9	16.9	14.7	16.3	16.1
	Total	17.6	16.6	16.4	15.2	14.9
	Effective interest rate (%)	18.0	18.0	18.0	18.0	18.0

Source: Author's calculation using Financial Statements of selected MFIs of MFIs and SCGs, July 16, 2005 and 2006.

Return on average performing assets (APA) is almost identical in SCGs and SCCs, close to effective interest rate and with minor variation on financial productivity across geographical regions while there is significant difference between effective interest rate and return on APA in case of SFCLs, MDBs and FI-NGOs. Financial productivity is relatively low in SFCLs, followed by MDBs, FI-NGOs, SCCs and SCGs and there is inverse relationship between return on APA and remoteness of the area. As expected, financial productivity of SFCLs, MDBs and FI-NGOs is lower in inaccessible hills, followed by accessible hills and relatively higher in Tarai. Financial productivity is highest in SCGs and lowest in FI-NGOs.

[21]Market penetration of savings services is estimated at 6%, 9%, 33% and 66% and that of credit services is estimated at 4%, 7%, 26% and 56% respectively in mountains, inaccessible hills, accessible hills and in Tarai districts.

Table 13: Total Operating Expenses/Average Performing Asset Ratio (%) across Service Delivery Units

S.N.	Areas	SCGs	SCCs	SFCLs	MDBs	FI-NGOs
1	Mountains	7.2	19.4	-	-	-
2	Inaccessible hills	5.4	16.2	17.3	17.2	15.7
3	Accessible hills	6.2	12.6	14.3	15.8	13.9
4	Tarai	4.6	11.5	11.6	14.6	12.9
	Total	5.9	16.4	15.4	15.6	14.2

Source: Author's calculation using Financial Statements of selected MFI of MFIs and SCGs, July 16, 2005 and 2006.

Total operating expenses (sum of financial cost, loan loss provision and administrative cost) to APA ratio is very low in case of SCGs (5 and 7%), while it ranges between 11 and 19% among MFI of other MFIs. In all these cases, there is a direct relationship between operating expenses ratio and geographical remoteness with high ratio in mountains and low ratio in Tarai. Variation on ratios is quite high in case of SCCs and SFCLs across geographical remoteness while it is relatively narrow in case of FI-NGOs and MDBs.

As expected operating self-sufficiency (OSS) is highest (300%) in case of SCGs and lowest (98%) in case of MDBs. In general, all the MFIs in Tarai and SCGs and SCCs in remaining three geographical regions have OSS more than 100% indicating that they have earned enough revenue to cover their total operating cost. There are SCCs in mountains, SFCLs, MDBs and FI-NGOs in hills (both accessible and inaccessible) not able to cover their operating costs and yet to be self-sufficient.

Table 14: Operating Self Sufficiency Ratio (%) across Service Delivery Units

S.N.	Areas	SCGs	SCCs	SFCLs	MDBs	FI-NGOs
1	Mountains	243.1	83.5	-	-	-
2	Inaccessible hills	327.8	105.6	69.9	76.7	77.1
3	Accessible hills	277.4	131.7	96.5	95.6	97.8
4	Tarai	389.1	147.0	126.7	111.6	110.9
	Total	300.4	101.4	106.7	97.9	105.4

Source: Author's calculation using Financial Statements of selected MFIs of MFIs and SCGs, July 16, 2005 and 2006.

Analysis of the cost structure of the MFI indicates limitations of the SFCLs, MDBs and FI-NGOs to expand their services in remote areas. The findings imply that SCCs is a sustainable model to ensure access to microfinance services in all four geographical areas except mountains. Innovation to reduce operating cost is one of the pre-requisite to expand microfinance services through SCCs in mountains. This conclusion remains valid among MDBs, SFCLs and FI-NGOs as well.

4.4 Efficiency and Productivity

Most of the MFIs are quite efficient and benefit from low salary levels, high staff productivity and an integrated approach to credit delivery, all of which has contributed to maintain cost structures at current low level. In the MFI covered under this research, on an average one staff serve 131 loan clients. Across MFIs, MFI of FI-NGO is the most productive than the MFI of other MFIs. Their local existence and unique delivery system distinguishes them from MDBs. In both MDBs and FI-NGOs, jobs are tied to staff performance; hence there is drive to attain higher productivity. Design consideration, legal framework and

management factor limits borrowers to staff ratio of SCCs and SFCLs to a lower end that warrants improvement through enhanced professionalism.

Table 15: Borrowers/Staff ratio (No) across Service Delivery Units

S.N.	Areas	SCGs	SCCs	SFCLs	MDBs	FI-NGOs
1	Mountains	-	72	-	-	-
2	Inaccessible hills	-	86	200	132	159
3	Accessible hills	-	118	117	140	192
4	Tarai	-	171	130	169	247
	Total		97	159	153	199

Source: Author's calculation using Financial Statements of selected MFIs of MFIs and SCGs, July 16, 2005 and 2006.

In addition to being productive, the MFIs covered by this research are efficient and minimize cost of service delivery. It cost the sample MFI just NRs. 642 (i.e. 9 dollar) to maintain one client. Across MFIs, cost per borrowers is highest among MFI of MDBs and lowest in SFCLs. FI-NGOs and SCCs are in between. SCCs/SFCLs are able to achieve higher efficiency as a result of its lower operating costs and larger loan sizes.

Table 16: Cost per Borrowers (Rs.) across Service Delivery Units

S.N.	Areas	SCGs	SCCs	SFCLs	MDBs	FI-NGOs
1	Mountains	-	518	-	-	-
2	Inaccessible hills	-	497	203	1953	1344
3	Accessible hills	-	448	217	1652	931
4	Tarai	-	406	280	1281	686
	Total		486	293	1542	987

Source: Author's calculation using Financial Statements of selected MFIs of MFIs and SCGs, July 16, 2005 and 2006.

The findings of this research indicates that key microfinance actors are located at the frontier of microfinance services and strategy to strengthening existing MFIs and using thousands of SCGs to a full potential is most fundamental to expand microfinance services in remote areas.

4.5 Portfolio Quality

With portfolio at risk (PAR) over 30 days of 10.6%, the MFIs covered by this research reports almost one tenth of the portfolio as delinquent which is quite high. PAR is more (25.6%) in case of SFCLs, followed by SCCs (13.2%) and FI-NGOs (11.5%). With an average 3.6% PAR, MDBs are performing fairly well. As with productivity, organizational culture (zero tolerance on overdue) is also the key determinant of portfolio quality.

Table 17: Portfolio at Risk (%) Across Service Delivery Units

S.N.	Areas	SCGs	SCCs	SFCLs	MDBs	FI-NGOs
1	Mountains	12.4	12.6	-	-	-
2	Inaccessible hills	8.6	17.2	33.4	5.6	13.6
3	Accessible hills	5.1	11.4	17.2	4.1	12.1
4	Tarai	6.7	8.7	21.4	2.3	8.7
	Total	8.2	13.2	25.6	3.6	11.5

Source: Portfolio report of service delivery units of MFIs as of July 16, 2005 and 2006.

Writing off delinquent loans currently remains a taboo practice among MFIs in general and MFIs covered by this study in particular. As a result, loan loss rates reported by these units

are likely to understate actual portfolio loss. Most of the microfinance managers lack clear understanding on true sprit of write-offs as they fear that once a loan is written-off, it can no longer be recovered in future.

5. CHALLENGES AND OPPORTUNITIES ON EXPANDING THE FRONTIER

There exist evidences that microfinance has been integrated into an economic and development process supporting emergence, growth and development of both commercial oriented and community based MFIs thereby improving access to financial services to thousand of people mostly women (80%). The former is more complex delivering large, competitive and diversified services with MFI concentrated in relatively accessible areas so as to limit their operational expenses with both positive (low interest rates, diversification of offer, proximity, etc) and negative (higher risk, overindebtedness, occasional unfair competition and profit search geared towards more profitable clients) effects, the later has relatively better presence in remote areas. Hence, close scrutiny of the existing state of operation of the MFIs provides both challenges and opportunities on expanding the frontier of microfinance services.

5.1 Key Challenges

The extent of market penetration of microfinance services in rural areas depends on existence of economic opportunities and MFIs' ability to develop demand-driven products and services; to implement cost-effective screening, distribution, monitoring and enforcement mechanisms; and to manage covariance and other risks in loan portfolio. Hence, the key challenges to expand the frontier of microfinance services in Nepal are the following.

Policy environment: Expansion of microfinance has been hindered due to policy environment governing their efficient operation such as unsound macroeconomic policy and management; insufficient institutional capacity within MFIs to achieve high levels of outreach in a sustainable manner; underdeveloped legal systems; inadequate prudential regulation and supervision of financial intermediaries; and poor governance and other political factors that raise risks.

Rural Economic settings: Rural populations are mainly engaged in small-scale agriculture or agriculture-related activities and are generally poorer than their urban counterparts. The inherent impediments to efficient microfinance operation in such areas includes (i) low population density, small average loans and low household savings, which increases transaction costs of financial intermediation, (ii) lack of infrastructure (communications, electricity, transportation, etc.), limited social services (education, health, etc.) and low integration with complementary markets result in highly fragmented financial markets that involve high costs of overcoming information barriers and limit risk diversification opportunities and (iii) seasonality of agricultural production and susceptibility to natural disasters (such as flood, drought and disease) heighten probability of covariant risks (in prices and yields) affecting client incomes and add to costs of rural financial intermediation. The combination of these specificities leads to increased transaction costs and risks for financial intermediation and for these reasons commercial oriented MFIs have largely avoided serving rural areas. Reversing this trend is yet a challenge.

Cost structure of commercial MFIs: The modalities adopted by commercial MFIs are not exactly suitable to expand the frontier of microfinance in remote areas. Their services are

concentrated in competitive and saturated environment of the accessible areas due to their more labor-intensive nature. As far as provision of microfinance services is concerned, there is direct relationship between cost structure and accessibility of the area (i.e. geographical frontier). At present challenges is to reduce cost structure of commercial MFIs by increasing staff productivity through an innovation on service delivery methodologies.

Partnership between community-based MFIs and apex institutions: Community based MFIs are characterized by low cost of operation and local ownership and have penetrated relatively well in the remote areas while they offer quite a narrow range of financial services due to lack of capacity to expand the services and manage the commercial finance at a reasonable cost. They mainly rely on internal deposit mobilization to meet financial services of their clients. Thus, capacity and resource constraints have undermined their full potential and ability to intensify their market penetration. Establishing a functional partnership between apex institutions and these MFIs on capacity enhancement and access to loanable fund is one of the cost effective and efficient alternatives to expand microfinance services remote areas and this has yet to be properly addressed.

Business linkages of commercial MFIs with Savings and Credit Groups: Thousands of SCGs promoted by different multi-lateral agencies, I/NGOs and government institutions through out Nepal servings over million people have not been used properly on the absence of vision. Mechanism to properly use these groups especially by establishing business linkages/networking with commercial MFIs is to be worked-out.

Technology in microfinance: Technology is inevitable for expanding the frontier of microfinance services and there are couples of challenges on technology promotion. First, small MFIs have very low or limited capacity to manage technology on their own, hence, there is therefore a need to analyze how a back end information systems can be managed through a third party. Second, there is a need to analyze the appropriate technological solutions to facilitate the provision of front end transactions, e.g. mobile phone, cards, etc. Third, technology solutions can only be rolled out in a country where there is an enabling legal and regulatory environment. This requires a broad regulatory environment that supports the use of electronic payments, enforceable financial contracts, telecommunication policy that foster widespread access and ensure privacy and data security. Finally, there is a need to address the issues related to customer adoption, both at the institutional levels and household levels, requires the extent to which the sector is ready to adopt these technologies.

5.2 Emerging Opportunities

Nepalese microfinance sector has accommodated microfinance models emerged across the globe and diversified their products and services delivery strategies consistent to emerging global practices with some level of maturity on their development. All these models are tried with mixed success providing invaluable lessons and opportunities on shifting the frontier of microfinance services outwards in remote areas.

Gradual entry of commercial MFIs in remote areas: There exist instances that increased competition in densely populated accessible areas has pushed the frontiers of microfinance either up-market to wealthier clients or down market to underserved, poorer clients; or into new geographic locations, thereby gradually serving harder to reach clients in more sparsely populated rural areas. While competitive market pressures have initially deter commercial MFIs from focusing on rural markets, over time competition has gradually pushed them to

expand their rural operations out of a need to identify new markets for expansion[22]. Due greater focus in rural areas and social commitment to serving the poor or competitive pressures, commercial MFIs that expand into rural areas are not only be able to offer more demand-driven products but operate more sustainably too.

Promotion and Strengthening of Community Based MFIs: At present community based MFIs are present in 27 out of 33 remote districts with reasonable success on meeting financial needs of people living in those areas. They are emerging as member owned, controlled and capitalized movement and alternative strategy to micro-finance service delivery. Opportunities to expand the frontier exist if the issue of capacity and resource constraints inherent to them is properly addressed. Such an effort will also enable apex institutions, which are currently working at below potential level to expand their operation towards full potential

Using the Potentials of Existing SCGs: At present SCGs are not properly used due to lack of vision and mechanism. In fact, they possess potential to work as financial intermediaries owned by the poor. Strengthening their capacity to manage microfinance operation by ensuring increased access to more loanable fund is one of the pre-requisites to use their potentials at a desired level. Rather than making it granted forever, once SCGs demonstrate mature financial behavior, banks should be encouraged making loans to them in certain multiples of their accumulated savings without collateral and at market interest rates based on their credit history (i.e. SHG banking). This mechanism, though not so common, has special significance to expand outreach of microfinance services in remote areas at low cost using existing decentralized formal banking networks and GOs/NGOs involved on their formation and growth as their partners. Linking SCGs to access external credit based on their capacity will potentiality stimulate their self-help capacity and enhance their potentials to address poverty problem.

Technology in microfinance: According to CGAP technology programme, the high potential programme to microfinance could be mobile phone banking, ATM and point of sale devices, credit cycle management, shared information systems, and agent. Feasibility of these technological solutions needs to be addressed to better serve the need of the target group and support to expand the outreach of microfinance services.

6. CONCLUSIONS AND RECOMMENDATIONS

Microfinance sector has penetrated 37% of its potential market with highest penetration in Tarai (66%), followed by accessible hills (33%), inaccessible hills (9%) and mountains (6%) districts. The low market penetration in remote area is attributable to difficulties to reach minimum number of clients per MFI due to prevailing low population density and high poverty incidence. Provision of microfinance services to large number of un-served and underserved micro-entrepreneurs and poor households living in those areas where demand for such services is still huge is yet a challenge. Commercial MFIs have comparative advantage to extend their services in urban and densely populated peri-urban areas while that of community based MFIs are better positioned to serve even in remote areas. On the other hand, there are SCGs throughout Nepal but not fully used due to lack of vision.

[22]Hill operation of Nirdhan, western GBB and central GBB is an example to cite with.

Existing cost structure limits the expansion of services by commercial MFIs (MDBs and FI-NGOs) in remote areas, and even community-based model like SFCLs is not an exception to provide microfinance service in those areas. On the other hand, such limitation is either minimum or does not exist in case of SCCs and SCGs. Innovation to reduce operating cost is one of the pre-requisite to expand microfinance services of existing MFIs in remote areas.

Leverage is quite high among MFIs and despite, they benefit from low cost structure compared to their peers in rest of the world, particularly on account of high staff productivity and government provisions requiring commercial banks to invest a portion of their deposits in small scale finance. The main challenge to future growth, however, stems from poor portfolio quality. While the products and service delivery methodologies deter commercial MFIs to expand their services in remote areas, the capacity and resource constraints undermine potential of community based MFIs to intensify their penetration in their working areas and expand their establishment and development in more remote areas. Business linkages of commercial MFIs with large number of informal SCGs promoted under different GOs/NGOs programme in remote areas as well as partnership of apex institutions with community based MFIs on capacity enhancement and access to loanable fund is the cost effective and efficient alternatives to expand microfinance services in those areas.

Key recommendations emerging out of the findings and conclusions of this paper are:

1. Support the reforms of legal/regulatory and supervisory framework for microfinance. This requires drafting a national microfinance policy/strategy, review and reform of existing microfinance legal and regulatory framework and strengthening the microfinance regulator. Considering their number, there is a need to develop criteria for determining which categories of MFIs should be licensed and regulated by NRB and which categories of MFIs might only have a reporting requirement to the regulator or some other institution.
2. Support the MFI to reduce their cost structure in remote areas through proper diffusion of technology in microfinance (e-banking) and piloting of the use of modern technologies such as palm top, transfer of data by mobile, etc. As these technologies goes hand in hand with the expansion of telecommunication facilities and a strong partnership with telecommunication service providers is required during piloting phase.
3. Promote the partnership between community-based MFIs and apex institutions to expedite the use of wholesale capital;
4. Foster the business linkages of commercial MFIs with SCGs i.e. SCG banking, through a design of the incentives packages for the commercial MFI to work with SCG and attain operational and financial viability.
5. Develop the packages of services to promote and strengthen community based MFIs. Facilitate the transformation (emergence, growth and development) of SCG into more formal structure that can scale-up their operation further.

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Annex: Supplementary Tables

Table 1: Service Delivery Units Surveyed under this Study

Geographical Region	Districts	SCGs	SCCs	SFCLs	MDBs	FI-NGOs
Mountains	Jumla	3	2	-	-	-
	Rasuwa	3	2	-	-	-
	Taplejung	3	-	-	-	-
	Dolakha	3	2	-	-	-
Inaccessible Hills	Myagdi	3	-	-	-	1
	Bhojpur	3	2	-	-	-
	Lamjung	3	-	1	1	-
	Dailekh	3	2	-	-	-
Accessible hills	Dhading	3	-	2	-	-
	Kavre	3	2	-	-	-
	Makawanpur	3	-	-	1	-
	Baglung	3	-	-	-	1
Terai	Jhapa	3	2	-	-	-
	Sunsari	3	-	-	-	1
	Rupandehi	3	-	2	1	-
	Kailali	3	-	2	1	-
	Total	48	14	7	4	3

Table 2: Outreach of SCGs under Micro-credit Component of the Rural Development Programmes as of July 2006

S.N.	Name of the Programme	Supporting agency	Districts (No)	Groups (No)	Members (No)	Savings Mobilization (Rs.)	Remarks
1	Decentralized Local Governance Support Programme	UNDP	66	21730	530108	657000000	Dec. 2006
2	Rural Urban Partnership Programme	UNDP	20	5273	220299	113923000	Dec. 2006
3	Microenterprise Development Programme	UNDP	20	2448	19636	10996909	Dec. 2006
4	Rural Energy Development Programme	UNDP	25	5061	116077	66827514	Dec. 2006
5	Tourism for Rural Poverty Alleviation Programme	UNDP	6	781	15565	10216275	Dec. 2006
6	Participatory Conservation Programme	UNDP	22	3631	123322	101953634	Dec. 2006
7	Mainstreaming Gender Equity Programme	UNDP	16	305	8949	1074750	Dec. 2006
8	Western Upland Poverty Alleviation Programme	IFAD	8	595	14681	6263500	Oct. 2003
9	Bishwor with the Programme Poor	GON	75	6823	100520	70000000	-
10	Women Development Programme	GON	75	48927	316349	421974892	July 2006
		Total	75	95574	1465506	1460230474	

Source: NRB, Report of the Task on Policy Study to Link SCGs with Financial Service Providers