TRANSFORMATION OF CIVIL SOCIETY ORGANISATIONS INTO MICROFINANCE INSTITUTIONS IN NEPAL

By

Nara Hari Dhakal

P. O. Box 10475

Kathmandu, Nepal

Sunday, 06 May 2012

Table of Contents

TABLE OF CONTENTS I

LIST OF TABLES II

1. INTRODUCTION 1

2. BRIEF HISTORY OF MICROFINANCE SECTOR DEVELOPMENT IN NEPAL 2

3. TRANSFORMATION IN MICROFINANCE SECTOR: GLOBAL EXPERIENCES 6

3.1 BOLIVIA: MAINSTREAMING MICROFINANCE 6
3.2 INDONESIA: TRANSFORMATION OF THE MAINSTREAM 7
3.3 BANGLADESH: TRANSFORMATION OF A PROJECT 8
3.4 INDIA: TRANSFORMATION EXPERIENCES, OPTIONS AND FUTURE 9

4. TRANSFORMATION EXPERIENCES OF NEPAL 9

4.1 NGOS INTO DEVELOPMENT BANKS 10
4.1.1. Overview 10
4.1.2. Ownership structure and governance 10
4.1.3. Access to loanable funds from commercial sources 12
4.1.4. Product diversification 12
4.1.5. Outreach and sustainability 13
4.2 NGOS INTO FINANCIAL INTERMEDIARY 13
4.2.1. Expanding frontier of microfinance services 14
4.2.2. Access to loanable funds from commercial sources 15
4.2.3. Substitute to the microfinance operation of the state-owned Commercial Banks 16
4.2.4. Promoting sustainable model for Microfinance Operation 17
4.3 SMALL FARMERS GROUPS INTO SMALL FARMER COOPERATIVES LTD 18
4.3.1. Overview 18
4.3.2. Institution development and demand driven approach 18
4.3.3. Outreach and viability 19
4.3.4. Model for hills and remote areas 20
4.3.5. Provision of multi-purpose services 20
4.4 WOMEN SAVINGS AND CREDIT COOPERATIVES LTD 21
4.4.1. Overview 21
4.4.2. Shift on role 21
4.4.3. Area expansion 22
4.4.4. Reduction on dependence with commercial banks for loanable funds 22
4.4.5. Linkages to apex institutions 23

5. FACTORS TRIGGERING TRANSFORMATION 23

5.1 GROWTH 23
5.2 DIVERSITY 24
5.3 SUSTAINABILITY 25
5.4 FOCUS 25

6. CONCLUSION AND RECOMMENDATIONS 26

6.1 CONCLUSIONS 26
6.2 RECOMMENDATIONS 28

ANNEX 1: SUPPLEMENTARY INFORMATION 29

REFERENCES 32

List of Tables

TABLE 1: OWNERSHIP STRUCTURE OF MDBS IN NEPAL _____ 11
TABLE 2: OUTSTANDING LOAN OF MDBS BY SOURCES IN NEPAL _____ 12
TABLE 3: OUTREACH AND SUSTAINABILITY OF THE MFIS IN NEPAL _____ 13
TABLE 4: MICROFINANCE OPERATION BY FI-NGOS _____ 14
TABLE 5: RMDC'S LENDING TO FI-NGOS _____ 15
TABLE 6: SOCIAL MOBILISATION DONE BY MCPW'S PARTNER FI-NGOS AS OF JUNE 2002 _____ 16
TABLE 7: LENDING SERVICES SUPPORTED BY MCPW'S PARTNER FI-NGOS AS OF JUNE 2002 ___ 17
TABLE 8: LOANABLE FUNDS IN 82 WOMEN SCCS SUPPORTED BY MCPW'S AS OF AUGUST 2002 22

1. Introduction

Extensive involvement of civil society organisations (CSOs) in providing microfinance services is the characteristic feature of microfinance industry around the world. In some countries, CSOs have become, and continue to be, the dominant source of institutional microfinance. For instance, in Bangladesh there are 656 NGOs involved in microfinance operation with 9.46 million active loan accounts with an outstanding total loan balance of US$513 million at the end of 2003 (Credit and Development Forum 2003). There are similar instances in India, Nepal, Indonesia and other Asian countries. Transformation of microfinance CSOs into regulated microfinance institutions (MFIs) has been gradually taking place in some countries in cognizance to increased attentions paid to limitations of this modality on aspects related to ownership, governance, institutional linkages; service scale up and access to commercial sources of funds, prudential regulation and supervision; portfolio management and internal control.

Conversion of CSOs in the form of credit union in their efforts to formalise their transaction is quite common in most countries; however, transformation of NGOs into MFIs is relatively new phenomenon, little more than one decade of experiences. Transformation of PRODEM into BancoSol in Bolivia in February 1992 was the first and the important milestone in institutionalising microfinance service delivery. In 1993, NGO-Corposol in Colombia transformed itself into a MFI called Finansol and the number of such transformation gained momentum then after reaching at 39 by the end of 2003 (Fernando, 2004 pp. 1). The process of transformation has been one of the major contributions of Bolivian microfinance to international experiences (Rhyne 2001, pp. 117).

This development of the CSO microfinance subsector is quite ironic. CSOs enter into microfinance market either as a promoter or practitioner or both essentially with the growing realisation of the failure of rural financial institutions (RFIs) including state-owned and private development banks and commercial banks to serve poor and low income households. As a promoter, they promote informal savings and credit groups (SCGs) or savings and credit organisations (SCOs) and enhances the capacity of SCGs/SCOs on money management such as savings mobilisation, loan management, simple book keeping and accounting, etc. As a phase-over initiatives of their involvement, these informal CBOs are supported to acquire legal status mainly as savings and credit cooperative (SCCs) or credit

union. As a practitioners; most NGOs use savings mobilisation as one of their social mobilisation packages using self-help group approach and involve themselves on lending money thus pooled as well as at times using financial resources obtained from bi-lateral and multilateral donors and international NGOs. Rational of their involvement is backed by their claim that business culture and physical setup of RFIs were intimidating to the poor and incompatible with their socioeconomic characteristics in addition to their profit motive that keep them away from serving the poor with appropriate financial services. Thus, transformation of CSOs, either as promoter or practitioners, into MFI represents a dramatic change in providing financial services for the poor, exhibit an essential stage of movement towards a more commercialised microfinance industry and consider as a "natural progression" for MFIs that adhere to financial system approach (White and Campion 2002, p.23). This relates to the exchange of business, which is undisturbed by regulators and is free from taxes to the regime of a formal financial intermediary (Stauffenberg 2002, p. 19).

Nepal has unique experiences of transformation of microfinance operation initiated by CSOs as promoters or practitioners into MFIs and this paper is an attempt towards documenting these experiences. Information used in this paper are obtained from secondary sources and mainly through a review of the published and unpublished information available in Nepal Rastra Bank (NRB), Rural Microfinance Development Centre (RMDC), Agriculture Development Bank, Nepal (ADB/N) and Department of Women Development (DWD). Secondary information has been supplemented by the information collected through a discussion with the Chief Executive Officers (CEO) of the transformed institutions.

This paper contains six sections. After this introductory section, history of microfinance sector development in Nepal is discussed in section two. Section three documents global experiences on transformation of microfinance sector; while transformation experiences of Nepal are analysed in section four. Factors triggering transformation are assessed in section five while section six summarises major conclusion of the analysis and offers some recommendations for strengthening transformation process.

2. Brief History of Microfinance Sector Development in Nepal

The history of formal microfinance services in Nepal is temporally short but eventful. The chain of events seems to be marked by a costly process of trials and errors rather than by

institutional dynamism. The landmark for microfinance was set by cooperative societies instituted under the Rapti Valley Development Scheme in early 1950s which were primarily intended to provide credit to agricultural sector. Initially these institutions evolved under an executive order on the absence of legal basis for this purpose. The Cooperative Department was established in 1954 with the objective of promoting and assisting the operations of these cooperative societies. Realising that this arrangement undermined financing needs of these societies led to the establishment of Cooperative Bank in 1963.

The Land Act 1964 had a component of compulsory savings to be mobilised from farmers based on their land holdings. Such savings were collected by ward committees. These committees were also entrusted with the responsibility of loan disbursement, loan recovery, and handover excess funds to District Land Reform Office. Ward Committees were allowed to lend for both production and consumption purposes with higher interest charged on the latter. The first phase of land act implementation began in 1964 in 16 districts. Another 25 districts were added in subsequent year. This put increased management responsibility on District Land Reform Office. In 1966, Land Reform Savings Corporation (LRSC) was established to address management problems.

Under its charter the Cooperative Bank was authorised to lend only to the cooperative societies and could not lend directly to the individuals or cooperative bodies which was found to be too narrow. The ADBN emerged in cognizance to the shortfall in the supply of funds for agricultural loans experienced by credit cooperatives as a successor institution to cooperative bank (Sinha, 2000). Later in 1973, the LRSC was merged into ADBN as it was thought to be duplicating and overlapping with the functions of ADBN. Since then, ADBN has virtually been sole financial institution specialising in agricultural and rural credit in Nepal. A well-structured and specialised programme to cater to the financial needs of the poor was provided further impetus with the launching of the Small Farmer Development Programme (SFDP) in 1975 within ADBN. This programme, which covered the entire country by 1991/92, aims at organising farmers below poverty line into small groups and providing credit on a group guarantee basis. However, the overall coverage of SFDP is still relatively low (Shrestha, G. K. 1999). Over the past few years, a process of institution development of small farmer groups into inter-group and main committee and transforming them into Small Farmers Cooperative Ltd (SFCL) has been under way. This is the first and oldest attempt towards transformation of informal CSOs into locally owned and managed

credit union, a member based MFI that can take over activities of SFDO on a self-sustaining basis. The whole motive of such transformation is local empowerment, local level self-sustainable MFI promotion and expansion of the microfinance services in a manageable way in the other areas in need of such services thereby ensuring geometrical growth in microfinance operation using simple transformation process. ADBN has, so far, been able to convert its 144 sub-project offices into registered SFCLs.

Promotion of the priority sector lending provides yet another milestone on Nepalese microfinance history. Considering very limited share of commercial banks on agricultural credit (less than one percent), NRB in 1974 directed commercial banks to invest at least 5% of their total deposits in "*small sector*" to increase the flow of institutional credit towards development of small farmers, industries and small sector of the economy [Asian Development Bank (AsDB), Manila and NRB 1994]. This scheme then was known as "*Small Sector Supervised Credit*" which was renamed as "*Priority Sector Credit*" in 1976 wherein lending requirement for commercial banks to priority sector was increased to 7%. It was revamped and renamed as "*Intensive Banking Programme (IBP)*" in 1981 in order to strengthen priority sector programme which was intended to do away with collateral requirements and to get banks to engage in group-based lending (DEPROSC, Nepal and J. Ledgerwood, 1997). Initially IBP was undertaken by two large commercial banks [Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB)] and latter by the first joint venture bank in Nepal, the Nepal Arab Bank Ltd. (NABIL). Owing to serious drawbacks on understanding on the complexity involved on microfinance operation, unfortunately, in practice, neither of the objectives of the programme was achieved; rather it largely bypassed the poorer segments of population, reaching instead non-poor small sector. In order to address this issue, NRB further increased lending requirements to 12% in 1990 and directed that 25% such loans or 3% of total portfolio of commercial sector must be extended to hardcore poor under "*deprived sector credit*" programme.

The next avenue in developing Nepalese microfinance sector came in the form of the first gender-focussed programme namely Production Credit for Rural Women (PCRW) in 1982 by Ministry of Local Development (MLD) and later converted into DWD, Ministry of Women, Children and Social Welfare in collaboration with the United Nations Children Fund (UNICEF) and NRB. Operational strategy of PCRW involves organising women groups and training them to undertake group-based borrowing from NBL, RBB, and ADBN.

PCRW is one of the largest women development programme implemented by the government that covered all the 75 districts of the country with relative success on women's economic empowerment. Encouraged by the results and learning from experience of this initiative, the same department in 1994 started the Microcredit Project for Women (MCPW), under loan assistance of Asian Development Bank (AsDB). This was more innovative in the sense that for the first time in a government-sponsored programme, it involved NGOs as intermediaries in financial service delivery (DEPROSC, Nepal and J. Ledgerwood, 1997). Institutional support to selected NGOs to enable them expand delivery of community development and savings mobilization services to Project beneficiaries and supporting their transformation into financial intermediary (FI) NGO is one of the key output of the project. Of the 95 partners of the project, 35 NGOs transformed into FI-NGOs and these are considered as the new actors in Nepalese microfinance sector.

Impressed by the success of the solidarity group lending and realising the need for institution development of women beneficiaries, DWD also started to federate the small women groups formed under PCRW and MCPW into women saving and credit cooperatives (SCCs) or some other form of multipurpose cooperatives. Over 200 women SCCs (of which 82 were under MCPW involving over 10,000 women group members) are formed federating women groups through such transformation process and early experiences of operation of these groups are quite encouraging. Transformation of women's groups into women SCCs has been the regular activities of the DWD.

NGOs and cooperatives have also played an increasing role in the delivery of microfinance services. While the proportion of the over 30,000 NGOs[1] engaged in microfinance is not known, the number with limited banking licenses provided by NRB under Financial Intermediary Act 1999 has grown to 44 in a period of four years of introduction of this policy and act. FI-NGOs acquire loanable fund from two apex institutions namely Rural Microfinance centre (RMDC) and Rural Self Reliance Fund (RSRF).

The SCCs are another actor in Nepalese microfinance sector. Through history of cooperative emergence and growth can be traced back to mid 1950s, it gained impetus and attained increased attention and growth after the enactment of Cooperative Act 1992. The Act helped promote significant growth in cooperatives and by 2003/04 over 6,000 000 cooperatives

[1]Registered under the Society Registration Act, 1978

registered under this act. These include over 2300 SCCs (Sharma 2004) which are savings and credit focused, as opposed to multipurpose cooperatives. SCCs are viewed as a feasible alternative model to provide microfinance services especially in remote hills and mountains.

In 1992, as an important initiative to augment the supply of microfinance, the first two Regional Rural Development Banks (RRDBs), one in the eastern and other in the far western region were established with government and NRB funds as replications of the Grameen Bank of Bangladesh. By mid-July 1997, five RRDBs were established, one for each region. While initially four RRDBs were established under the Commercial Banks Act 1984, the fifth was registered under the Development Bank Act 1996 (Sharma and Nepal, 1999). As of July 2004, Grameen Model has been replicated through five RRDB, four Microfinance Development Banks (MDBs), one cooperative and three FI-NGOs[2] in Nepal. The rational for establishing RRDBs was to offer a proven model of low cost, sustainable credit delivery system to poor women by-passed by other programmes.

Thus, at present Nepalese microfinance sector is quite complex. Despite floriferous growth in microfinance sector, performance of this sector is not encouraging. Though there are large numbers of MFIs, there is virtual absence of equality. Especially MFIs in remote hills and mountain are in disadvantaged situation compared to the one in the accessible hills and the Terai (DEPROSC and Ledgerwood, 1997).

3. Transformation in Microfinance Sector: Global Experiences

3.1 Bolivia: Mainstreaming Microfinance

Microfinance revolution in Bolivia is triggered by NGOs like in many parts of the world where microfinance initiatives have seeded by economic turmoil in the mid-1980s. The sector is characterized by rapid growth and at present Bolivia has an array of MFIs including banks, NGOs, and Fondos Financieros Privados (FFPs)[3]. Among banks, BancoSol, an offshoot of an NGO called Prodem is the most celebrated one. There is a tendency among NGOs operating in microfinance programs to become FFPs after they reach a critical stage. Very few get to the level of full-scale commercial banks like BancoSol. Prodem, while it

[2]The three FI-NGOs are NRDSC, NERUDO and TRWS

[3]FFP is an innovative institutional structure for microfinance, as it allows NGOs to take an equity position in a commercial activity.

promoted BancoSol, also continued as an NGO to address developmental needs of its rural customers. Apart from BancoSol, another bank that has a significant microfinance portfolio is a relatively young one, Banco Economico (Rhyne, 2001). Recently Prodem and many large NGOs in Bolivia have converted themselves to FFPs. In addition, there were organizations such as Fassil and Acceso that came from commercial world. While Fassil survived, Acceso quickly closed shop as it went on an overdrive in consumer credit. Accesso's collapse has lessons for evolving regulatory norms to suit MFI needs, and has implications for future entrants to the market. The transformation in Bolivia has revealed the concept of an "*ideal capitalist*". The process brought four key elements to MFIs ownership such as (i) NGOs came in through developmental mission; (ii) private investors who came in were motivated by recognition with returns; (iii) public sector investors came for safe investment and prestige; and (iv) involve international technical partners to disseminate best practices (Rhyne, 2001).

3.2 Indonesia: Transformation of the Mainstream

While most microfinance initiatives worldwide have taken the "supply-driven" route, the microfinance initiative in Indonesia exhibits the "demand" route. In Indonesia, microfinance did not move from organizing people into groups and training them. Neither did it emerge from SHGs. The pioneering institutions in microfinance did not have any of the value attributes discussed earlier. Of the two most well known institutions, Bank Dagang Bali (BDB) was established in 1970 as a private bank. The promoters of BDB were two enterprising people with first-hand experience of small enterprise and finance (M-CRIL, 2002). The bank grew and survived through innovation of products and seizing opportunity for arbitrage between low interest on savings and high interest on loans. BDB became a model for state-owned Bank Rakyat Indonesia (BRI). It sets mainstream to move downwards towards the poor. The move was to provide banking and not just credit or savings to the poor. The trigger provided by BDB attained nationwide coverage in 1984 with the restructuring of the unit desa (local banking) system of state-owned BRI (Wardhana, 2001). This has lessons for embedding microfinance in the general financial system. Under the old system the state channeled resources for the poor through banking system offering a line of credit at subsidized interest. However, the banking system soon realized that this was not sustainable. The state accepted challenge to move from subsidized credit to sustainable micro-banking. By moving towards packaging of credit to meet needs of the poor, the system sorted out problems of arbitrage between the cost of credit available from the

institutions that were sponsored by the state and the local players. The problem of improper identification of the "beneficiary" leading to leakage was solved. The question of continuing access to services was, therefore, successfully addressed by embracing microfinance methods. After conscious shift towards micro-banking, banks offer complete financial services to the poor and people who transact in small amounts.

3.3 Bangladesh: Transformation of a Project

The Bangladesh experience is widely discussed and well quoted in the literature on microfinance. Here there are no issues pertaining to transformation, because microfinance did not branch out from developmental activities, but was a core. Microfinance emerged in response to inability of commercial banks (the Bangladesh Krishi Bank and other financial institutions) to meet banking needs of the poor. In the 1970s, loan recovery of these institutions averaged 65% of the dues. During that period, political parties offered to waive loans of farmers (Montgomery, Bhattacharya, and Hulme, 1996). Around this time, Professor Yunus started action research on effective delivery of credit to rural poor – which later grew into a large microcredit program, known as the Grameen Bank. The program was successful, and in 1983, the project was converted to an independent bank through legislation. Unlike the experiences of other countries, Bangladesh experience looks at legitimizing a successful experiment and not allowing it to drift into other forms of inappropriate incorporation. The Bangladesh experiment gained overall approval in as much as it has become a universal standard in microfinance. This is one of the most replicated models of microfinance around the universe.

Following Grameen, other institutions in Bangladesh also entered the field. The Bangladesh Rural Advancement Committee (BRAC), set up in 1970, got into organizing groups under two pilot programs in the first half of the 1980s. BRAC's methodology shared similarities with Grameen. With Grameen being a worldwide fable, it was not difficult for other institutions in Bangladesh to get regulatory support. BRAC eventually did spin off a banking company in 2001. In the case of Association for Social Advancement (ASA), the metamorphosis was even stark. Though ASA was established in 1978 as an organization of social and political activists, it changed its focus to social and economic upliftment of the poor in 1985. By 1991 it was a fully focused organization using microfinance as a singular tool for achieving its objectives (www.asabd.org).

However, with institutions such as Grameen Bank, BRAC, ASA pioneering microfinance and providing models for other countries to follow, they did not have a need to transform. They could grow at their own pace without transformation. One reason why they had no regulatory problems was that they were focused exclusively on credit. It was only after they reached a very large size and sophistication that they wanted offers other banking services. It was only recently that Professor Yunus of Grameen Bank raised the issue of the need for an appropriate legislation for microfinance banks (Yunus, 2003). In Bangladesh there are dual example of something that started off as a MFI entering other areas of development, and NGOs picking tab from Grameen and launching their own successful microcredit programs. The transformation was two way. Unlike Indonesia, MFIs in Bangladesh carry value attributes listed such as dealing predominantly with the poor and having developmental roots.

3.4 India: Transformation Experiences, Options and Future

The transformation into MFI in India is still at a nascent stage. There are large numbers of small initiatives being carried out at various places. The estimated numbers of MFIs that have requested finances from commercial sources consult rating agencies such as M-CRIL and Planet Finance. When NGOs want to move to the mainstream, they choose from three popular forms of organizations: non-banking finance companies, banks and co-operatives. Experiences indicate that there is lack of ideal path for spin off that has implications for regulation. Need for regulatory changes to allow MFIs to graduate into other legal forms as they grow organically has been felt to permit NGOs to invest in equity of MFIs, as is the case in Bolivia. Regulations should ensure that they help genuine MFIs and not others masquerading as MFIs.

4. Transformation Experiences of Nepal

Though transformation experiences in Nepal is quite recent, it is very interesting but at a nascent stage. In general, there are three different legal windows such as Cooperative Act 1992; Financial Intermediaries Societies Act 1999, first amendment 2001; and Development Bank Act 1996 to transform Nepalese CSOs into MFIs. In this section, transformation experiences under three legal options are discussed.

4.1 NGOs into Development Banks

4.1.1. Overview

Enactment of Development Bank Act 1996 opened opportunity to NGOs to transform into Microfinance Development Bank (MDB). The first MDB was the Nirdhan Uttan Bank (NUB) promoted in December of 1998 by a NGO called Nirdhan which was operating as a private Grameen Bank Replicator since 1993. The paid-up capital of NUB is NRs. 10 million. DEPROSC Development Bank (DDB) was another MDB promoted by DEPROSC in January 2001 with a paid-up capital of NRs 10 million (USD 128,000). Chhemak Bikas Bank (CBB) promoted by Chimeki Sanstha in 2002 with a paid-up capital of NRs 10 million (USD 128,000) was the third MDB in Nepal. The forth MDB was Swabalamban Bikas Bank (SBB) promoted by Center for Self-Help Development (CSD) in 2002 which was providing financial services to the households below the poverty line as a Grameen Bank Replicator in the Eastern and the Central Region of Nepal Terai since 1994 with a paid up capital of NRs 10 million (USD 128,000). All four MDBs have permission to work in 10 different districts. These NGOs expected an ownership structure with shareholders that would maintain an appropriate balance between their social mission and profitability with incentive for better management and governance, increased access to funds from commercial sources; service diversification; and outreach and sustainability on microfinance operation.

4.1.2. Ownership structure and governance

Significant changes on ownership structure and governance was the most vivid and distinct effect of the transformation of NGOs into MDBs. At present all the four MDBs possess ownership structure consisting of multiple owners with risk capital partly to comply with legal requirements. The ownership that initially solely with parent MFI has been shared with other promoters with relatively small share owned by founder NGOs. Under transformed structure, their owners consist of founder NGOs, commercial investors, private individuals and others. In these MDBs, ownership of parent NGOs is relatively small which ranges between 12% and 21.5%. There has been significant private risk capital coming from purely private banks (36% in NUB; 55.5% in DBB; 51% in SBB and CBB) in their paid-up capital. In some MDBs, private individuals have significant share ownership, especially so in NUB and CBB, essentially, in response to legal requirement that public companies registered under

Company Act 1997 of Nepal should allocate at least 33% of their share capital to general public. In all four MDBs, issue appears to have been not one of seeking maximum level of private risk capital participation, but finding most appropriate level of such capital to achieve social mission in respect of target group is at an increasing rate.

Table 1: Ownership Structure of MDBs in Nepal

Owners	Ownership structure (%)			
	NUB	DBB	SBB	CBB
Founder NGOs	12.0	21.5	22.0	17.0
Commercial investors	36.0	55.5	51.0	51.0
Private individuals	41.0	9.0	10.0	32.0
Others	11.0	14.0	17.0	0.0
Total	100.0	100.0	100.0	100.0

Source: Concerned MDBs
Note: Others are: Grameen Trust Bangladesh (case of NUB), Agriculture Development Bank (case of DBB) and Women Cooperative Society Ltd. (case of SBB).

As expected transformation has brought change in governance and institutional sustainability to comply with legal requirements of banking authorities to retain MFI license with new ownership structure and board of directors. The legal and regulatory requirements have led to improve on portfolio management, loan loss provisioning, internal control, liquidity management, risk management and information management, and maintain capital adequacy. These institutions are spending considerable resources for staff training and to put in place proper systems and transparent procedures for retaining license. In addition to meeting an array of "*safety and soundness*" tests, such MDBs had to meet standard "*fit and proper tests*" while appointing management and board members. They have brought experienced bankers and accounting personnel for specialised functions such as asset management and liability management, treasury management and internal controls. The new board of directors (BODs) includes reputed persons with either more business or banking experiences and independent professionals. These changes and improvements on composition of BODs have been instrumental to make them more robust than their founder NGOs in terms of governance, operations, and institutional stability with significant room for further improvements. In institutions where founder NGO maintain close operational link, other shareholders are not effectively carrying out their oversight functions; operations are not effectively supervised by new authorities, transformation has yet to produce positive results in governance, operations, and institutional sustainability. Thus, current experience is mixed as to extent at which transformation has brought better governance and institutional stability.

4.1.3. Access to loanable funds from commercial sources

Transformation has been instrumental to bring a major shift in sources of funding. First, loans have gradually replaced donor grants, but the loans have not come entirely from commercial sources. These institutions have gained increasing access to funds from both commercial and semi-commercial sources. NUB, CBB and SBB borrow from RMDC, the apex lending agency and their outstanding liabilities to RMDC amounted to Rs. 5.2 million, 25.2 million and 32.0 million respectively as of July 15, 2004. DDB has once borrowed from RMDC but discontinued borrowing upon full repayment of the loans. Nevertheless, loans from commercial and semi-commercial sources constitute the most dominant sources of loanable funds to these institutions. For DDB, loan acquired from commercial sources constitute to be the largest liability.

Table 2: Outstanding Loan of MDBs by Sources in Nepal

Owners	Liabilities by sources (%)							
	NUB		DBB		SBB		CBB	
	1998	2003	2000	2003	2001	2003	2001	2003
Deposits								
Loan - RMDC								
Loan - commercial banks								
Others								
Total								

Source: Concerned MDBs

Although transformation has eased constraints on commercial borrowing, extent of their reliance is determined by market-specific factors such as outreach; operation and financial performance; portfolio management and marketing ability of the MDBs. In general, as MDBs penetrate deeper into deposits markets over time, their demand for debt financing is likely to diminish gradually.

4.1.4. Product diversification

Product diversification has been gradual phenomenon in MDBs. Within the provision of Development Act 1996, MDBs have begun to offer and expand voluntary savings services. By 2003, they were financing a sizable proportion of their loan portfolio with deposits. NUB has improved its voluntary deposit services, although most of its deposit volume consists of compulsory deposits of the borrowers. Despite legal ability to capture savings, MDBs

demonstrate their reluctance to take advantage of their ability to mobilize savings, essentially attributed by dominating influence of their original lending culture. Concern and disappointment are voiced about seeming slowness of MDBs to develop savings programmes for low income populations. MDBs are gradually exploring possibility of adding other services such as money transfers and payment services, to their menu.

4.1.5. Outreach and sustainability

Expanding outreach and attaining sustainability was the most important issue for all four MDBs and all four have experienced rapid growth in the number of borrowers. NUB provides a case where transformation produced positive impact on depth of outreach. It had only 15,382 active loan clients at the time of transformation in July 1999. By mid-July 2002, this number increased by 92.4% to 29,589 borrowers. The average loan balance per borrowers increased by 44.4% from $63 in July 1999 to $ 91 in July 2002, both remained low at 36% of the per capita income for 2002. A poverty audit of NUB in 2001 confirmed that its transformation has not resulted in mission drift, and the poorest groups were strongly represented in its clients.

Table 3: Outreach and Sustainability of the MFIs in Nepal

Owners	Liabilities by sources (%)							
	NUB		DBB		SBB		CBB	
	1998	2003	2000	2003	2001	2003	2001	2003
Active loan clients (No)								
Outstanding loans (Rs. '000)								
Operating self-sufficiency (%)								
Financial self-sufficiency (%)								

Source: Concerned MDBs

All the four MDBs witnesses significant improvement on their operating and financial self-sufficiencies after transformation. NUB has almost attained operating self-sufficiency and approaching on achieving financial self-sufficiency albeit some disturbances from recent insurgency and conflict situation.

4.2 NGOs into Financial Intermediary

Enactment of financial intermediary act 1999, first amendment 2001 has opened opportunities to NGOs involved in microfinance to graduate into financial intermediary (FI)

NGOs. Expediting the enactment of the FI act and facilitating emergence of FI-NGOs was ultimate goals of HMGN's executed MCPW Project under loan assistance from AsDB. With the enactment of the FIA in December 1999 and first amendment 2001, 35 out of 87 MCPW's partner NGOs acquired FI license and became legally recognised FI. Further, additional nine NGOs working outside MCPW project districts also obtained FI licence and became FI-NGOs. FI NGOs are new tier in Nepalese microfinance sector primarily geared towards efficient retailing microfinance services at grassroots level to expand frontier of microfinance by increasing the access to credit to women, providing substitute to microfinance services provided by two state-owned commercial banks namely NRB and RBB and promoting sustainable model for microfinance operation.

4.2.1. Expanding frontier of microfinance services

Of the 44 FI-NGOs obtaining financial intermediation license from NRB, available information on microfinance services extended by 13 FI-NGOs indicates quite encouraging role of these institutions on expanding frontier of microfinance services (Table 4).

Table 4: Microfinance Operation by FI-NGOs

S.N.	Particulars	Unit	Total	Mean
1	FI-NGOs involved on on-lending	No	13	-
2	Members	Rs.	15,417	1,186
3	Amount disbursed	Rs.	106,799,441	8,215,342
4	Amount recovered	Rs.	67,759,080	5,212,237
5	Outstanding balance	Rs.	39,393,685	3,030,283
6	Overdue amount	Rs.	0	0
7	Recovery rate	%	100	100

Source: RMDC Report, 2004

As of December 2003, these institutions have provided financial services to a total of 15,417 women, number of members served by them ranged between 270 and 7,555 members with an average of 1,186 members. Average loan disbursed by these institutions was NRs. 8.2 million; loan collection NRs. 5.2 million and outstanding loan balance NRs. 3.0 million. This is quite encouraging and implies high potentials of these institutions on expanding frontier of microfinance services in their working areas. Institution like NRDSC has been quite successful to extend outreach of their services to over 7000 families. Since mostly these institutions are at the early stage of microfinance operation, they possess the prospects for growth. It is irony to mention that over 50% FI-NGOs have yet to start micro-lending.

Frontier of microfinance would expand greatly if all the FI-NGOs thus graduated will involve on financial intermediation.

4.2.2. Access to loanable funds from commercial sources

Upon acquiring FI license, FI-NGOs are qualified to increased access to loanable funds. RMDC is the only apex institutions for FI-NGOs to obtain loanable fund to enable them involve on on-lending. Twenty out of the 44 FI-NGOs have developed functional linkages with RMDC which has played paramount role for enhancing their managerial capacity. These institutions have participated in various management training such as business planning, accounting and book keeping, portfolio management, management information system and governance issues as well as exposure visits to grassroots sites of institution involved on micro-lending to observe household survey techniques, use of PRA tools like wealth ranking for selecting target groups, group formation, group management, savings collection, loan disbursement, collection, portfolio management, internal and fraud control, staff productivity and branch management. RMDC has approved wholesale loans to 20 FI-NGOs amounting to Rs. 161.2 million, of which Rs. 91.4 million has been disbursed and Rs. 35.0 million has been recovered with an outstanding balance of Rs. 56.3 million. Loan has been provided on instalments so that these institutions will acquire skill and competence on money management and demonstrate seriousness on maintaining credit discipline. Repayment rate is quite encouraging and is 100% on-time payment (Table 5).

Table 5: RMDC's Lending to FI-NGOs

S.N.	Particulars	Unit	Total	Mean
1	FI-NGOs receiving wholesale loans from RMDC	No	20	-
2	Amount approved	Rs.	161,215,000	8,060,750
3	Amount disbursed	Rs.	91,410,000	5,377,059
4	Amount recovered	Rs.	35,039,650	2,335,977
5	Outstanding balance	Rs.	56,370,350	3,315,903
6	Overdue amount	Rs.	0	0
7	Recovery rate	%	100	100

Source: RMDC Report, 2004

Lack of access to wholesale loans from apex institution is the main factor to limit these institutions start retail lending. Two stringent requirements of RMDC, among others, i.e. Rs. 0.25 as net-worth requirement and (b) Rs. 0.5 million as loanable fund as liquidity

requirement, appeared to be difficult and acted as barrier for most of the FI-NGOs to establish business linkages with RMDC. Creating enabling environment to enable FI-NGOs start retail lending ensuring access to wholesale loans from RMDC is one of the challenges to these institutions. Besides RMDC, there are instances that some FI-NGOs have established business linkages with other credit based projects on livestock development and community ground water irrigation on providing lending services for livestock and irrigation development. There are FI-NGOs that have obtained revolving fund from INGOs and RSRF, reinforcing that FI-NGOs have accessed loanable funds from commercial sources.

4.2.3. Substitute to the microfinance operation of the state-owned Commercial Banks

Of the 20 FI-NGOs receiving wholesale loans from RMDC, 16 were the partners NGOs of MCPW project that were involved in series of activities meant to graduate them into financial intermediary. Initially these NGOs involved as social intermediaries; gradually graduated into credit agents (CAs), and finally acquired FI license from NRB under Act for NGOs involved on Financial Intermediation 1999 first amendment 2001. All 16 FI-NGOs involved in social intermediation and their capacity was enhanced using package[4] of services encompassing targeting, group formation, savings mobilization, loan processing, and upgrading basic knowledge and skill of women clients on managing small business. On an average, they have conducted 556 household survey, identified 354 target beneficiaries, organized 257 women beneficiaries into 37 solidarity groups, conducted/coordinated basic training and skill training respectively to 147 and 42 women beneficiaries and assisted 128 women to obtain and repay loan to participating bank branches of NBL and RBB. As of June 2002, 16 FI-NGOs were supporting 6655 women organised into 842 groups supported with a cumulative savings mobilisation of Rs. 11.6 million from these members (Table 6).

Table 6: Social mobilisation done by MCPW's partner FI-NGOs as of June 2002

S.N.	Particulars	Unit	Total	Mean
1	FI-NGOs	No.	16	-
2	Groups formation	No.	842	53
3	Members enrolled	No.	6655	416
4	Savings mobilisation	Rs. '000	11,699	731

Source: MCPW, Project Completion Report, 2003

[4]Social mobilization packages include among others activities like area selection, household survey, target group identification, group formation, basic training, savings mobilization and management, lending, recovery and skill training.

These FI-NGOs had demonstrated success and proven capability on social mobilization and are able to maintain fairly high[5] loan recovery rate. Of these 16 FI-NGOs, 15 institutions were graduated as CAs[6] and obtained fees based on their loan recovery performance. Finally, they graduated into FI-NGOs. During project period, these NGOs have undergone series of capacity enhancement programme and they have improved their technical and management capabilities. While working as MCPW partners, the 16 FI-NGOs were involved on social preparation of their women group members and assisted them on promoting lending. Amount of loans supported by these institutions was Rs. 53.2 million, of which Rs. 37.2 million was recovered and Rs. 16.0 million was outstanding balance. Of the amount balance, Rs. 1.0 million was overdue and loan recovery rate was 91.7% (Table 7).

Table 7: Lending Services Supported by MCPW's partner FI-NGOs as of June 2002

S.N.	Particulars	Unit	Total	Mean
1	FI-NGOs	No.	16	-
2	Amount disbursed	Rs. '000	53,248	3,328
3	Amount collected	Rs. '000	37,211	2,326
	Outstanding loan balance	Rs. '000	16,037	1,002
4	Overdue amount	Rs. '000	1,045	65
5	Repayment rate	%	92	92

Source: MCPW, Project Completion Report, 2003

Performance of these institutions on loan management was quite encouraging and satisfactory. These FI-NGOs are currently providing microfinance services to women beneficiaries they had already served and with phase-over of the MCPW project, these women has virtually no business linkages with the participating bank branches. To some extent these institutions substituted the microfinance services extended by two state-owned commercial banks. Unlike commercial banks their services is reliable and easy as these services are currently available at the door step.

4.2.4. Promoting sustainable model for Microfinance Operation

FI-NGOs are relatively young and it is too early to assess sustainability of the microfinance component of these institutions. However, early experiences of operation of the FI-NGOs

[5]Loan recovery rate was 88% in case of partner NGOs and 78 percent in case of WDS supported women beneficiaries.
[6]The CA accreditation process, working modality and fee structures were finalized lately in June 1999 and CA is provided a maximum of 4% of recovered amount if repayment rate is above 95% and no commission if recovery rate is below 80% base on performance.

such as NRDSC, CYC, DCRDC and Mahuli indicate that they have already acquired operating self-sufficiency and are in process to acquire financial self-sufficiency. It is more likely that NRDSC and Mahuli will acquire financial self-sufficiency by the end of FY 2004/05. There exist prospects that transformation of NGOs into FI has been effective and instrumental to promote sustainable model for microfinance operation in Nepalese microfinance sector.

4.3 Small Farmers Groups into Small Farmer Cooperatives Ltd

4.3.1. Overview

Under SFDP, ADBN started to form joint liability groups of small farmers in 1975 through its Sub-Project Offices (SPOs). Prudent to prevailing development thinking of that time, "cheap" money meant for productive purposes was channeled to group members. Sustainability of this approach has been questioned on their high overheads of SPOs and low collection rates. In order to institutionalize the whole concept, ADBN with the support of GTZ introduced an action research Institutional Development Programme (IDP) in 1987. The objective of IDP was to transform ADBN-run SPOs into fully self-administered and managed cooperatives of small farmers (Lamsal, Sejuwal and Shakya, 2001). In 1993, as a result of the IDP, the first four SPOs were transformed into SFCL under Cooperative Act 1992. As of July 2004, 143 SFCLs were established in 36 districts. Currently, the SFCL in Nepal comprise over 80,000 rural households with outstanding loans of US$ 11.5 million and internally generated resources of US$ 2.5 million. Female membership is increasing and stands at 40%. Transformation of SPOs into SFCLs is a major policy shift towards an institution building and more demand driven approach to serve poor client in a sustainable manner by developing and promoting viable model for microfinance operation especially in hills and remote areas.

4.3.2. Institution development and demand driven approach

A SFCL is a multi-service cooperatives designed to deliver both financial and non-financial services to its members. SFCLs are CSOs that pool their joint resources to meet basic needs and to defend their members' interest. They are member-owned and controlled and have an open membership policy towards "*poor members*". A SFCL is a three-tiered organisation with

small farmer groups, inter-groups and main committee as the three pillars. Small farmers groups are formed as joint liability groups at the village level, usually consisting of 5 to 12 members. These bodies allow members to start and operate financial and non-financial services required by the group and/or group members. From each small farmer group within a defined area, one representative joins so-called inter-group. The inter-group further validates specific group requests and gives approval recommendations to main committee. One representative of each inter-group joins so-called main committees at Village Development Committee (VDC) level. The nine member main committee approves the SFCL programmes and decides on their implementation in addition to any other projects such as office building construction, livestock insurance scheme, consumer stores, etc. In order to handle daily operations, SFCL employs a chief manager, an assistant manager and a helper. Either the chief manager or the assistant manager should be female. They deliver various financial and non-financial services. Financial services include various forms of voluntary and compulsory savings products, a variety of loan products as well as livestock insurance scheme. Non-financial services include construction of irrigation channels, establishment of milk collection centers and nursery establishment; and women empowerment programmes. New products are continuously added[7].

4.3.3. Outreach and viability

By July 2000, SFCLs had captured a significant share of formal/semi-formal rural financial market, serving 6% of total borrowers. The market share of SFCLs followed a strong path towards profitability with impressive growth rates in terms of deposit mobilisation and increase in revenue. An ADBN/GTZ study in 2001 (Wehnert and Shakya) showed that from a sample of 33 SFCLs, their average financial self-sufficiency ratio increased from a poor 39% by mid-July 1997 to 118% by mid-July 2000, putting SFCLs in the category of successful MFIs. Both economic and social living conditions of members had further improved after joining SFCLs. In particular, dependency on money lenders had decreased significantly. Client children have easier access to school due to improved income levels.

Over the last couple of years, however, business climate and security situation have deteriorated due to Maoist conflict, adversely affecting performance of SFCLs. Thirty four SFCLs have so far been attacked by extremists, and documents, furniture and buildings have

[7]A prominent example is design of a savings product addressed to children and their parents.

been burnt down. The average financial self-sufficiency ratio therefore dropped to 89% by 2001 and further decreased to 83% by July 2002 (Wehnert and Shakya 2003). Through their unique organisational set-up, SFCLs deliver their services to members. Important messages from main committee can be effectively delivered through inter-group representatives without calling in an assembly. Particularly for hill and remote areas, the three-tier structure appears to be appropriate since small farmers will be able to do majority of their activities within their groups on the local level.

4.3.4. Model for hills and remote areas

Unlike the conventional notion that SFCLs from the Terai region of Nepal achieve faster OSS than SFCLs in the hill areas, study by Wehnert and Shakya 2001 uncovered that SFCLs from hill areas started with an OSS rate of 51.6% in 1996/97, which increased to 79.9% in 1997/98 and to 93.7% in 1998/99 and reached 122.6% in 1999/2000, while for those in Terai, OSS ratio was 32.7% in 1996/97, which jumped to 85.2% in 1997/98 and further increased to 92.6% in 1998/99 and finally to 121.8% in 1999/00. Their findings suggest that the SFCL model is the concordance with both the Terai and hill regions of Nepal. Particularly in the hill and remote areas, there is less room for a variety of service providers that could compete for clients. The concept of establishing one service provider through federative process that officer a variety of services in a professional manner has proved to be successful and provide proven and viable model for micro-financing for the hills and remote areas.

4.3.5. Provision of multi-purpose services

Subsequent to transformation process of the SFCLs, innovative activities are being undertaken by SFCLs in addition to their regular savings and credit programmes. Besides, autonomy to individual SFCL for policy formulation to address local needs has also contributed to this end. Though nature of innovation varies across SFCLs, some notable observations are: construction of their own office building, management of livestock insurance scheme, provision of veterinary services, establishment of village banking, management of telecommunication services, operation of consumer store and agricultural marketing, support in dairy business, and management of transport facilities. Thus SFCLs present premier self-help poverty reduction initiatives in that they provide savings opportunities and credit access to poor farmers. In addition, they promote a range of other

financial and non-financial services. Other services offered are dairying, livestock insurance, veterinary services, various income generating skill training and social development activities such as literacy and awareness about family planning. They all directly contribute to enhancing of income opportunities and quality of the members. Provision of demand driven financial and non-financial services has enabled SFCLs to emerge effective multi-service institutions at grassroots level.

4.4 Women Savings and Credit Cooperatives Ltd

4.4.1. Overview

As a phasing out strategy of the PCRW and MCPW projects efforts have been made to transform women SHGs formed under women development programme of DWD into women SCCs through federative process with the ultimate goal of enhancing women's ownership; making project most cost effective and result oriented; and mainstreaming groups roles and capacity addressing their own needs and priorities. The transformation process starts once individual women organize into small SHG. Number of such groups is federated into bigger group called inter-group or committee. These committees are involved in savings mobilisation, revolving fund and participation on community development activities. Once such committees gain experiences and develop confidence on management, they are formally registered into local institutions either as women SCC. DWD has already promoted over 300 women SCCs and taking this as one of its main strategy since late 1990s. The institutions thus developed are involved both social and financial intermediation at grassroots level. The ultimate objectives of transformation process is to change the role of WDS from implementers to facilitators, phase out programme, increase area coverage, reduce their dependence with commercial banks for meeting their demand for credit capital.

4.4.2. Shift on role

These cooperatives are involved on group formation, recommend and facilitate WDS in loan disbursement and repayment, and collect and mobilize savings and revolving funds. Their involvement has been instrumental to increase group solidarity and establish linkages with development agencies and local government to avail services in favor of their institutions or community. These institutions have also organized and facilitated to conduct functional

literacy classes. Thus Women SCCs are gradually assuming the role that WDS staff was performing in the past implying a shift in role of WDS from implementers to facilitators.

4.4.3. Area expansion

Federation of groups into women SCCs has been quite instrumental for time savings to WDS staff. The time thus saved has been used for expanding women development programme (WDP). In general, formation of two women SCCs have been instrumental to expand WDP in one VDC. As the process of federation gain momentum, WDS are quite successful to extent the outreach of their programme. The momentum on area expansion partly depends on extent at which WDS staff is skillful enough to assume their role of facilitators and capable of transforming functions they have done in the past to these institutions.

4.4.4. Reduction on dependence with commercial banks for loanable funds

All the women SCCs mobilised savings on regular basis, at least once a month. These institutions have managed loanable funds from diverse sources such as members' savings, revolving fund, wholesale loans obtained from apex institution like RSRF, share capital and retained earnings. These institutions are gradually heading towards self-sufficiency and their members' dependence with commercial banks for loanable funds has been gradually reduced. As of August 2002, 34% of loanable funds to 82 women SCCs developed under MCPW was savings, 29% was grant and 16% was share capital - See Table 8.

Table 8: Loanable Funds in 82 Women SCCs Supported by MCPW's as of August 2002

S.N.	Particulars	Unit	Total	Mean	Percent
1	Women SCCs	No	82	-	-
2	Shareholders	No	10,282	125	-
2	Share capital	Rs.	2,416,650	29,471	16
3	Savings	Rs.	5,230,344	63,785	34
4	Grant	Rs.	4,544,781	55,424	29
5	External loan	Rs.	1,572,019	19,171	10
6	Net profit	Rs.	1,043,999	12,732	7
7	Other	Rs.	720,384	8,785	5
	Total	Rs.	15,528,177	189,368	100

Source: MCPW, Project Completion Report, 2003

The information presented in above table indicates that these SCCs have sizable amount of loanable funds for on-lending to their members and their dependence with commercial banks for access to loan has been gradually declining. These SCCs still possess prospects for expanding outreach and size of the loanable funds.

4.4.5. Linkages to apex institutions

RSRF is the main apex institution to provide wholesale loans to women SCCs. These women SCCs have acquired wholesale loans from RSRF. Of the women SCCs developed under MCPW, nine SCCs have received wholesale loans from RSRF. All 82 women SCCs promoted under MCPW have received revolving fund under MCPW and there are WDS developed women SCCs that have received revolving funds from other multilateral institutions like UNICEF.

5. Factors Triggering Transformation

Transformation of Nepalese CSOs into MFIs is not the natural phenomenon; rather it is an outcome of the opportunities provided by the legal and regulatory environment influenced by the international movements on transformation. There are at least four factors such as growth, diversity, sustainability and focus that trigger transformation of CSOs into regulated MFIs in Nepal. These factors are discussed in greater details hereunder.

5.1 Growth

Growth is the most significant factor that triggers transformation affecting both promoters and practitioners. Most parent organisations of MDBs and FI-NGOs promoted SHGs however commercial banks were reluctant to provide loans to them at pace of their needs. It was not easy for them to deal with attitudes of people manning these organisations. In several instances, it was an enthusiastic bank manager who made differences but not fully institutionalised. In such situations, NGOs tend to get into action by opening a microfinance division, or setting up a separate MFI. The geneses of Nepalese MFIs such as MDBs, FI-NGOs, SFCLs and women SCCs are rooted to the failure of banks to meet investment needs of the poor and disadvantaged groups.

Since NGOs have multiple developmental objectives and microfinance meets a sub-set of these, microfinance activity is visible and has scope for rapid growth. The incorporation of a NGO as a not-for-profit entity (trust, public society) is not ideal for lending activities. When activity is small, it would be possible to work within this framework, but growth means documentation, regulation, follow-up, and money management which requires a clear demarcation between charitable and commercial activities of an organization for which keeping microfinance as a distinct activity/division is a necessary condition. Growth needs infusion of funds for microfinance operations and a not-for-profit entity does not help scaling up borrowings or attract investments from outsiders on the absence of appropriate legal framework and operational culture. On the absence of the capital base in NGO, leveraging has been difficult. If microfinance activities form biggest chunk of the surplus earning activities of a NGO, taxability of their operations is a concern.

5.2 Diversity

The diversity of financial services that a MFI wants to offer was another factor that triggered transformation. In most cases, NGOs start with credit but soon realise the need to provide other support services. While MFIs have reduced their own lending risks through group guarantees and addressed issue of wilful default, they have not been able to fight with the situation where underlying economic activity fails and borrowers faces a genuine problem. This can be tackled with a combination of savings and risk mitigation products. But, MFIs realise that NGO format is not suited for carrying out these activities owing to stringent regulations. They necessarily have to look at transformation options.

Although diversity is closely linked to size, it need not necessarily be so. Apart from loans, MFIs would want to offer savings services to customers which are one of the essential services. It is also a source of loanable fund for expanding lending services. Some MFIs also want to offer insurance and other services. For instance, when Nirdhan wanted to work with poor women a few decades ago, it was constrained by lack of fund and offering other types of financial services to address needs of social security as a NGO. For meeting these felt needs it was necessary to transform legal status as a development bank that enabled them to diversify their services. In all the MDBs and FI-NGOs, the first step in diversifying services has been offering savings services and possibility of exploring insurance services. Unlike lending services, savings and insurance services are very closely regulated and monitored.

Local need and pressure to meet basic financial services by diversifying products and services triggered NGOs to examine options of transformation.

5.3 Sustainability

Beyond a certain level, MFIs must seek external funds for keeping credit activities expanding so as to response market demand. When MFIs seek funds from financial institutions, issues such as ownership and capital adequacy become critical. MFI must transform into legally recognised institutions with transparent systems and accountability to survive in long run. In most cases, promoters of MFIs do not have sufficient capital to invest and therefore main constraint is that they are dealing with "*other people's money*". NGOs have no clear-out ownership structure and making people liable under this format was a problem commonly realised. If they were to be sustainable, the only option is to deal with mainstream institutions (Rhyne, 2001 pp. 5). Thus the trigger for sustainability could be from within or outside. For instance donors may be prime movers by granting seed money and they may want activity to be ongoing without further investments. In the case of Nirdhan and DEPROSC, PLAN was willing to extend a returnable grant to start pilot operations with an understanding that grant would be used on the system on a professional way. These institutions started their operations as NGO, pilot tested some products and delivery channels, and in meantime, transformed themselves into MDBs under Development Bank Act 1996. Early experiences indicate their operations to be sustainable. Transformation enabled them to acquire commercial sources of funding to expand their outreach and heading towards acquiring operating and financial self-sufficiency. Further, most FI-NGOs were in a difficult situation before they acquire FI position as they were not legally qualified to borrow from apex institutions and their sustainability was a dream. Graduation to FI qualified them to borrow from RMDC and thereby instrumental for attaining sustainability.

5.4 Focus

In general NGOs must maintain their original mandate and undertaking microfinance is transaction intensive and requires distinct orientation and skills. For NGOs, there is always a conflict between microfinance, which earns returns, and therefore "*commercial*" and other activities that are "*developmental*". This is one reason for NGOs to spin off their microfinance

activities. The entity that emerges to carry out microfinance should be understood and recognized by the mainstream and therefore it should have an appropriate institution form. This necessitated most CSOs to transform within available legal form.

To start with, all the MDBs and FI-NGOs had an exclusive entity to manage microfinance and have taken it as one of their activities leading to diffuse focus on microfinance. There are many instances of such a spin-off. Most started microfinance services to SHGs motivating them to mobilize savings and experienced that savings services along will not meet financial needs of their clients. Many realized the need to link SHGs with banks was not happening at planned pace, hence, decided to assume the role of a "*provider*". This involved specialized systems and procedures and a change in the orientation of staff members. Besides, some also wanted to make their institution as an example that could commercially provide financial services to the poor. Thus, most MDBs and FI-NGOs decided to build an arm's length relationship between developmental work of promoting NGO and commercial work providing credit related services. It can be seen in this case that one of the sub-processes of transformation is spin-off of new organizations.

6. Conclusion and Recommendations

6.1 Conclusions

With the transformation of PRODEN into Bancosol in 1992, a new modality emerged in the microfinance industry. There is interesting case of transformation of Nepalese civil society organisations into MFI. There are three different legal windows for Nepalese civil society microfinance in Nepal such as Cooperative Act 1992, the Financial Intermediaries Societies Act 1999, first amendment 2001 and Development Bank Act 1996. There is significant transformation of CSOs into MFI as large number of SHGs has transformed as SFCLs and women SCCs under Cooperative Act 1992, sizable number of NGOs are transformed into FI-NGOs under Financial Intermediaries Societies Act 1999 and four larger NGOs are transformed into MDBs under Development Bank Act 1996.

Empirical evidences shows that the result of transformation is quite effective and encouraging. NGOs transformed into MDBs has met the expectation of change in ownership structure with shareholders that would maintain an appropriate balance between their social

mission and profitability, with incentive for better management and governance, increased access to funds from commercial sources; service diversification; and outreach and sustainability on microfinance operation. On the other hand, FI NGOs are new tier in Nepalese microfinance sector and these institutions are gradually assuming the responsibility to efficiently retail the microfinance services at grassroots level to expand frontier of microfinance by increasing the access to credit to women, providing substitute to microfinance services provided by two state-owned commercial banks namely NRB and RBB and promoting sustainable model for microfinance operation. Further, transformation of SPOs into SFCLs is a major policy shift towards an institution building and more demand driven approach to serve the poor client in a sustainable manner by developing and promoting viable model for microfinance operation especially in hills and remote areas. Similarly, the transformation process of women solidarity groups into women SCCs has been proved to be effective in changing role of the WDS from implementers to facilitators, phase out the programme, increase the area covered, reduces the dependence of the programme with commercial banks for meeting the demand for credit capital.

With the concerns that most MFIs have for community involvement and within Nepalese regulatory framework, the obvious choice for these CSOs was to assume legal position such as MDBs, FI-NGOs and cooperatives. There are at least four factors such as growth, diversity, sustainability and focus that trigger transformation of these institutions into regulated MFIs. There are some initiatives for converting these transformation initiatives towards effective development of microfinance operation for addressing poverty issues. The expectations of opponents of transformation that it would lead to mission drift did not appear to have become a reality in Nepalese cases. Instead, with access to more resources, these institutions have substantially expanded their scale and scope of operations and are serving large number of poor and low income households.

Geographical mapping of transformed MFIs provides indications that these institutions are still concentrated in terai and accessible hills rather than remote hills and mountains. Even within terai and accessible hills, these institutions are concentrated in eastern, central and western regions in response to market forces than in mid and far western regions where the services of these institutions are required the most.

6.2 Recommendations

Given the dynamic nature of its subject matter, a study like this can never be fully up to date or fully complete. However, the message that is clear from this paper is that Nepalese CSOs have started transformation initiatives with clear vision and expectations for expanding the frontier of microfinance which are the functions of legal framework and linkages with the apex institutions. Transformation initiatives had added significance in Nepal where microfinance sector started without clear-cut preparation in an ad-hoc basic as evidenced by the existence of large number of SCOs in rural areas and inclusion of savings and credit component in almost all the grassroots level interventions such as agriculture, forestry, irrigation, and rural roads. Transformation is the effective vehicle to bring the series of informal microfinance initiatives into mainstream of microfinance sector.

This paper has provided clearer picture that momentum on transformation of potential Nepalese CSOs into MFIs has been constraints by the main elements of legal framework that demands clear-cut analysis. The first step in this endeavor could be comprehensive overview of existing legislation affecting microfinance operation vis-a-vis the transformed MFIs. This would not be sufficient in itself to explain strengths and weaknesses of a legal framework. This should be supplemented by assessment on enforcement of legal provisions including supervisory practices and analysis of crucial elements for an effective regulatory requirement. Clear recommendations for improving regulatory framework for microfinance operation need to be developed and enforced. An analysis of all influential stakeholder groups is a prerequisite, as only then can realistic proposals for the amendment of the current legal environment be devised.

Transformation process, especially in case of FI-NGOs, SFCLs and women SCCs is yet supply driven, guided essentially by promoters including donors and few cases by practitioners. There is a need to make transformation more demand driven through an advocacy strategy to explain fundamentals of microfinance regulations to potential CSOs of inaccessible hills and mountains. This will be instrumental to expand frontier of microfinance operations in areas where existence of such institutions are justified.

Annex 1: Supplementary Information

Table A- 1: Social Mobilisation Services Provided by MCPW's partner FI-NGOs as of June 2002

S.N.	Name of FI NGO	Groups (No)	Members (No)	Savings Mobilisation (Rs. '000)
1	CYC	49	420	235
2	DCRDC	35	268	277
3	RAF	32	303	75
4	Gramin Mahila Bikash Sanstha	30	200	352
5	Gramin Mahila Utthan Kendra	34	392	650
6	Nepal Mahila Samudayik Sewa Kendra	27	250	230
7	SUPER	50	375	250
8	SWAN	18	189	386
9	SOLVE	50	502	458
10	Srijana Bikash Kendra	68	524	2,267
11	MANUSHI	60	360	505
12	Nepal Mahila Utthan Kendra	23	163	127
13	NESDO	41	287	316
14	Mahuli Samudaykk Bikash Kendra	78	483	254
15	Samudayik Mahila Bikash Kendra	64	448	582
16	Srijana Samudiyak Bikas Kendra	65	465	2,010
	Total	**842**	**6,655**	**11,699**

Source: MCPW, Project Completion Report, 2003

Table A- 2: Microfinance Operation by FI-NGOs

S.N.	Microfinance Institutions	Districts (No)	Members (No)	Disbursement (Rs.)	Collection (Rs.)	Outstanding Loan (Rs.)
1	NRDSC, Biratnagar	2	7,555	76,585,700	51,369,988	25,215,712
2	NESDO, Parbat	1	460	1,784,000	842,225	995,099
3	CYC, Baglung	1	1,250	1,654,220	977,183	977,037
4	RAF, Baglung	1	302	1,236,800	929,610	307,190
5	SOLVE, Dhankuta	1	383	2,489,000	1,349,752	1,139,248
6	DCRDC, Baglung	2	1,105	2,583,500	1,023,569	1,559,931
7	CWDC, Saptari	1	1,194	8,979,250	5,468,936	3,510,314
8	Mahuli, Saptari	1	653	7,170,756	4,756,808	2,413,948
9	UNYC, Bardia	1	545	1,035,015	590,144	444,871
10	MANUSHI, Kathmandu	1	270	1,590,000	281,425	1,308,575
11	WDCN	1	145	275,000	69,800	205,200
12	Jeevan Bikas Samaj, Morang	1	275	786,000	74,640	711,360
13	FORWARD, Sunsari	1	1,280	630,200	25,000	605,200
	Total	15	15,417	106,799,441	67,759,080	39,393,685
	Average	1	1,186	8,215,342	5,212,237	3,030,283

Source: RMDC, Kathmandu

Table A- 3: Lending Services of Bank's Supported by MCPW's partner FI-NGOs as of June 2002

S.N.	Name of FI-NGOs	Banks' Name	Bank Lending (Rs. '000)				Repayment rate (%)
			Lending	Repayment	Outstanding	Overdue	
1	CYC	NBL Baglung	2,421	2,246	175	20	97.3
2	DCRDC	NBL Baglung	3,775	3,234	541	44	98.3
3	RAF	NBL Baglung	1,355	1,292	63	11	98.6
4	Gramin Mahila Bikash Sanstha	NBL Ghorahi	808	527	281	-	100.0
5	Gramin Mahila Utthan Kendra	NBL Ghorahi	120	39	81	-	100.0
6	Nepal Mahila Samudayik Sewa Kendra	NBL Ghorahi	779	631	148	-	98.4
7	SUPER	RBB Tulsipur	2,613	542	2,071	-	93.8
8	SWAN	RBB Lamahi	360	44	316	-	100.0
9	SOLVE	NBL Dhankuta and RBB Hile	3,295	2,423	872	40	196.3
10	Srijana Bikash Kendra	NBL Prithbichowk and RBB Pardi	10,383	7,276	3,107	69	92.6
11	MANUSHI	NBL Lazimpat	2,472	2,161	311	6	99.7
12	Nepal Mahila Utthan Kendra	NBL Chapagaun	502	366	136	-	86.1
13	NESDO	NBL Kushma	1,104	996	108	35	95.0
14	Mahuli Samudaykk Bikash Kendra	RBB Kathauna	1,351	719	632	-	100.0
15	Samudayik Mahila Bikash Kendra	NBL Rajbiraj	4,535	2,128	2,407	623	58.9
16	Srijana Samudiyak Bikas Kendra	NBL Golbazar	3,697	2,888	809	88	92.8
	Total		**53,248**	**37,211**	**16,037**	**1,045**	**91.7**

Source: MCPW, Project Completion Report, 2003

Table A- 4: RMDC's Lending to FI-NGOs

S.N.	Partner's Name	Address	Approved Amount (Rs.)	Disbursed Amount (Rs.)	Amount Recovered (Rs.)	Outstanding Balance (Rs.)	Overdue Amount (Rs.)
1	NRDSC	Biratnagar	55,235,000	42,735,000	18,076,000	24,659,000	-
2	NESDO	Parbat	10,755,000	3,540,000	1,588,000	1,952,000	-
3	CYC	Baglung	8,125,000	3,125,000	1,645,000	1,480,000	-
4	SOLVE	Dhankuta	10,000,000	4,000,000	1,760,000	2,240,000	-
5	RAF	Baglung	2,000,000	1,400,000	1,240,000	160,000	-
6	DCRDC	Baglung	7,500,000	3,800,000	1,710,000	2,090,000	-
7	CWDEC	Rajbiraj	11,600,000	7,100,000	3,054,650	4,045,350	-
8	MCDC	Saptari	4,860,000	4,560,000	2,226,000	2,334,000	-
9	UNYC	Bardiya	1,200,000	600,000	260,000	340,000	-
10	Manushi	Kathmandu	5,000,000	2,900,000	720,000	2,180,000	-
11	Nepal Mahila Utthan Kendra	Lalitpur	950,000	300,000	60,000	240,000	-
12	Jeevan Bikash Samaj	Morang	8,490,000	4,450,000	980,000	3,470,000	-
13	FORWARD	Sunsari	13,600,000	8,600,000	1,380,000	7,220,000	-
14	Srijana Samudaik Bikas	Siraha	3,200,000	1,100,000	320,000	780,000	-
15	Nepal Mahila Samudayik	Dang	4,200,000	1,100,000	20,000	1,080,000	-
16	Srijana Bikash Kendra	Pokhara	2,000,000	900000	-	900,000	-
17	WEAN	Kathmandu	4,000,000	1200000	-	1,200,000	-
18	SWAN	Dang	3,000,000	-	-	-	-
19	SUPER	Dang	3,000,000	-	-	-	-
20	Grameen Mahila Bikas Sanstha	Dang	2,500,000	-	-	-	-
	Total		161,215,000	91,410,000	35,039,650	56,370,350	-
	Mean		8,060,750	5,377,059	2,335,977	3,315,903	

Source: RMDC, 2004

References

Asian Development Bank and Department of Women Development (2003), "Project Completion Report of the Microcredit Project for Women" Kathmandu.

Cater, R. and G. Chulin (2001), "Equity Investments in MFI and Transformation: The Case of XAC, Mongolia" *Input Paper for the UNCDF/SUM and UNDP Africa Global Meeting May 30 - June 1, 2001, Young and Promising Microfinance Institutions* Ulaan Baater and New York.

Credit and Development Forum (2003), "Microfinance Statistics", Vol. 15, Dhaka.

Charitonenko, S., A. Campion and N. A. Fernando (2004), "Commercialization of Microfinance: Perspective from South and Southeast Asia" Asian Development Bank, Manila.

Department of Women Development (2003), "Women Development Programme: Annual Progress Report 2058/059" Kathmandu.

DEPROSC, Nepal and J. Ledgerwood (1997), "Critical Issues in Nepalese Microfinance Circumstances" IRIS Centre, Maryland.

Fernando, N. A. (2004), "Microfinance Success Story? Transformation of Non-government Organisation into Regulated Financial Institution" Regional and Sustainable Development Department, Asian Development Bank, Manila.

HMGN, "Act for Non Government Organisation involving in Financial Intermediation 1999".

HMGN, "Development Bank Act, 1996".

HMGN, "Cooperative Act, 1992".

Lamsal, P. P., C. B. Sejuwal and R. Shakya (2001), "Innovations in Development Finance: How Agriculture Development Bank of Nepal Transformed an Unsustainable Credit Programmes into Self-reliant Local Financial Intermediaries Owned and Managed by the Poor" Agriculture Development Bank, Kathmandu.

Montgomery R., D. Bhattacharya and D. Hulme (1996), "Credit for the Poor in Bangladesh" in Hume D., Mosley and Paul, "Finance Against Poverty" Routledge, London.

Rhyne, E. (2001), "Mainstreaming Microfinance: How Lending to the Poor Began, Grew and Came of Age in Bolivia" Connecticut: Kumarian Press, Washington DC.

Rural Microfinance Development Centre (2004), "Progress Report 2004" Kathmandu.

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

Shrestha G. K. (2001), "Micro-credit Programme in Nepal" Nepal Rastra Bank, Kathmandu.

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

Sriram M. S. and R. S. Upadhyayula (2002), "The Transformation of the Microfinance Sector in India; Experiences, Options and Future" Indian Institute of Management, Ahmadabad.

Stauffenbery, Damian von (2002), "Trends in Latin American Microfinance" *MicroBanking Bulletin, Issue No. 8*, Microfinance Information Exchang, Washington DC.

Wardhana, Ali (2001), "Introduction in Robinson, Margerite, *The Microfinance Revolution: Sustainable Finance for the Poor:* The World Bank, Washington DC.

Wehnert U. (2003), "Innovations in Nepal's Microfinance Sector and Benefits for the Asia - A Review of the Lessons Learned from the Small Farmer Cooperatives Ltd. System", a paper presented on workshop on *Sharing Microfinance Resources and Knowledge in South Asia* organised by Centre for Microfinance, Kathmandu, Nepal.

Wehnert U. and R. Shakya (2001), "Are Small Farmer Cooperatives Ltd. Viable Microfinance Organization? – A Second Viability Check", Working Paper No. 1, Rural Finance Nepal, Kathmandu, Nepal.

Wehnert U. and R. Shakya (2003), "Microfinance and Armed Conflict in Nepal: The Adverse Effects of Insurgency on Small Farmer Cooperatives Ltd.", Working Paper No. 3, Rural Finance Nepal, Kathmandu, Nepal.

White, V. and A. Campion (2002), "Transformation: Journey from NGO to Regulated MFI" in *The Commercialization of Microfinance: Balancing Business and Development*, edited by D. Drake and E. Rhyne, Connecticut: Kumarian Press.

Younus, M. (2003), "Some Suggestions on Legal Framework for Creating Microcredit Bank" Grameen Bank, Dhaka.