MICROFINANCE AND LOCAL ECONOMIC DEVELOPMENT IN NEPAL

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EXECUTIVE SUMMARY

Poverty reduction is the most often cited objective of Microfinance Institution (MFI). Microfinance is often seen as an effective strategy for extending financial services to the poor and other disadvantaged groups not reached by the formal finance sector. This study attempts to assess the impact of microfinance services on poverty reduction using both the extensive and intensive approaches to impact assessment through before and after comparisons as well as with and without microfinance services comparisons. These approaches have enabled the study of changes over time and matched pairs of observations between borrowers and members of a control group. Each pair had similar starting values for impact variable and other characteristics like age, gender, sources of livelihood, caste and ethnic dimensions.

Although Nepalese MFIs offer savings and lending services they are not very diversified. All clients surveyed used micro-savings and micro-credit services offered by the MFIs. Microcredit has been used both for production (66%) and consumption (36%) purposes. Microfinance contributes to a reduction in poverty in client HHs and about 56% clients reported that their income increased after participation in microfinance programme. These HHs have been able to build slightly more financial, physical and human capital than non-clients. Micro-credit has served to reduce their dependency on moneylenders, reducing the average interest rate burden especially for the poor. The indirect use of micro-credit to promote income generating/micro-enterprise activities (IG/MEA) has led to increase in income earning opportunities of the poorest of the poor providing wage employment opportunities by the borderline and non-poor clients. The client managed IG/MEA managed has generated self and wage employment with one IG/MEA generating 1.28 full-time jobs employing men and children besides women.

Access to financial services has significant impact on clients in a wide range of economic and social indicators, including increased income, improved nutrition, better food, better clothing, better housing, lower child mortality, lower birth rate, higher adoption of family planning practices, better health care, better education for children, women empowerment, participation in social and political activities, etc. Thus, a direct link is provided between microfinance and at least five of the MDGs: eradicating extreme poverty and hunger; achieving universal primary education; promoting gender equality and empowering women; reducing child mortality; and improving maternal health. Effectively designed microfinance products and services appeared to be an effective tool to create an enabling environment for achieving the remaining MDGs such as combating HIV/AIDS, malaria, and other diseases; and ensuring environmental sustainability. However, microfinance by itself is not a panacea for poverty reduction. There is a need to address other issues of development policy and implementation, which affect poverty reduction and utility of microfinance at a different level altogether including cost effective medical care, promotive/preventive health and remunerative employment opportunities for women.

Despite the tremendous potential of microfinance services for addressing income and human poverty, only 33% of the HHs below the poverty line has such access. The MFIs are concentrated in the Tarai and accessible hills and are very rare or virtually not present in the inaccessible hills and mountains where the majority of the poor live. There is a greater need to expand microfinance services in the high hills and mountains. The sustainability of MFIs is yet another challenge. Providing sound financial services to the poor is a specialized activity requiring expertise and a long-term commitment from promoters. Achieving large-scale sustainable microfinance requires engaging more MFIs with different objectives and services with different policies and institutional support. Strong MFIs must be supported to strengthen their capacity to expand their outreach and wherever possible replicate success as a campaign.

In view that poor need wide arrays of flexible financial services and they have high expectation from MFIs, a market-led and demand-driven approach that encourages portfolio diversity by offering poor savings, insurance, and cash transfer services in addition to various loan products is likely to meet such expectations. The government has a critical role to play in this venture. Instead of acting as direct providers of financial services, government should create an environment that encourages MFIs to serve the poor, safeguard their money, promote competition and develop technical expertise of the supervisory and regulatory authorities.

This study's conclusion on the microfinance path towards poverty reduction is that: *micro-credit can directly improve the access of the poor to finance for productive assets and activities that will enable income growth and welfare improvement through enterprise development, increased ability to address vulnerability and economic empowerment*. The study has provided recommendations to MFIs, policy makers and donors to improve the impact of microfinance services on poverty reduction.

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ACRONYMS AND ABBREVIATIONS

ADBN	Agriculture Development Bank, Nepal
CBB	Chemaki Bikas Bank
CBS	Centre Bureau of Statistics
CECI	Canadian Centre for International Studies and Cooperation
DDB	DEPROSC Development Bank
CMF	Centre for Microfinance
FI-NGOs	Financial Intermediary NGOs
FGD	Focus Group Discussion
GDP	Gross Domestic Product
HH	Household
HPI	Human Poverty Index
IBP	Intensive Banking Programme
IG/MEA	Income Generating/Micro-enterprise Activity
LDCs	Least Developed Countries
MCPW	Microcredit Project for Women
MDB	Microfinance Development Bank
MDG	Millennium Development Goal
MDGR	Millennium Development Goal Report

MFIs	Microfinance Institutions
MLD	Ministry of Local Development
NABIL	Nepal Arab Bank Ltd.
NBL	Nepal Bank Limited
NGOs	Non Government Organization
NHDR	Nepal Human Development Report
NPC	National Planning Commission
NRB	Nepal Rastra Bank
NUB	Nirdhan Uthan Bank
PCRW	Production Credit for Rural Women
PGBB	Paschimanchal Grameen Bikas Bank
PRA	Participatory Rural Appraisal
PRSP	Poverty Reduction Strategy Paper
RBB	Rastriya Banijya Bank
RMDC	Rural Microfinance Development Centre
RRDB	Regional Rural Development Bank
RSRF	Rural Self Reliance Fund
SBB	Swabalamban Bikas Bank
SCC	Savings and Credit Cooperative
SFCL	Small Farmers Cooperative Limited
SFDB	Small Farmer Development Bank
SFDP	Small Farmer Development Project
SPO	Sub Project Office
UNDP	United Nations Development Programme
UNICEF	United Nations Children Fund
WDS	Women Development Section

1. INTRODUCTION

1.1 Background of the Study

A small and landlocked country in South Asia, Nepal is one of the 49 least developed countries (LDCs) of the world. The country's per capita income, at US$ 240 in 2003, makes it the poorest country in South Asia. According to the Nepal Human Development Report (NHDR) 2004, Nepal's Human Development Index score stood at 0.471. Infant mortality, at 68 per 1000 live birth, is the highest in South Asia. Indicators of life expectancy at birth (60.98 years), adult literacy (48.6%) and mean years of schooling (2.75 years) are among the lowest in the world (UNDP 2004a). Agriculture dominates the Nepalese economy with around 39% share in GDP. More than a decade after the introduction of economic reforms, poverty is still widespread in Nepal.

Poverty is widespread in Nepal where around 38% of the population lives below the poverty line in 2001. A recalculation on poverty incidence in the LDCs using a US$ 1 a day poverty line anchored on national income date showed a 51% poverty incidence in Nepal. The incidence of poverty increased dramatically to over 80% when calculated using a US$ 2 a day national accounts consistent poverty line. The number of poor almost doubled from about 4.9 million in 1977 to about 9.5 million in 1996. Data indicate that significant segments of the poor are the hardcore poor, barely making a subsistence living in fragile ecosystems that lack basic infrastructure (UNDP 2004b).

Poverty is a complex phenomenon in Nepal. First, the proportion of the poor in rural areas is almost twice as high as in urban areas. Second, there is a high regional variation in the incidence of poverty with the mountain regions having the highest concentration of the poor. Finally, poverty is also high among lower castes and disadvantaged social groups, especially dalits comprising Damai, Kami, Sarki, Mushar and Dusad.

Poverty in Nepal is also very clearly linked to entitlements and access to assets. Given the predominance of rural poverty, land is obviously a key asset. Land distribution in Nepal is highly skewed with 47% of the holders owning only 15% and the top the 2% of HHs owning 11% of the total cultivated land (CBS, 2002). Apart from land, other assets are also distributed unequally between the poor and non-poor. In addition, poverty in Nepal is associated with lack of access to education, health facilities and economic infrastructure. The poor also generally have limited access to paid employment. Employment is therefore a key asset which is integral to poverty reduction and it is essential that any poverty reduction strategy must aim at reducing underemployment and unemployment. Nepal's Human Poverty Index (HPI) value in 2001 is calculated at 39.2. More significant is the fact that human poverty in rural areas (at 42%) is almost twice as high as the urban areas (25.2%). HPIs also vary widely across ecological zones: the highest in the mountains, followed by the Tarai and Hills (UNDP 2004a).

Poverty reduction has been an explicit goal of planning in Nepal since the mid 1980s. The 10th Plan/PRSP (2002-2007) also states poverty reduction as its sole objective. A strategy of broad based economic growth focusing on raising agricultural productivity and encouraging private sector led growth is emphasized in the plan along with extra efforts to make development inclusive of targeted programmes aimed at poverty reduction (NPC 2002).

Nepal's Gross Domestic Savings is only about 14% of its GDP and the level of rural HH savings is even much lower at 7% in 2001/02. Low levels of HH income have led to low levels of savings, and a limited extent of self-financing of farm and off-farm employment as well as income generating activities. Considering the need to ensure adequate access to financial services to promote growth and reduce widespread poverty in Nepal, the government has implemented a large number of targeted credit programmes to widen

the access of the rural people, particularly the poor, to subsidized credit since the early 1970s. Several targeted credit and microfinance programmes have been implemented since then with the ultimate goal of poverty reduction. The sector gained momentum after the restoration of democracy in 1990 when significant effort was made to expand the frontier of microfinance started from the government and non-government sector with or without assistance from bi-lateral and multi-lateral agencies.

Within the existing legal and regulatory provisions of Nepal, MFIs are those institutions established and operated under the Cooperative Act 1992, Development Bank Act 1996 and Act for Non Government Organisations involved in Financial Intermediation 1999. Within these frameworks Nepalese MFIs are: Regional Rural Development Banks (RRDBs), Microfinance Development Bank (MDB), Financial Intermediary NGOs (FI-NGOs), Savings and Credit Cooperatives (SCCs), Small Farmers' Cooperative Limited (SFCLs) and apex institutions providing wholesale loan to MFIs for promoting retail lending. The number of MFIs has been growing since the implementation of financial reforms and the creation of the legal and regulatory framework. As of July 2004, there are five RRDBs, four MDBs, 44 FI-NGOs, over 2800 SCCs and 161 SFCLs formally active in the Nepalese microfinance sector. Further, there are three apex institutions namely the Rural Microfinance Development Centre (RMDC), the Small Farmer Development Bank (SFDB) and the Rural Self Reliance Fund (RSRF) to provide wholesale microfinance services to these MFIs.

Despite the greater efforts put forward by government and non-government sectors to address it, poverty is ever increasing. To most, microfinance means providing very poor families with very small loans to help them engage in productive activities or expand their tiny businesses. Over time, microfinance has come to include, a broader range of services (credit, savings, insurance etc.) with the growing realization that the poor and the very poor who lack access to traditional formal financial institutions require a variety of financial products. Financial services for poor people are particularly important in helping them to take advantages of opportunities to improve their lives and to maintain and build up their assets. Poor people manage their finances through a variety of mechanisms, which are, however, limited. Providing access to services, which overcome these constraints, can be of enormous benefit. However, the cumulative impact of microfinance programmes has not been significant, as its outreach has been limited to a small, relatively less poor segment of the rural population. The remaining population, which includes the poorer segments, has continued to depend on informal financial sources.

1.2 Rationale of the Study

Microfinance has emerged to be a dynamic sector with increased academic and professional interest in view of its far reaching implications for local economic development. In the recent years, there has been a paradigm shift on approaches to provide microfinance services from a "*welfare approach*" or "*directed credit approach*" to "*institutionalist approach*" or "*financial market approach*" based on the logic of subsidization that has led to high default rates and transaction costs, resulting in the failure of these programmes. The new paradigm holds that subsidies are detrimental to the growth and development of the sector. The result has been a poorer allocation of financial resources and unsustainable institutions and at present there has been attempt to establish institutions offering microfinance services on sustainable and commercial bases. Such MFIs emphasize financial self-reliance and viability, and charge high interest rates because of high lending costs. The objective is to reach large numbers of the poor in a sustainable manner. In Nepal, these two approaches (*welfarist approach and institutional approach*) still co-exist and many MFIs are caught between the twin challenges of finding new sources of external funding to increase their loan portfolio in order to ensure their financial viability and providing services to low-income and poor

people to reconcile their economic and social objectives. There existed a long debate on whether micro finance benefits all the poor (including the poorest of the poor) or whether it excludes those below a certain level of poverty.

Concern has been raised that the "*institutionalist approach*" or "*financial market approach*" may dilute the original poverty focus of MFIs. There has also been growing interest on the impact of microfinance services on the poor, particularly on the hardcore poor. It might be thought that if such institutions are designed to serve only poor clients and if payment rates are high, no further detail analysis is needed on their poverty impact. There has been an argument that such a view is often misleading due to the following reasons.

- There is no guarantee that only the poor will be served unless strong eligibility criteria such as land ownership are enforced. Often the aim is to deter the non-poor by the inconvenience of frequent meetings or the stigma of being a member of a credit group of the poor. Such disincentives need to work and eligibility criteria, where they exist, may not be enforced.

- High repayment rates may be due to social pressure within a group or family and may not reflect the ability to repay (if for example loans have to be taken from moneylenders to repay the micro-credit).

- Even if the poor are genuinely served by MFIs when a public fund is required to finance the MFIs, there is the question of its cost effectiveness in reaching the poor when compared with other alternatives. This requires a comparison of the cost of transferring the funds through a MFI per unit of benefit received by target group with the benefit-cost ratio for alternative schemes for reaching the hardcore poor, such as food subsidies, workfare, and integrated regional development initiatives. Such a comparison must take account of not just the administrative costs involved, but also the leakage rate (i.e. benefits to the non-poor).

Hence, there is a strong case to assess the depth of outreach of microfinance services, the impact of access to microfinance services on the welfare of clients and the cost of achieving impacts. This has been further reinforced by the overall goal of MF services such as "*substantial reduction on poverty and vulnerability*" among its clients, especially women. Thus, the ultimate goal of MF services has generated a series of research questions that revolves around the MFI objective of poverty reduction as shown below.

- What is the socio-economic situation of the people served by microfinance?

- Does microfinance contribute to enterprise creation, growth and development and ultimately to increased income of the poor and disadvantaged communities?

- Does access to microfinance services contributes to the economic empowerment of the client? Why do microfinance institutions focus on women and are such focus instrumental to ensuring repayments and group discipline?

- What effects does microfinance have on other sources (both formal and informal) of finance?

- What can be the appropriate products and services in reaching the poor and responding to their financial needs?

The above questions are pertinent for the growth and development as well as the increased role of microfinance services for poverty reduction. Some research conducted in the past has shown that although the impact of credit seems to be positive to the

working poor, it is less beneficial to the hardcore poor and in some cases even increased hardship by putting people into debt. Further, earlier studies have focused on the impact in terms of increased income, which is not the only indicator of a secured livelihood. These issues demand close scrutiny and careful assessment to make microfinance services act as catalyst to poverty reduction.

1.3 Objectives of the Study

This study attempts to assess the impact of microfinance services on poverty reduction. The following are the specific objectives of this study:

- To analyze the various aspects of the outreach of the microfinance services among the rural households (HHs) and investigate the degree to which these services meet the financial needs of poor families;

- To analyze the role of microfinance services on improving access, use and contribution of financial services on improving the livelihood of poor and disadvantaged groups;

- To document the contribution of microfinance services on enterprise development, managing risks/vulnerability, economic empowerment of poor and disadvantaged groups, the effect on other financial services and investment in public infrastructure;

- To provide recommendations for improving microfinance practices that respond to the process of MFI intervention and channels of microfinance impact on poverty reduction.

1.4 Scope of the Study

Poverty relates to an income (*or more broadly welfare*) level below a socially acceptable minimum and microfinance as one of a range of innovative financial arrangements designed to attract the poor as either borrowers or savers. In the context of assessing the role of microfinance services on poverty reduction, the scope of this study has been the following:

- Review of the documents - plans, policies, acts, laws, programs, strategies, evaluation studies and reports, etc.

- Undertake field studies (representing hills and the Tarai) to gather information on the impact of microfinance on poverty reduction.

- Identify channels through which the effect of microfinance services can be transferred into poverty reduction.

- Analyze outreach and contribution of microfinance services to poverty reduction among the hard-core poor and vulnerable people of the community.

- Assess the extent of benefit to the poor from microfinance services in terms of the enhancement of their socio-economic status.

- Provide recommendations for improving microfinance practice through an understanding of the MFI intervention process and ultimately its impact on poverty reduction.

1.5 Report Organisation

This report has been divided into five sections. After the introductory section, section two provides a conceptual and analytical framework of the study while section three provides a discussion on outreach, access, use and contribution of microfinance services. Section four assesses both the direct and wider/indirect impact of microfinance services on poverty reduction and the implications of such services on achieving the millennium development goal (MDGs). The conclusion and recommendations of the study are provided in section five.

2. REVIEW OF LITERATURE

2.1 Impact on Poverty Reduction

Microfinance has been extensively examined over the past 10 to 15 years, and the resulting literature is now very large. A focused review of the literature conducted to evaluate recent publications regarding the impact of microfinance on poverty reduction indicates that Microfinance has proven to be an effective and powerful tool for poverty reduction (Morduch and Haley, 2002 pp. 1-5). The number of rigorous studies of client outreach and impact has grown considerably, especially in the past few years, spurred in part by the development of monitoring tools such as CGAP's Poverty Assessment Tool, Cashpor Housing index, Participatory Wealth Ranking, and USAID's AIMS Tools. The resulting studies indicated that: (i) the tools are relatively inexpensive and practical to use, and they yield useful data for both programmes and donors; (ii) average loan size is an easy indicator to collect but proves to be unreliable when measuring depth of outreach. Minimal extra effort in data collection can yield much richer information for marketing and evaluation; (iii) MFIs show considerable diversity in their ability to reach poor populations; (iv) excellent financial performance does not imply excellence in outreach to poor households; (v) at the same time, reaching the poor is not at odds with maintaining excellent financial performance and professional business practices; (vi) programs that make poverty reduction an explicit goal and make it a part of their organizational culture are far more effective at reaching poor households than those that value finance above all else and (vii) these lessons point to natural evolutions in the microfinance sector. Many MFIs have tended to focus foremost on their own financial survival, and have generally been reluctant to invest substantially in evaluations. Currently, the majority of MFIs neither determines the composition of their clientele upon intake nor evaluates the effectiveness of their programme in terms of poverty reduction. The development and use of the new tools for market analysis and evaluation suggests that failure to monitor and evaluate can cut costs in the short-run at the expense of achieving long-term social and economic goals.

Evidence shows the positive impact of microfinance on poverty reduction. While quality of many studies could be improved, there is an overwhelming amount of evidence substantiating a beneficial effects on (i) increases in income (Wright 2000 pp. 15; Khandker 2001, 1998, pp. 32), (ii) reductions in vulnerability (Wright 2000 pp. 11). Finally, there are fewer studies with evidence on health, nutritional status and primary schooling attendance, but the existing evidence is largely conclusive and positive (Wright 2000, pp. 15). Despite disagreement on specific definitions of levels of poverty, there is a general consensus that microfinance is not for everyone. Most importantly, entrepreneurial skills and ability are necessary to run a successful microenterprise and not all potential customers are equally able to take on debt. While these points will be true across all strata of poverty, it is assumed that they will have a greater effect on the very poorest. The sick, mentally ill, destitute etc. who form a minority of those living below the poverty line are typically not good candidates for microfinance. Most researchers agree that this group of people would be better candidates for direct basic assistance. More optimistically, microfinance can be effective for a broad group of clients, including those who are living in the *bottom half* of those below a country's poverty line (to use a categorization proposed by CGAP). The "*poorest"* constitute the group that generally intersects the various definitions of extreme poverty: landlessness, limited access to basic social services, average per capita income of less than $1 a day, and bottom third of a relative poverty ranking. Specifically, various studies show there is no evidence of an inverse relationship between a client's level of poverty and their entrepreneurial ability borrowing patterns and the inclination to save have been found to be similar across clients at different levels of poverty; financial performance of MFIs targeted to the poorest clients can be comparable to those of MFIs that do not reach the poorest (Khandker 1998. pp. 6; Gibbons and Meehan 2000 pp. 23; Churchill 2000 pp.

17). There is little evidence that clients with existing micro-enterprises or employment (often defined as "the economically active") are the only ones that can benefit from microfinance (Robinson 2001 pp. 49), and the little evidence that exists here is subject to debate about methodology.

While it has been demonstrated in a number of studies that the poorest can improve their socioeconomic conditions, researchers have pointed to several general issues that make microfinance work for the poorest. Even a well-designed microfinance programme is unlikely to have a positive impact on the poorest unless it specifically seeks to reach them through appropriate product design and targeting (Wright 2000 pp. 16). Experience shows that unless there is a targeting tool, the poorest will either be missed or they will tend to exclude themselves because they do not see the programs as being for them, do not have the "correct" clothes, etc. (Navajas et al 2000 pp. 23; Simanowitz 2000, pp. 29). There is a strong tendency to move to the top of the clientele group, and to give little attention to the needs of the poorest, with the end result that their proportion diminishes over time (Navajas et al 2000 pp. 12). Only MFIs that design programs around the needs of the poorest are likely to retain them as clients.

There is general consensus that facilitating savings is important, because there is a high demand for it among the poorest and because savings play a role in protecting against the seasonality of cash-flows and fulfilling an insurance function. In addition, building up deposits reinforces financial discipline for customers and can eventually yield collateral and serve as a source of funding for MFIs. Savings alone, however, have only a minor developmental impact such as the protection against shocks might allow children to remain in school or income-earners to get medical treatment and minimize time away from work, but it is slow to create any significant wealth in itself unless credit is also available. MFIs that focus on savings more than credit tend to reach a smaller proportion of the poorest, have a lower and slower impact on poverty reduction, and are therefore less conducive to reaching the Millennium Goals by the target dates. While the savings-first institutions are easier to finance by donor agencies (far less start-up capital required), the few comparative studies available show that borrowers fare better than non-borrowers (Chen and Snodgrass 1999 pp. 12).

There are strong potential synergies between microfinance and the provision of basic social services for clients. The benefits derived from microfinance, basic education, and primary health is interconnected, and programs have found that the impact of each can increase when they are delivered together. First, the marginal cost of providing education or basic health information can be substantially reduced when the infrastructure for microfinance is already in place · Services provided need to be relevant to the needs of the target group and not just an add-on that is of poor quality (MkNelly and Dunford 1999 pp. 18). Very few studies directly compare alternative interventions. Most researchers conclude that it is difficult to isolate the impact of a specific development tool as each contributes to the others. While the question of which development tool gives the "biggest bang for the buck" is legitimate in principle, in practice it is difficult to compare the benefits achieved by different interventions. With this in mind, it should be noted that microfinance has the potential to have an *immediate* impact on a wide range of poverty reduction targets: income, health, nutrition, and education. Basic health is likely the most crucial intervention, but should be combined with microfinance in order to strengthen the impact on the first Millennium Goal of reducing those living on less than $1/day. Expanding primary education for children has a wide-ranging impact on the poverty reduction targets (income, health, nutrition, fertility) but any benefits will be *delayed,* thus reducing its effectiveness for reaching targets by 2015.

Microfinance compares favorably to other interventions particularly with regard to cost effectiveness and prospects for sustainability: An advantage of microfinance is that

donor investment is recycled and reused (Wright 2000, pp. 17). Direct comparisons done by Khandker (1998, pp. 12) show that microfinance can be a more cost-effective developmental tool than alternatives including formal rural financial intermediation, targeted food interventions, and rural infrastructure development projects. More over, unlike many other interventions, costs for microfinance tend to diminish with the scale of outreach (Christen et al 1995 pp. 11). Few, if any, other development tools have the potential to become sustainable such that, after initial start-up grants, new inputs are not required for every future client. There need not be a trade-off between reaching the poorest and attaining financial sustainability. Although there are no rigorous econometric models to substantiate it, there is ample evidence that MFIs targeting the poorest can fare as well financially as those that don't (Gibbons and Meehan 2000; Churchill 2000). There is also ample anecdotal evidence that MFIs that target poorer clients can achieve substantially higher repayment rates than those that target richer clients (Pro Mujer vs. BancoSol; Grameen/BRAC vs. traditional banking system in Bangladesh). It should be noted that emphasizing financial sustainability above all else can have the practical effect of excluding the poorest because of widespread misperception that the poorest are a greater credit risk and the reality that unit costs of small loans tend to exceed unit costs of larger loans.

2.2 **Lending Services**

In the absence of adequate risk mitigation instruments such as collateral, insurance, and futures, MFIs are forced either to avoid rural areas or to design contracts that indirectly resolve problems. Use of joint liability contracts or group credit is one popular indirect alternative wherein group lending has been successful in settings where regular meetings provide significant ancillary benefits, where a high degree of social cohesion exists, and when the loan size is still within the mutual insurance capacity of the group (IADB, 2001, p. 10). Nevertheless, in some cases group lending imposes high transaction costs on its members, such as their time involved in identifying members, group formation, attending group meetings and any mandatory training. For instance, Freedom from Hunger started working with two commercial microfinance credit unions in Mali, Nyèsigiso in 1996 and Kafo Jiginew in 1997, to target rural women through its *Credit with Education* group lending program (Freedom from Hunger, http://www.ffhtechnical.org). Freedom from Hunger's Malian field agents worked with women's groups to develop their capacity to manage their own Credit Association, to which the MFI gives a loan. The group is jointly liable to repay the loan, which is generally over 16 weeks. The members divide the large loan into small loans (initially $60-$80) customized to the member's request for investment in her individual microenterprise. If the Credit Association pays its entire loan back to the local organization, on time and with interest, it becomes eligible to immediately receive a new, usually larger loan. The result of participation in such microfinance programs is that the access to credit enables women to expand and diversify their enterprises and often replaces more costly sources of funding. Participants acquire inputs for their microenterprises in bulk at lower prices and begin to build fixed assets. Also, women's increased profits and their accumulated savings tend to be directly channeled toward their families' needs for food, medicine and school supplies. In addition, as women's incomes increase, so do their self-confidence and status in the community.

Two MFIs that have successfully tailored their loan products to the demand of their clients are Financiera Calpiá in El Salvador and Centenary Rural Development Bank of Uganda (CERUDEB). These MFIs offer individual loan products and have even attracted significant farm-based and agriculture-related microenterprises and households. The main reasons clients use CERUDEB's financial services are the low barriers to entry, including a minimum savings deposit balance of $6 and a minimum loan amount of $30. In addition to business loans, CERUDEB has instituted an innovative small-holder agricultural loan product, which is based on projected levels of agricultural production,

has a flexible repayment schedule and takes into account off-farm income (Navajas and Gonzalez Vega 2000 pp. 15-16).

The Microenterprise Access to Banking Services (MABS) project in the Philippines has broken new ground by demonstrating that MFI can profitably serve the microfinance needs of the rural poor (Owens and Campion, 2003). One important hallmark of its successful program is its use of cash flow-based lending in rural areas. Another is its zero tolerance of delinquency. Since this USAID-funded program started four years ago, Chemonics MABS' project has worked with 102 rural bank branches and participating banks have disbursed over $31 million to more than 60,000 microentrepreneurs. As of March 2003, MABS participating banks had 33,587 active loan clients, with a total outstanding loan portfolio of PhP224.7 million ($4.5 million). In that same time period, micro-deposit balances (accounts with balances less than P 15,000 or $287) have increased by PhP162.0 million ($3.1 million). Total micro-depositors served by the participating banks now have increased by more than 135,000 from the time MABS started working with the banks (Charitonenko 2003 pp. 25).

Emerging best practices loan product design and deliver could be summarized as: full-cost pricing; credit decisions taken on the basis of household cash-flows and repayment schedules reflect client income cycles; use of chattel mortgages on equipment, livestock and household goods; use of stepped lending, gradually increasing the size of loans for individuals who repay debt on time; use of partial interest rebates have proved to be popular and effective and use of technology such as PDAs, and smart cards

2.3 Savings Services

The experience of commercial MFIs, and particularly the BRI Units, has shown that satisfying client demand for safe and liquid savings instruments is just as, if not more, important than satisfying their demand for credit (Holloh, 2001). While not all microfinance clients need to borrow at all times, most maintain savings or other types of deposit accounts continuously. Besides the fact that savings mobilization provides a large and stable source of funds for commercial MFIs, savings facilities also provide a valuable service for clients by offering a source of liquidity and expenditure management, as well as a chance for clients to build their debt capacity for future loans. These attributes are taken into consideration when designing demand-driven deposit services and for gauging client creditworthiness.

Many credit unions, such as the ones in West Africa including Kafo Jiginew in Mali and FECECAM in Benin, began with a strong emphasis on mobilizing client savings. By making the commitment to mobilize savings from inception, many credit unions have developed very efficient and successful savings mobilizing operations (Charitonenko et. al. 1998, p. 39). Kafo Jiginew is a commercial credit union that operates primarily in rural areas of Mali. It offers two types of savings accounts: voluntary, passbook savings and term savings accounts, in addition to its loans to rural individuals and village associations. By focusing primarily on rural markets, especially in Mali's cotton-producing zones, Kafo Jiginew has experienced some difficulties in having adequate funds for lending prior to the planting season. At the end of 2001, however, Kafo Jiginew was funding 75% of its loan portfolio with its $8 million savings portfolio, which reduces its need for external finance. The postal infrastructure has been a vehicle for the mobilization of rural savings and the provision of financial services to low-income populations in many countries. For example, in India, the use of postal infrastructure for savings mobilization accounts for 85% of the country's total savings in financial institutions (Sher 2001, pp. 32).

Emerging best practices savings product design and deliver could be summarized as: recognize savings mobilization as beneficial for the clients (rural poor can and do save)

and for the MFI in terms of providing it with a potentially large, stable source of funds; design takes into account that clients prefer security, liquidity, and convenience over returns; distribute savings boxes to rural savers; lotteries are also popular in rural areas; use existing infrastructure where possible to help keep down costs (post offices, ATMs, etc.) and use of technology (e.g. debit cards, PDAs, etc.).

2.4 **Cost Savings Innovations**

To mitigate the costs of serving potential rural clients, MFIs have used a number of methodological and technological innovations some are for rural finance in general, while others are specific to rural credit or rural savings mobilization. Innovations with respect to branch size, location and staff allocation are used by commercial MFIs. As population density declines, branch design becomes smaller and less expensive (Charitonenko et. al. 1998, p. 39). Branches or outlets are best placed near dense settlements or markets and kept open only on market days. In the absence of population centers, an alternative is mobile banking, in which agents go out on motorcycles to issue loans and collect deposits from groups or individuals, such as the case of ASA in Bangladesh. However, this approach can put the agent at risk of attack and theft if security measures are not in place.

Several MFIs have managed to mitigate covariance and repayment risks in their loan portfolios while engaging in rural micro-credit. Given the fluidity of funds between the household and the firm, best practice in individual lending is for lenders to evaluate the risk not of a single activity listed by the borrower on the loan application but rather of all the diverse cash flows of all household members (Schreiner, 2001, p. 8). To cope with the heterogeneity, seasonality, and the risk of agriculture, the best rural microlenders tailor loans to the production cycles of each borrower and check that the household can repay with non-farm income even if crops fail or if livestock die. Through time and repeated contact, loan officers grow to know the character and cash flows of borrowers and so can judge their risk better. Other effective approaches employed to reduce risk and strengthen the repayment potential associated with rural lending include: i) keeping microloan terms flexible, based on the cash flow of the rural household; and repayments based on frequent, small installments; ii) using chattel mortgages on equipment, livestock and household goods that can threaten the borrower's reputation as a way to deter defaults as the salvage value is often less than the cost of seizure and sale (Navajas, 1999; Churchill, 1999); iii) using stepped lending, gradually increasing the size of loans for individuals who repay debt on time; and iv) selecting loan officers carefully with a knowledge of local farming practices and non-farm economic activities, preferably from rural areas (Schreiner, 2001, p. 9). Charging interest higher rates to compensate for the higher risk is also possible, but has a limit as it can induce adverse selection wherein only risky clients demand credit (IADB, 2001, p. 10).

Time is money for both client and MFI. Therefore, borrower evaluation procedures should be kept short and simple. In addition, microcredit decisions should be able to be taken in a decentralized manner in the field by the credit officer, preferably on the basis of one visit. In some cases, credit officers' evaluations are assisted with portable computers, personal digital assistants (PDAs) or smart cards. For example, Swayam Krishi Sangam (SKS), a microfinance NGO in India, replaced its manual systems for recording transactions with a smart card-based system. SKS provided small hand-held computers to each loan officer and smart cards to each customer to record transactions, which greatly reduced meeting times and increased loan officer productivity. With the increased efficiency provided by this technology, SKS loan officers can now service three to four rural groups per day, or 120 to 200 customers (depending on the size of the village). Before, the loan officer could only service two groups per day, so the new technology has doubled loan officer capacity (Campion and Halpern, 2001 pp. 12).

Technological development necessary to reduce transaction costs has been slower for deposits than for loans (Schreiner, 2001, p. 8). The chief advance has been to recognize that the poor do save and that they value safety, liquidity, and convenience more than returns, particularly in countries where in-kind savings predominate and are not easily liquidated to meet short-term emergency cash needs. Interest paid on savings is of less importance for rural savers. As a result, many MFIs that offer rural savings pay little to no interest on liquid savings. Other advances include efforts to revive post-office savings in Africa, raffles for depositors, and the use of roving savings collectors. For example, the MABS project in the Philippines introduced a savings box that functions as a "piggy bank" for its savings clients who can bring the box to a branch to be unlocked and the savings deposited. Banco ADEMI's use of debit cards as a more modern technological innovation in savings mobilization (Campion and Halpern 2001, pp. 9).

Emerging best practices savings product design and deliver could be summarized as: branch/outlet location and size (in terms of personnel) dependent on population density/volume of business; reduced days/hours and mobile banking employed in areas without sufficient business to merit a full time presence; loan officers are carefully chosen from rural areas (with pre-existing knowledge of local farm and non-farm microenterprises) and trained well and MFI field agents travel to clients or clients travel to the MFI on foot, bus or motorbike.

2.5 **Microfinance-Poverty Nexus**

Despite the large inflow of microfinance services in the rural sector of Nepal, the incidence of rural poverty has been stubbornly high. Incidence of poverty was 36.2% in 1977, which increased to 42.5% in 1985/86, reduced to 40% in 1989/90 and again increased to 42% in 1996/97. As per the mid-term estimates of the ninth plan, incidence of poverty has reduced to 38%. The most serious message that these figure provides is that the proportion of people below the poverty line increased by close to 6 percent between 1977 and 1996 while the number of poor people, therefore, almost doubled, from about 4.9 million in 1977 to about 8.5 million in 1996 (UNDP 2004 pp. 15). Critics argue that this reflects limitation of microfinance programme as an instrument in arresting poverty in a country, which has the significantly large microfinance operation. Is the high incidence of poverty as a result of the failure of microfinance movement? or is it an outcome of the persistently low economic growth rate (which has been only 4% over the last decade) in the country? If substantial poverty reduction largely depends on sustained high economic growth, what is the net overall contribution of the microfinance movement in Nepal? In general microfinance supports mainly informal activities that often have low market demand. It benefits the poorest, and has sustained impact on poverty reduction among microfinance clients. It has also positive spill over impact, reducing poverty at the village level. But the effect is more pronounced in reducing extreme than moderate poverty (Khandker 2003, pp. 21).

3. RESEARCH METHODOLOGY

3.1 Conceptual Framework

Poverty is Multi-dimensional
Poverty means either the lack of command over commodities in general (i.e., a severe constriction of choice set) or a specific type of consumption (e.g. too little food energy intake) deemed essential for a reasonable standard of living, or the lack of "*ability*" to function in a society. Poverty is a deprivation of essential assets and opportunities to which every human being is entitled. To be poor is to be hungry, to lack shelter and clothing, to be sick and not cared for, to be illiterate and not-schooled. Thus, poverty is also associated with insufficient outcomes with respect to health, nutrition and literacy, to deficient social relations, to insecurity, and to low self-confidence and powerlessness. Poverty is not only due to material deprivation (low food consumption, poor housing, etc.) but also due to voicelessness and powerlessness, acute vulnerability to adverse shocks (illness, economic crises, natural disasters) and low human development (education, health etc.) also.

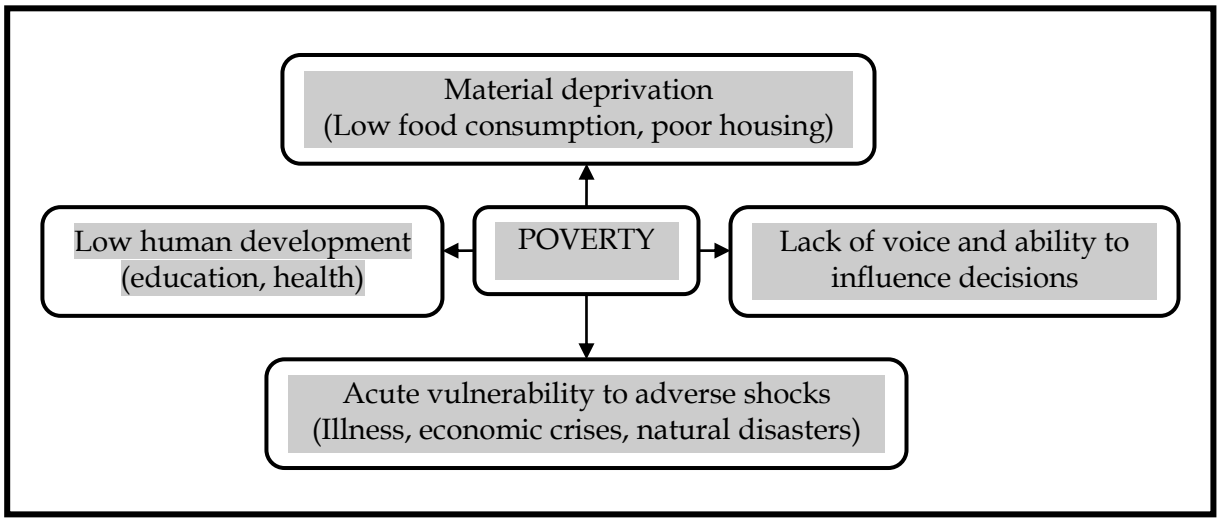

Figure 1: Dimension of Poverty
Source: Dhakal N. H. 2004b

Poverty is viewed from two different perspectives: *income poverty* and *human poverty*. The *income poverty* relates to poverty defined in terms of inadequate consumption or income. There are two measures of income poverty: (i) the international poverty line measuring the number of people below per capita income of US$1 per day, and (ii) the national poverty line as defined by the authorities of the country. HHs with per capita income of less than Rs. 4400 in 1996 price are considered to be HHs below the poverty line in Nepal. *Human poverty* encompasses a lack of capabilities, a lack of political freedom, an inability to participate in decision making, a lack of personal security and an inability to participate in the life of the community. The degree of deprivation on human dimension is measured using the HPI that incorporates five attributers of poverty: illiteracy, malnutrition among children, early death, poor healthcare, and poor access to safe water. NHDR 2004 estimates the HPI for Nepal at 39.6 with great disparity in rural (42.0) and urban areas (25.2).

In terms of understanding poverty, a simple distinction should be made within '*the poor*' group, i.e. between the long-term or '*chronic*' poor and those who temporarily fall into poverty as a result of adverse shocks, the '*transitory*' poor. Within the '*chronic*' poor one can further distinguish between those who are either so physically or socially disadvantaged that without welfare support they will always remain below the poverty

line (‘*destitute*’) and the larger group who are poor because of their lack of assets and opportunities (‘*non-destitute’*). Furthermore, within the ‘*non-destitute’* category, one may make comparison by the depth of poverty (i.e. how far HHs are below the poverty line) with those significantly below it representing the ‘*core poor*’, sometimes categorized by the irregularity of their income. Thus, the condition of poverty has been interpreted conventionally as one of a lack of access by poor HHs to assets necessary for a higher level of income or welfare. Assets are thought of as human (education, skill, confidence, etc.), natural (land, forest, water, etc.), physical (infrastructure, house, tools, etc.), social (networks of obligations, organization, social ties, etc) and financial (savings, credit, deposits, etc.).

Microfinance and Poverty Reduction

Microfinance services for the poor are among many interventions made to reduce poverty and relate to a wide range of flexible, appropriate services tailored to the preferences and needs of the poor provided by MFIs. In principal, microfinance services correspond to the chronic (*non-destitute*) poor and to the *transitory poor* in different ways. The lack of access to credit is readily understandable in terms of the absence of collateral that the poor can offer, in addition to various complexities and high costs involved in dealing with small, often illiterate borrowers. The poor have either to rely on loans from moneylenders at high interest rates or friends and family whose supplies of funds are limited. MFIs attempt to overcome these barriers through innovative measures such as group lending and regular savings schemes, as well as the establishment of close links between poor clients and the staff of the institutions concerned. The range of possible relationships and the mechanisms employed vary widely.

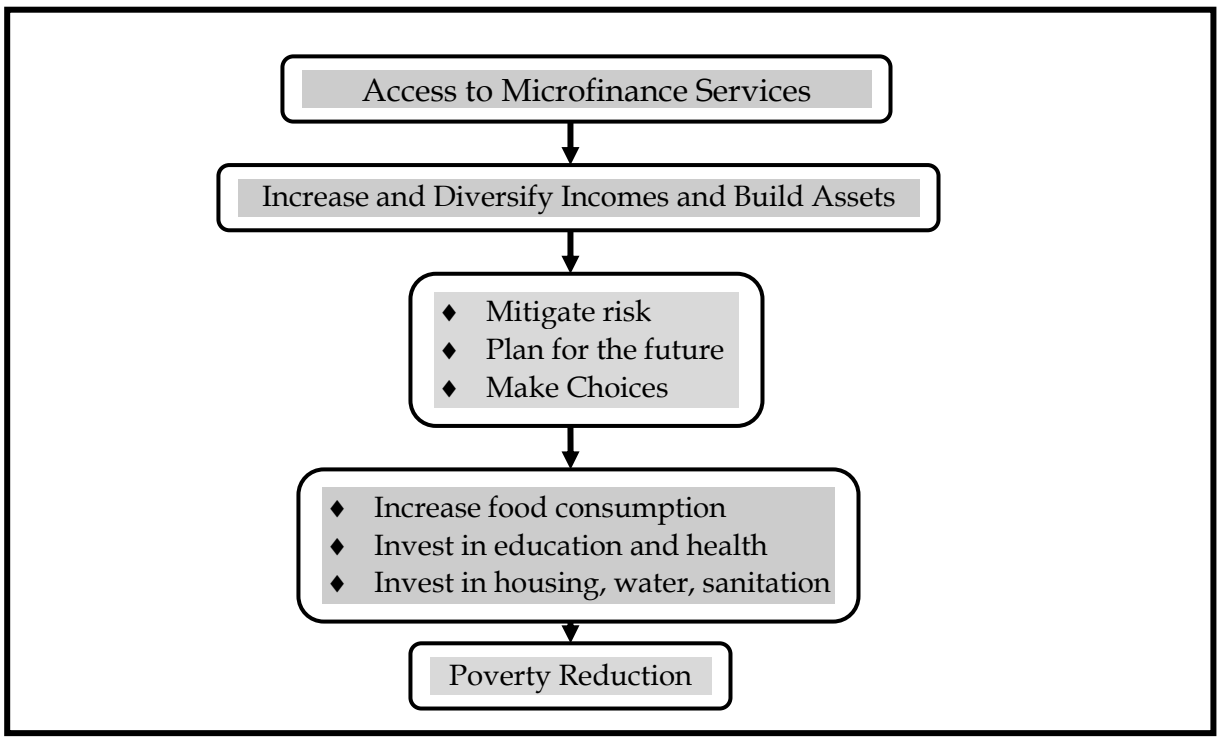

Figure 2: Chain of Impact of Access to Microfinance Services on Poverty Reduction
Source: Dhakal N. H. 2004b

The case of microfinance as a mechanism for poverty reduction is simple. If access to credit can be improved, it is argued, the poor can participate in productive activities that will allow income growth, provided there are no other binding constraints. This is a route out of poverty for the *non-destitute chronic poor*. For the *transitory poor*, who are vulnerable to fluctuations in income that bring them close to or below the poverty line,

microfinance provides the possibility of credit at times of need. In some schemes the opportunity of regular savings by a HH itself can be drawn on. The avoidance of sharp declines in family expenditures by drawing on such credit or savings allows '*consumption smoothing*'. In practice, such a distinction between the needs of the *chronic* and *transitory* poor for credit for '*promotional*' (i.e. income creating) and '*protectional*' (i.e. consumption smoothening) purposes, respectively, is over-simplified since the *chronic* poor will also have short-term needs that have to be met, whether it is due to income shortfalls or unexpected expenditures like medicinal bills, or social events like weddings or funerals. One of the most interesting generalisations to emerge from microfinance and poverty literature is that the poorest of the *chronic poor* (the *core poor*) will borrow essentially for protectional purposes given both the low and irregular nature of their income. This group, it is suggested, will be too risk-averse to borrow for promotional measures (i.e. for investment in future) and will therefore be a very limited beneficiary of microfinance schemes (*Hume and Mosley, 1996: 132*).

The view that it is the less badly-off poor who benefit principally from microfinance has become highly influential. Apart from the risk aversion argument noted above, a number of other explanations for this outcome have been put forward. A related issue refers to the interest rate charged to poor borrowers. Most microfinance schemes charge close to market-clearing interest rates, although these will often not be enough to ensure full cost-recovery given the high cost per loan of small-scale lending. It may be that, even setting aside the risk-aversion argument, such high rates are unaffordable to the *core poor* given their lack of complementary inputs. In other words, despite having a smaller amount of capital marginal returns to the *core poor* may be lower than to the *better-off poor*. If the *core poor* cannot afford high interest rates they will either not take up the services or take it up and get into financial difficulties. Also, where group lending is used, other members of the group may exclude the very poor, because they are seen as a bad credit risk, jeopardizing the position of the group as a whole. Alternatively, where professional staff operates as loan officers, they may exclude the very poor from borrowing again on grounds of repayment risk. A combination of these factors, it is felt by many, explains the weakness of microfinance in reaching the core poor.

3.2 Analytical Framework

Within the conceptual framework discussed above an analytical framework that depicts the impact of microfinance services on poverty reduction has been developed. The interactive factors are depicted in a chart with the immediate impact of microfinance services on micro enterprise creation and development at the center.

In Figure 3, the boxes at the top show the determinant factors which exist/prevail at the village and HH levels. The effect of adopting income generating/micro-enterprises activities (IG/MEA) can either be direct or indirect as illustrated by the circular box and the that follows. The access to microfinance services can also have a feedback effect on factors at HH levels, for example through the provision of equipments and training. The square boxes at the bottom depict outcomes through the adoption of IG/MEA. This can be observed by the increase in monetary HH income and proportion of IG/MEA income out of the total HH income. The impact of wealth may be noted by the improvement in housing.

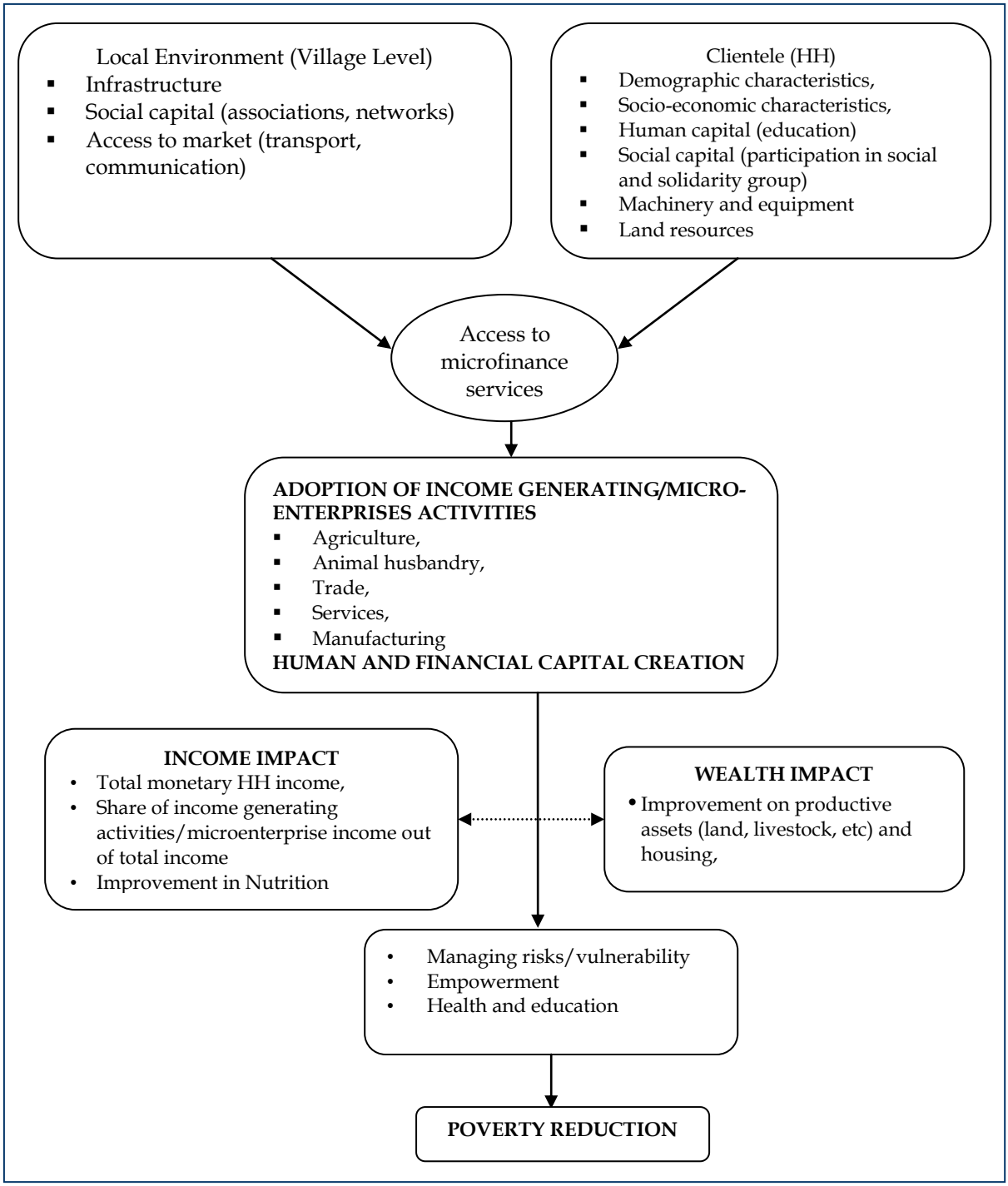

Figure 3: Analytical Framework of the Study
Source: Author's own design

3.3 **Hypothesis, Variables and Indicators for Assessment**

Using the analytical framework, the research questions raised are transformed into hypothesizes, taking input variables (MFI services) and moderating variables (client characteristics, programme characteristics, other context factors) that impact the poverty of the client HH on various aspects. These are related to the impact of microfinance on outreach; access, use and contribution; enterprise development; managing risks / vulnerabilities; economic empowerment, effect on other financial services and investment on public infrastructure and poverty reduction.

Table 1: Hypothesis of the Study

Area	Main hypothesis	Sub-hypothesis
Outreach	MFIs are extending financial services to the poor and other disadvantaged people not reached by formal sector finance.	▪ MFIs are operating in poorer areas of the country; ▪ MFI services reach those who do not have access to formal sector finance; ▪ MFIs serve all castes and communities including dalits and Janajatis; ▪ MFIs caters to the poor; and very poor ▪ Small loan size serves to target the poor; ▪ MFIs have effective outreach to all age groups (18-50 years); ▪ MFIs effectively reach women headed HHs;
Access, use and contribution	Microcredit is used for investment as well as other HH needs;	▪ Clients from all wealth ranks have equitable access to microfinance services;
Enterprises development	Microfinance increases enterprise activity	▪ Involvement in MFI increases non-agriculture enterprise activity within HH; ▪ Microcredit contributes to increase in enterprise income; ▪ Microfinance expands employment opportunities for poor people in non-agriculture enterprises; ▪ Clustering of certain types of MFI financial activities does not lead to a detrimental effect on natural environment; ▪ Microfinance has a positive impact on working practices in supported enterprises.
Managing risks / vulnerability	Microfinance builds the capacity of individuals, HHs and enterprises to manage risks;	▪ Microfinance builds capacity of individuals, HHs and enterprises to protect against risks ahead of time; ▪ Microfinance builds capacity of individuals, HHs and enterprises to cope with shocks resulting from risk after they occur.
Economic empowerment	Microfinance contributes to women empowerment at individual, HHs and community levels	▪ Microfinance increases women's access to financial services; ▪ Microfinance increases women's economic activity through access to credit for investment; ▪ Microfinance involvement increases women's awareness, mobility and skill development; ▪ Microfinance increases women's ownership of assets within the HHs; ▪ Microfinance increases women's management of enterprises within the HH economy; ▪ Microfinance enhances women's status in the HH as income contributors and decision makers; ▪ Microfinance increases women's empowerment at community level;
Poverty Reduction	Microfinance contributes to a reduction in	▪ Involvement in microfinance contributes to increased capital/asset formation at HHs level; ▪ Involvement in MFI helps clients to take

Area	Main hypothesis	Sub-hypothesis
	poverty;	advantage of educational opportunities for their children; ▪ Involvement in MFI contributes to poverty reduction by improving HHs incomes; ▪ Involvement in MFI reduces costs of borrowing; ▪ Involvement in MFI programme contributes to a reduction in incidence of poverty among clients;

The sub-hypothesis outlined in Table 2 is converted into variables that are meaningful and measurable. Indicators corresponding each of these variables are outlined in Table 3.

Table 2: Variables and Indicators for Analysis

Area	Variables	Indicators
Outreach	▪ MFIs operation in poorer areas;	▪ Ecological and development regional concentration of the microfinance services,
	▪ Reaching poor and very poor by MFI services;	▪ Access to formal financial services before joining MFI, ▪ Proportion of clients below the national poverty line, ▪ Proportion of very poor on total clients,
	▪ Reaching the excluded caste (dalits and Janajatis) by MFI services;	▪ Ethnic and caste distribution of clients,
	▪ Outreach to all age groups (18-50 years);	▪ Age range and distribution of the clients,
	▪ Reaching to women headed HHs;	▪ Percentage of women headed HH among total clients,
	▪ Small loan size assists on targeting the poor;	▪ Loan size by wealth ranks of the clients,
Access, use and contribution	▪ Equitable access to microfinance services to clients from all wealth ranks for production and consumption purposes;	▪ Loan access by wealth ranks, ▪ Loan use (production and consumption purpose) composition,
Enterprises development	▪ Promotion of non-farm enterprise activity;	▪ Micro-enterprise mix promoted under credit assistance,
	▪ Increase in enterprise income;	▪ Incremental income from the enterprises,
	▪ Employment creation;	▪ Employment (full and part-time) generation from enterprises,
	▪ Promotion of pro-environment enterprise activities;	▪ Enterprise and environment, ▪ Percent of eco-friendly enterprises,
	▪ Impact on working practices in supported enterprises.	▪ Employment mix by sex and age group,
Managing risks /	▪ Protection against risks ahead of time to individuals, HHs and	▪ Ability to finance at the time of risk,

Area	Variables	Indicators
vulnerability	enterprises;	▪ Physical and productive capital formation,
	▪ Coping with shocks resulting from risk after they occur to individuals, HHs and enterprises;	▪ Ability to manage finance at the time of risk, ▪ Human and financial capital formation,
Economic empowerment	▪ Increase in women's access to financial services;	▪ Percent of women clients,
	▪ Increases in women's economic activity through access to credit for investment;	▪ Proportion of women managed activities,
	▪ Increases in women's awareness, mobility and skill development;	▪ Increase in women's awareness, mobility and skill development,
	▪ Increase in women's ownership of assets within the HHs	▪ Ownership of assets by women,
	▪ Increase in women's management of enterprises within the HH economy;	▪ Proportion of women managing enterprises,
	▪ Enhancing women's status in the HH as income contributors and decision makers;	▪ Change in women's role in the HH,
	▪ Increases women's empowerment at community level;	▪ Change in women's empowerment at community level,
Poverty Reduction	▪ Increase in capital/asset formation at the HHs level;	▪ Financial, productive, and physical formation,
	▪ Clients taking advantage of educational opportunities for their children;	▪ Human capital formation,
	▪ Increase in HH income	▪ Number of sources of income, ▪ HH dependency burden, ▪ Reported trend in overall HH income,
	▪ Reduction on cost of borrowing	▪ Change in effective interest rates,
	▪ Reduction in the incidence of poverty among clients.	▪ Reduction on incidence of poverty,

3.4 Approaches of the Study

Of the two approaches of microfinance services provision viz. the welfare approach and institutional approach, this study has tried to make the assessment of the impact of microfinance services on poverty reduction using the welfare approach. In view of different approaches of impact assessment, an approach that compares the situations before and after microfinance services among clients as well as of clients and non-client HHs has been adopted in this study by commissioning a HH survey of the manageable size of the clients, non-clients and dropout clients (intensive approach) as well as using available information from surveys conducted in the past (extensive approach). Through this approach, it will be possible to look at changes over time and match observations made between pairs of borrowers and control group members. Each pair will have similar starting values for impact variables (like income or sales revenue) and other characteristics like age, gender, sources of livelihood, caste and ethnic dimensions.

3.5 **Method of Study**

Data Sources
The data required for this study were obtained both from secondary and primary sources. The secondary sources of information include the review of published and unpublished documents and other studies on the sector conducted by different agencies and institutions. Primary information will be collected from field studies using HH survey, semi-structured interviews and focus group discussions with clients of MFIs selected for study as well as through interviews with the staff of the MFIs.

Data Collection
Both extensive and intensive methods have been followed for data collection and analysis in this study. The extensive approach of this study adopts the before and after comparison method using information collected by the author while preparing the project completion survey of the Micro Credit Project for Women (MCPW) wherein a survey was made of 1081 HHs from 10 districts served by 10 WDS and 12 partner NGOs. The information used was obtained from the survey of the ILO study on microfinance, microenterprises and women's economic empowerment representing 140 clients surveyed from four MFIs clients [i.e. 35 clients each from Nirdhan Uthan Bank (NUB), SCCs, SFCLs and FI-NGOs].

The intensive approach compares before and after situations as well as clients with and without microfinance services. The survey was conducted in two districts (Bara and Lamjung) covering a total of 210 clients, 70 non clients as control groups[1] and 30 dropout[2] clients from the Kalaiya branch of the DEPROSC Development Bank (DDB) in Bara; the Bhotewadar Branch of the Paschimanchal Grameen Bikas Bank (PGBB) in Lamjung; SFCL Sundarbazar, Lamjung and Dumarbana, Bara; and three urban SCCs promoted by Lumanti, a Lalitpur based NGO, within the Kathmandu valley. Information was collected using a mix of data collection tools encompassing both quantitative (questionnaire based HH survey) and qualitative (focus group discussion, case studies and semi-structured interviews) tools so as to enable a comparison of information collected and find out qualitative justification of quantitative findings.

Table 3: Sample Size of the Intensive Study

S.N.	Type	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Clients	No	60	60	30	30	30	210
2	Non-clients	No	20	20	10	10	10	70
3	Dropouts	No	7	8	5	5	5	30
	Total	No	87	88	45	45	45	310

Source: Data collection 2004

Method of Analysis
This study is both quantitative and qualitative in nature. The impact of poverty as well as other social impacts of microfinance services have been assessed considering the situation before and after the project as well as situations with and without microfinance services by identifying and defining appropriate proxies such as inflation adjusted income level, employment generation and asset creation. A focus on HH, which determines the socio-economic status of clients and use of financial services, has been used as the unit

[1]Survey of non-client HHs as a quasi experimental group in the ratio of 1:3 clients HHs (case of intensive survey) was done. Non-clients were purposely selected to match the wealth ratio of the client sample and secondly, as far as possible, in terms of other features (main livelihood, social group).
[2]Survey of clients who have left a programme in a cluster in the previous two years has been done.

of analysis. Various methodologies used for impact assessment of the microfinance services are summarized hereunder.

- Triangulation of methods for poverty assessment: such as PRA, index scoring, HH income linking local indicators of HH status to standardize wealth rank categories that are comparable across different areas.

- Formulation of an involvement index: an index to measure '*involvement in a microfinance programme*' across entire sample of MFIs with different approaches and products, as a basis for cross-sectional analysis (comparison of 'low' involvement and 'high' involvement clients).

- Financial landscaping and HH portfolio analysis: to explore alternative financial options and relative contribution of microfinance to HH portfolio, using both FGDs and questionnaires.

A comparative analysis of the findings of different models represented in extensive and intensive studies such as Self Help Group, Grameen Replicators, SCCs and SFCLs and FI-NGOs was conducted. All clients HH surveyed were given a wealth ranking which was used as a basis for analysis for all indicators. The impact on key socio-economic attributes was measured through a comparison of the clients with the control group. Information gathered from dropouts was used as a proxy to assess the quality of MFI services and provide feedback on MFI services. Independent means and the chi-square test has been used on comparative data, assessing the statistical significance of differences between clients and non-clients and between different categories of clients.

Dissemination of Findings
A workshop was organized in Kathmandu to share key findings of this study among planners, policy makers, promoters and practitioners of the microfinance services and obtain their feedback. This report incorporates comments, suggestions and concerns raised by the participants in the workshop.

4. RESULTES AND DISCUSSIONS

4.1 Evolution of Microfinance Initiative

The lack of access to formal financial services in rural and semi-urban areas and the inability of the informal sector to provide sustainable financial services to the poor have led to the emergence of innovative financial institutions in Nepal. These innovative financial institutions, usually labelled "*Microfinance Institutions (MFIs)*", have emerged with the support of the government, civil institutions and donor organizations. Over the last few years, two broader consensuses have been reached among Nepalese planners and policy makers for the growth and development of microfinance sector. First, the financial needs of the poor populations are structural needs and institutions that target the poor must be sustainable. Second, MFIs cannot be successful without appropriate legal and regulatory framework. Backed by the two above consensuses, greater focus has been made on setting a legal and regulatory framework, adopting a policy to gradually withdraw subsidy, and providing greater attention on MFIs sustainability.

As discussed in the introduction, Nepalese MFIs are the RRDBs, MDB, FI-NGOs, SCCs; SFCLs and apex institutions providing wholesale loans to MFIs for retail lending viz. the RMDC, SFDB and RSRF. The numbers of MFIs have been growing since the implementation of financial reforms and creation of legal and regulatory framework that exceed 2855 (five RRDBs, four MDBs, 46 FI-NGOs, over 2800 SCCs including 161 SFCLs) MFIs.

The history of formal microfinance services in Nepal is short but eventful. The chain of events seems to be marked by a costly process of trial and error rather than by institutional dynamism. The landmark was set by cooperative societies instituted under the Rapti Valley Development Scheme in the early 1950s, which were primarily intended to provide credit to the agricultural sector, establishing 13 credit cooperatives. Initially, these institutions evolved under an executive order as the country lacked a legal basis for the purpose. The Cooperative Department was established in 1954 with the objective of promoting and assisting operations of these cooperative societies. The realization that this arrangement undermined the financing needs of these societies led to the establishment of the Cooperative Bank in 1963. The Agriculture Development Bank of Nepal (ADBN) emerged in cognizance of the shortfall in supply of funds for agricultural loans experienced by these credit cooperatives (Sinha, 2000). 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 by the ADBN. This programme, which covered the entire country at times, aimed at organising farmers into small groups and providing credit on a group guarantee basis. Over the past few years, a process has been stated to institutionalise small farmer groups formed under the SFDP into the SFCL. This process is being undertaken with the purpose of creating locally owned and managed MFIs that can take over activities of the SFDP on a self-sustaining basis. The ADBN has, so far, been able to convert its 161 sub-project offices into registered SFCLs.

In 1974, one year before the launching of the SFDP, the Nepal Rastra Bank (NRB) directed commercial banks to invest 5% of their total deposits in the "*small sector*" to promote rural finance (AsDB, Manila and NRB 1994). This scheme was collectively renamed the "*priority sector*" that diverted credit to cover agriculture, cottage industry and service sectors. The lending requirement for commercial banks to the priority sector was increased to 7% in 1976 and to 12% in 1990. The NRB directed that 25% of these priority sector loans or 3% of the total portfolio be given to the hardcore poor under the "*deprived sector credit*" programme.

The NRB introduced the Intensive Banking Programme (IBP) in 1981 to strengthen the priority sector programme to promote group-based lending and promote priority sector lending addressing the issues of collateral requirements. The programme was undertaken by two large commercial banks namely the Nepal Bank Limited (NBL) and the Rastriya Banijya Bank (RBB). The Nepal Arab Bank Ltd. (NABIL), the first joint-venture bank in Nepal, later followed it. Unfortunately, neither of the objectives of the programme was achieved. It instead largely bypassed the poorer segments of the population, reaching instead only the small non-poor sector.

The next main step in Nepalese microfinance sector development came in the form of the first gender-focussed programme, the Production Credit for Rural Women (PCRW), in 1982. This was collaboration between the Ministry of Local Development (MLD), the United Nations Children Fund (UNICEF) and the NRB. This involved organising women groups and training them to undertake group-based borrowings from the NBL, RBB, and ADBN. Encouraged by the results and learning from the experience of this initiative, the same department in 1994 started the Micro Credit Project for Women (MCPW). This was more innovative since, for the first time in a government-sponsored programme, it involved NGOs as intermediaries in financial service delivery.

NGOs and cooperatives have also had an increasing role to play in delivering microfinance in Nepal. While the proportion of the over 30,000 NGOs[3] engaged in microfinance is not known, the number with limited banking licenses provided by the NRB under the Financial Intermediary Act 1999 has grown to 46 within a period of five years of the enactment of the act and policy. FI-NGOs acquire loanable funds from two apex institutions namely the RMDC and the RSRF.

As already discussed, the first credit cooperatives were established by executive order in the Rapti valley of Chitwan district in 1956, which is often described as the beginning of institutional credit in the rural sector (Sharma, S. R. and V. Nepal. 1997). Initially these cooperatives were provided financial support by the Government through the Cooperative Development Fund. The growth of these credit cooperatives received a significant impetus with the establishment of the Cooperative Bank in 1963, which was later converted into the ADB/N. Subsequently, the management of cooperatives was handed over to the Department of Cooperatives in 1979. In cognizance to the growing political interference and to institutionalise cooperatives as people's institutions, a new cooperative act (Cooperative Act 1992) was enacted in 1992. This Act helped promote the growth of cooperatives and by 2003/04 over 6,000 cooperatives registered under this act. These included over 2800 SCCs, which are savings and credit focused, as opposed to multipurpose cooperatives. SCCs are viewed as feasible alternative models to provide microfinance services, especially in remote hills and mountains of Nepal.

In 1992, in an important initiative to augment the supply of microfinance, the first two 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 Banks Act 1996 (Sharma and Nepal, 1999). As of May 2004, the Grameen Model has been replicated through five RRDB, four MDBs, one cooperative and three FI-NGOs[4]. The rationale for establishing RRDBs was to offer a proven model of low cost, sustainable credit delivery system to poor women who were by-passed by other programmes.

[3]Registered under the Society Registration Act, 1978

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

Since mid 1990s' UNDP has been supporting the microfinance movement in Nepal through the establishment of a **Local Development Fund (LDF)** with two components: seed capital and credit capital to operate as a revolving fund at district level to sustain and institutionalize its Village Development Programme (VDP). The outreach of services under LDF is reported to be significant with potential to grow and meet credit need of the un-served and potential to expand the services in the remote hills and mountains albeit without linkages with mainstream microfinance initiative. Despite several challenges on operations and viability, credit component of LDF includes many features of *modified village banking model* with prospects for viability if properly refined.

A cursory analysis of the evolution and development of microfinance sector suggests that Nepalese microfinance sector has evolved into a mix of formal and semi-formal sources in addition to large informal sources comprising moneylenders, friends and relatives, thereby serving as a laboratory of microfinance based on its geographical diversity with a multitude of different approaches[5].

4.2 Structure of Microfinance Sector

The structure of the microfinance sector is quite complex. The Nepalese microfinance sector can be classified into two categories based on institutions such as government initiated models and semi-formal sectors. A discussion on each of these sub-sectors follows.

Government Initiated Microfinance Programs
These relate to various microfinance programs implemented in Nepal under government's involvement which can be broadly divided into two groups based on modality and approach adopted.

- ***Government-Mandated Models*:** These include models implemented through commercial banks and government line agencies. The initiatives so far include the establishment of the RMDC[6] and the implementation of programs like Jagriti (Women Empowerment Program), Biseshwor with the Poor, Intensive Banking Program (IBP), SFDP and PCRW. The government has established and implemented these programs for achieving poverty reduction goals.

- ***Grameen Bikas Bank*:** The Grameen bank model was developed in Bangladesh and was replicated in Nepal through five RRDBs in over 24 districts of the country since 1991.

Semi-formal Sector
The semi-formal financial sector[7] provides microfinance services through NGOs, SCCs and MDBs as discussed below.

NGO/SCC Model-External Funds: A substantial number of NGOs and SCCs provide microfinance services using external funds provided by the government and/or INGOs.

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[5]Readers who are interested in the microfinance sector of Nepal should look into the Centre for Microfinance (CMF) directory of MFIs in Nepal (CMF, 2003) to get an overview on the microfinance sector

[6]RMDC an apex institution to provide wholesale loan to Nepalese MFIs established in 1999 focus on providing lending services to its client MFIs at rate sufficient to cover cost incurred for financial intermediation. Establishment of RMDC has opened new impetus in Nepalese microfinance sector. Basically RMDC expect its partner MFIs to know details about their clients, target market and market share. It anticipates that partner MFIs will identify needs of client and helps to define appropriate products to meet such needs.

[7]The semi-formal sector is described as such because NGOs and SCCs are sometimes registered entities but are neither regulated nor supervised as the formal sector institutions.

- *Government Sector Program:* The RSRF executed by the NRB, IDP of the ADBN to federate the small farmers' group into the SFCL are examples of government microfinance programs under the semi-formal sector.

- *INGO Sector Program:* INGO support to local NGOs/SCCs to enable them provides microfinance services to their clients. They provide (i) revolving funds for on-lending, (ii) grants to cover operating costs including staff and administration expenses, rent and transportation, (iii) matching funds whereby INGOs match (or provide a multiple of) amount of savings collected by the NGO/SCC from its members and (iv) technical assistance including program development, group formation, staff and client training and financial management. Action Aid, CECI-Nepal, PLAN-International, Save the Children Federation, US, PACT-Nepal, etc. are the INGOs involved in supporting the Nepalese microfinance movement.

Indigenous NGO/SCC Models-Internal Funds*:* There are *s*everal thousand indigenous savings and credit groups in Nepal. They are generally small, unregistered organizations owned and managed by local village members. In these institutions, decision-making is highly participatory and democratic. There are very few or no paid staff members. Funds for on lending usually come from group savings. Despite their ability to achieve financial sustainability, their institutional viability becomes questionable with their growth due to a leadership crisis, the lack of ability to hire full-time employee(s), the lack of capital funds, a weak management system and the lack of basic physical facilities.

Microfinance Development Banks*:* After the enactment of the development bank act 2052, MDBs have been gradually emerging in Nepal. Most of MDBs possess experience of 3 to 10 years on microfinance operation as NGOs. Some of the MDBs that are active in the Nepalese microfinance sector are: NUB, DBB, Chhimeki Bikas Bank (CBB), Swabalamban Bikas Bank (SBB) and Sana Kisan Bikas Bank (SKBB). Nepalese MDBs have been mostly implementing microfinance programs using the lending methodology developed by the Grameen Bank of Bangladesh with or without modifications.

4.3 Microfinance Institutions

The activities of MFIs must be guided and governed by the prevailing legal and regulatory framework for the security of activities as well as the protection of clients against fraud and mismanagement. Under the Nepalese legal and regulatory framework, there are two legal options to facilitate the emergence of MFIs.

- *Community based organization* - includes either SCCs established under cooperative act 2048 or NGOs established under society registration act 2034 and with license to work as financial intermediary under Financial Intermediary Act 2055.

- *Capita based organization* - includes development financial institutions established under development bank act 2052 and registered as a company.

Thus, within the existing legal and regulatory framework namely Financial Intermediary Act, 2055; Financial Intermediary Rules, 2056; Cooperative Act 2048; Cooperative Rules, 2049; and Development Bank Act 2052, Nepalese MFIs are MDBs including GBBs, Credit Union consisting of SCCs and SFCLs and FI-NGOs. At present four MDBs, five GBBs, over 2800 SCCs including over 161 SFCLs and 46 FI-NGOs are active in the Nepalese microfinance sector.

4.4 Scale of Microfinance Services

Analysis of evolution of Nepalese microfinance sector reveals that over the last decade, it has been expanded significantly in terms of service providers (including MFIs) and clients served. Review of the clients served by Nepalese microfinance sector both in the formal and semi-formal segments, excluding informal sector, reveals to have reached to an estimated 655,000 members[8]. This estimate, however, includes clients borrowing from more than one source. Assuming that about 15% clients have borrowed from more than one source, the effective numbers of HHs with access to microfinance services has been estimated at 5,57,000 (Sharma 2004).

The available disaggregated information (See Table 4) reveals that the Nepalese microfinance market is fairly well balanced between "*cooperatives, private and government-owned GBB / Replicators*" and "*government supported microfinance programmes*". Cooperatives sector (including SCCs and SFCLs) appeared to be the biggest players in terms of outreach followed by RRDBs. Despite the biggest share in the microfinance sector, they are often criticised on their viability, quality and depth of outreach. Other actors such as MDBs and microfinance NGOs are gradually making their presence in the microfinance sector. Further, the SFCLs, which are outcomes of the transformation process of ADBN's Sub Project Offices under SFDP, have gained an increasing share in rural financial market. This is quite interesting to make a note that SFCLs possess prospects to attain largest share in the Nepalese microfinance sector.

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 2004 557,000 HHs have access to microfinance services. According to latest estimates, total population of Nepal has been 242,00,000 and 38% population live below poverty line in 2004 (ADB 2004). With the average HHs size of 5.6 members per HH, this indicates that there are 1,642,143 HHs below the poverty line in Nepal. These statistics indicates that about 33.92% of the total HHs below the poverty line has access to microfinance services in Nepal. Scenario of outreach of microfinance services in Nepal has been changed with the availability of the Nepal Living Standard Survey (2003/04) results which has estimated incidence of poverty at 31%. With the estimated population of 2004, this indicates there are 1,339,642 HHs below poverty line. Using the analytical methodologies discussed above, this indicates that about 41.6% HHs have access to microfinance services in Nepal. Technically speaking, this statistics implies that additional 782,642 HHs are yet to be served by the microfinance sector in Nepal. Hence, the breadth of outreach is yet to be expanded to ensure assess to microfinance services to people below the poverty line and it appears that the gap between demand and supply of micro financial services will not be reduced any time soon.

Table 4: Outreach of Microfinance Services in Nepal (As of July 2004)

Financial Institution	Number	Members (No)	Percentage
RRDBs	5	146,000	22.3
MDBs	4	90,000	13.7
SCCs	2650	160,000	24.4
SFCLs	161	88,000	13.4
Government Supported microfinance programmes	1	76,000	11.6
ADBN (SFDP)	1	66,000	10.1

[8]This figure does not include the rural clients of ADBN's development banking segment and the clients of NBL and RBB since all three banks are considered to serve the better off clients in rural areas.

Microfinance NGOs	44	29,000	4.4
Total	2868	655,000	100.0

Source: Sharma S. R. (2004)

The institutional and financial sustainability are major concerns in financial system. Major financial institutions such as the RBB, the NBL, the RRDBs and the ADBN need to go through extensive reforms for meeting the financial need of the poor and excluded in the rural areas. An analysis of the concentration of microfinance services reveals that MFIs are concentrated in the Tarai and accessible hills. There is virtually no formal MFI with only limited presence of the SHG and credit union model in the inaccessible hills and mountains. MFI services are more concentrated in rural and peri-urban areas than in urban areas and such services are very much limited for the urban poor.

4.5 **Characteristics of Microfinance Services**

All the MFIs surveyed have a stated policy that only one member (woman in case of DDB, the PGBB and SCCs and either man or woman in the case of SFCLs) per family should be a client. This has been observed in practice. All 210 sample clients surveyed have savings with MFIs and all have received micro-credit from these institutions. About 91% of the clients had no access to non-financial services. While most clients have received initial trainings in group procedure and transactions, non-financial services offered by the MFI either have low coverage or do not target microfinance clients as just 5% of the clients have enterprise-related training or support (mainly SFCLs and SCCs) and 4% are involved in social development such as health care and child education.

Table 5: Characteristics of Client Households

S.N.	Type	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Sample size	No	60	60	30	30	30	210
2	Clients from women headed HHs	No	2	5	3	4	5	19
3	Clients from women headed HHs	%	3.3	8.3	10.0	13.3	16.7	9.0
4	Access to financial services							
	Savings services	No	60	60	30	30	30	210
	Lending services	No	60	60	30	30	30	210
5	Non financial services	No	0	0	7	5	7	19
	Enterprise training	No	0	0	4	2	4	10
	Health/Education	No	0	0	3	3	3	9
6	Non financial services	%	0.0	0.0	23.3	16.7	23.3	9.0
	Enterprise training	%	0.0	0.0	13.3	6.7	13.3	4.8
	Health/Education	%	0.0	0.0	10.0	10.0	10.0	4.3

Source: Field Survey 2004

Micro-savings form a major part of total HH savings for all clients, except for non-poor clients. The non-poor are more likely to have access to alternative mechanisms such as formal and informal sources. Micro-savings primarily act as collateral to micro-credit and over time it is also a form of saving-up (Rutherford 1999) although all MFIs (SFCLs and SCCs) tend to 'lock up' savings so that a client may have to leave the programme if she decides to withdraw her savings. The average savings balance of the clients was Rs.

2061, highest being among clients of SCCs (Rs. 5560/-) followed by SFCLs (Rs. 3540) and MDB (Rs. 432).

Table 6: Average Savings and Loan Balance of the Client Households

S.N.	Type	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Average savings balance	Rs.	389	476	2857	4281	5560	2061.1
2	Average loan size							
	Average initial loan	Rs.	13514	14310	30300	28500	17500	18850
	Average outstanding loan	Rs.	9321	9920	14540	13250	14230	11500
3	Credit use	No	60	60	30	30	30	210
	Consumption	No	18	21	11	8	13	71
	Production	No	42	39	19	22	17	139
4	Credit use	%	100	100	100	100	100	100
	Consumption	%	31	35	37	27	43	34
	Production	%	69	65	63	73	57	66

Source: Field Survey 2004

All the sample clients have borrowed from MFIs in the last two years. The clients have used micro-credit both for consumption (34%) and investment (66%) purposes. The use of micro-credit for *consumption purposes* can be grouped into four categories: (i) risk related uses (medical expenses, urgent house repair, debt repayment, food for current consumption, marriage related costs, death/birth ceremonies, etc.), (ii) housing (constructing a new house or room, house improvement such as roof, electricity, sanitation, whitewash, kitchen repair, toilet construction, etc.), (iii) education (school fees, uniform, transport, stationary, etc.) and (iv) other HH expenses (festivals and pilgrimages, purchase of HH assets, clothing, etc.).

Table 7: Access to Formal Financial Services of the Sample Client Households

S.N.	Type	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	**Reaching the un-reached**							
	Access to bank credit before	No	8	6	5	7	9	35
	Access to formal saving before	No	11	8	15	13	11	58
2	**Reaching the un-reached**	%	13	10	17	23	30	17
	Access to bank credit	%	18	13	50	43	37	28
	Access to formal saving	%	13	10	17	23	30	17

Source: Field Survey 2004

The productive use of micro-credit refers to directly IG/MEAs such as non-farm enterprises (fixed and working capital), animal husbandry, cash crop production and also borrowing for overseas employment. The average initial loan size is Rs. 18,850 (US$ 269) and the outstanding loan balance is Rs. 11,500 (US$ 164). The credit amount through SFCLs is higher than through the DDB and PGBB. The clients of SFCLs also have access to micro-credit as an internal group loan from their savings, which represents a reliable significant source of credit especially during emergencies.

The services of these MFIs are mainly targeted at those who do not have access to formal sector finance. About 83% and 72% of the clients surveyed have no access to bank credit and formal savings, respectively. These are mainly better-off HHs with higher access in urban areas receiving microfinance services from SFCLs and SCCs. The survey findings reveal that these MFIs have provided clients with a powerful avenue for access to microfinance services and have successfully served the un-served. The DDB and PGBB have been more effective in reaching the un-reached, than the SFCLs and SCCs. The social profile of the overall sample broadly reflects the population profile in sample clusters, with most MFIs having a mix of social groups or castes. About 21% of MFI clients are dalits and 36% janajatis indicating that MFIs serve all castes and communities including the dalits and janajatis.

Table 8: Socio-economic Groups of Client Households

S.N.	Type	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
A	**Total Clients**	No	60	60	30	30	30	210
1	Dalits	No	17	12	7	6	2	44
2	Janajatis	No	24	21	10	11	9	75
3	Other	No	36	39	20	19	21	135
B	**Total Clients**	%	100	100	100	100	100	100
1	Dalits	%	28	20	23	20	7	21
2	Janajatis	%	40	35	33	37	30	36
3	Other	%	60	65	67	63	70	64
C	**Non-clients**	No	20	20	10	10	10	70
1	Dalits	No	5	4	2	2	2	15
2	Janajatis	No	5	8	5	6	4	24
3	Other	No	15	12	5	4	6	46
D	**Non-clients**							
1	Dalits	%	25	20	20	20	20	21
2	Janajatis	%	25	40	50	60	40	34
3	Other	%	75	60	50	40	60	66

Source: Field Survey 2004

The wealth ranking of the clients who joined the MFI in the past three years was as follows: 64% poor, 24% borderline poor and 12% non-poor. The DDB and PGBB have the greatest depth of outreach and SFCLs/SCCs have less depth. In general, the PGBB caters to a larger proportion of poor clients, followed by the DDB, SCCs and SFCLs. The proportion of the '*very poor*' among the recent MFI clients surveyed is 15%, which is slightly less than their incidence in the local community. The incidence of dropouts was higher for the very poor (47%) and non poor (27%) than the poor (17%) and the border line (10%).

Microfinance is sometimes assumed to be '*self targeting*' for the poor due to the small ('*micro*') size of credit (*and savings*). This hypothesis is strongly supported by the data in terms of the inverse correlation between maximum loan size and the '*height*' of outreach i.e. the proportion of the non-poor in recent clients. The correlation between the smaller size of and depth of the first loan and the depth of outreach to recent clients (i.e. proportion of the very poor) and poor is positive, but less strong. The DDB and PGBB with the smallest first size have the highest proportion (79-80%) of very poor and poor clients. Nevertheless, low loan sizes do not always exclude the non-poor who, whilst having larger borrowing requirements, can still be attracted by favorable interest rates, the possibility of large loans in the future, and opportunities for women of group

membership. In general the small size of microfinance loans serves to target the poor. But the non-poor are also interested in small loans, and the poor sometimes need larger loans.

Table 9: Wealth Ranking Results of the Client Households

S.N.	Type	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Within previous three years	%	100	100	100	100	100	100
	Very poor	%	30	26	0	0	0	15
	Poor	%	50	63	28	33	53	49
	Borderline poor	%	20	11	39	38	30	24
	Non-poor	%	0	0	33	29	17	12
2	More the three years	%	100	100	100	100	-	100
	Very poor	%	10	5	0	0	-	5
	Poor	%	40	5	8	0	-	16
	Borderline poor	%	45	82	25	33	-	52
	Non-poor	%	5	9	67	67	-	27
3	Total	%	100	100	100	100	100	100
	Very poor	%	23	18	0	0	0	12
	Poor	%	47	42	20	23	53	39
	Borderline poor	%	28	37	33	37	30	33
	Non-poor	%	2	3	47	40	17	16
4	Drop-out	%	100	100	100	100	100	100
	Very poor	%	71	75	0	0	60	47
	Poor	%	29	25	0	0	20	17
	Borderline poor	%	0	0	20	20	20	10
	Non-poor	%	0	0	80	80	0	27
5	Average loan size							
	Average initial loan	Rs.	13514	14310	30300	28500	17500	18850
	Average outstanding loan	Rs.	9321	9920	14540	13250	14230	11500

Source: Field Survey 2004

The clients of SCCs/SFCLs' have greater flexibility on loan use and are more likely, across all categories of involvement, to use micro-credit for immediate HH needs. SHGs under SFCLs have access to group funds, based on their savings, for internal loans and these are used primarily for HH needs. Poorer clients are more likely to borrow smaller amounts and for HH expenses than the better off.

Micro-credit contributes about 58% of the total HH borrowings among clients. Micro-credit received from the MFI is one source (58% share) of clients who also borrow from informal sources (moneylenders, friends, family and relatives) as it continues to be important on account of its easy and speedy accessibility and flexibility in amount and terms. Comparison with non-clients suggests significant reduction in clients' dependency on high cost informal sources. If there were no MFI services, clients would have borrowed half of the micro-credit amount from higher informal sources. The interest payment savings through MFI's microcredit services has been estimated at Rs. 1,696 ($ 24)/borrower which is not a small amount for a poor HH.

There has been similar access across all wealth ranks in DDB and PGBB samples and lower access by the poor in other models. Since all clients surveyed represent group

based micro-lending methodologies, an issue often raised is whether group leaders (office bearers, chairperson, secretary, etc.) use their position to influence group decisions, including loan decisions in their favour. In general, a group leader tends to be better off than other group members and more educated, the latter being a requirement for handling basic group records and accounts. There are instances where group leaders have influenced lending decisions in their favour in SFCLs/SCCs. In other MFIs, more then 40% of the group leaders were poor or very poor and many have had no schooling.

Table 10: Sources of Finance of the Client Households

S.N.	Type	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Source of credit – clients	Rs.	22475	23950	54192	51400	29050	32499
	MFI	Rs.	13514	14310	30300	28500	17500	18850
	Moneylenders	Rs.	6068	5509	10026	13415	3457	7150.2
	Others	Rs.	2893	4132	13866	9485	8093	6498.9
2	Source of credit - non-clients	Rs.	15400	16240	24733	25250	25500	19823
	MFI	Rs.	0	0	0	0	0	0
	Moneylenders	Rs.	7059	8068	10995	11505	11079	9119
	Others	Rs.	8341	8172	13738	13745	14421	10704
3	Source of credit - clients	%	100	100	100	100	100	100
	MFI	%	60	60	56	55	60	58
	Moneylenders	%	27	23	19	26	12	22
	Others	%	13	17	26	18	28	20
4	Source of credit – non-clients	%	100	100	100	100	100	100
	MFI	%	0	0	0	0	0	0
	Moneylenders	%	46	50	44	46	43	46
	Others	%	54	50	56	54	57	54
5	Interest cost savings	Rs.	1216	1288	2727	2565	1575	1696

Source: Field Survey 2004

4.6 **Socio-economic Characteristics of Clients**

The average family size of clients surveyed ranges between 4.8 and 5.4 persons with an average of 5.1 members. The average family size is larger among HHs in the Tarai district (Bara) than in the hill district (Lamjung). The average family size is almost identical across the categories (clients, non-clients and dropouts) of HHs surveyed.

Table 11: Family Size of the Sample Population

S.N.	Type	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Clients	No	5.1	5.2	5.4	4.9	4.8	5.1

2	Non-clients	No	5.2	5.1	5.5	5.1	4.7	5.1
3	Dropouts	No	5.0	5.2	5.4	5.0	4.9	5.1
	Total	No	5.1	5.2	5.4	4.9	4.8	5.1

Source: Field Survey 2004

In general MFIs have effective outreach to almost all age groups across economically active people. The age of sample client ranges between 21 and 56 years and the average age of these clients is 38 years. The composition of clients in terms of age group is almost identical across all MFIs. The average literacy rate of these clients is 36%. The literacy rate is slightly larger among clients serviced by SCCs/SFCL compared to the clients of the DDB and PGBB. MFIs have effectively reached to women headed HHs[9]. Women headed HHs are regarded to be vulnerable groups in the local community, especially those headed by women who are bringing up a young family by themselves, are widowed or abandoned, or have husbands who are not able to support their families. Women headed HHs are 9% of the client HHs (more in urban SCCs and SFCLs compared to the DDB and PGBB). Focus group discussions have revealed that the proportion of women headed HHs served by MFIs is slightly higher than their proportion in the local community, indicating that MFIs are effective in reaching this category of vulnerable groups.

Table 12: Socio-economic Characteristics of the Client Households

S.N.	Type	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Age of the respondent							
	Mean	Yr.	37	37	38	39	39	38
	Min	Yr.	24	23	22	23	21	21
	Max	Yr.	54	52	51	49	56	56
2	Literacy rate	%	32	33	40	40	43	36
3	Women headed HHs	%	3.3	8.3	10.0	13.3	16.7	9.0
4	Land holding	%	100	100	100	100	100	100
	Landless	%	27	22	0	0	100	28
	0-0.5 ha.	%	70	70	53	60	0	56
	>0.5 ha	%	3	8	47	40	0	16
5	HH type	%	100	100	100	100	100	100
	Kuchha	%	63	75	27	3	100	58
	Mixed	%	37	25	50	50	0	32
	Pakka	%	0	0	23	47	0	10
6	HHs livelihoods	%	100	100	100	100	100	100
	Agro-based/livestock	%	35	33	50	47	10	35
	Non-farm self employment	%	10	7	23	20	40	17
	Labor (Causal)	%	55	60	27	33	30	46
	Other	%	0	0	0	0	20	3

Source: Field Survey 2004

About 28% of the clients are landless, 56% own less than 0.5 ha and 16% own more than 0.5 ha land. This finding indicates the capacity of MFIs to mainly target HHs below the poverty line. About 58% of the clients live in Kuccha houses, 32% in a combination

[9]HH head is defined as person who bears chief responsibility for the maintenance and main decisions of the HH.

of Kuccha and Pakka houses, and 10% in Pakka houses. A Majority of the clients own basic utensils in the HHs and only some have a radio, a TV and modern utensils. A majority of the client HHs derive their livelihood primarily from causal or wage employment (46%), followed by agro-based/livestock self-employment (35%), non-farm self-employment (17%) and others (3%). There exist differences on HH livelihoods across MFIs, reflecting differences between methodologies such as the targeting approach, credit products and terms, with majority causal labour among DDB and PGBB clients while agro-based activities are the predominant livelihood among the clients of SFCLs and non-farm self employment among clients of SCCs.

4.7 **Direct Impact on Income and Non-income Dimensions of Poverty**

The direct impact comprises both income and non-income dimensions[10]. Income related effects of microfinance services include diversification on income sources, reduced dependency on causal labor, lower dependency ratio, overall increase in income and reduced cost of borrowing as elaborated briefly below.

4.7.1. **Capital Formation**

Microfinance has contributed to increased capital/asset formation at the HH level. Capital formation in the client's HHs can be broadly grouped into three categories viz. financial capital, productive as well as physical capital and human capital. Each of these capital leads to the subsequent empowerment of the clients at the individual, HH, and community level.

Financial capital formation
Savings is a form of capital accumulation carried out by all the clients surveyed by setting aside a part of their current income for future use. All the MFIs surveyed provided an option for regular savings deposits, small and frequent savings on regular intervals. Unlike other categories of MFIs, SCCs offer diverse types of savings products encompassing regular savings, voluntary savings, housing savings and children savings[11]. Clients value greatly the ability to save with MFIs. A key response to FGDs is that the involvement in a microfinance programme has enabled clients to increase their savings. Microfinance services have provided women clients with an opportunity to save small amounts on a regular basis. Due to microfinance, nearly all client HHs across all wealth ranks have a savings account. There is high incidence of savings (financial capital) among MFI clients including the poor but little difference in overall HH savings between clients and non-clients.

Productive and physical capital formation
In the local socio-economic circumstances of the study area, a lack of asset is one indicator of deprivation for low-income HHs. Productive assets represent an economic opportunity to improve income. Improved housing and the ability to purchase HH assets reflect consumption to enhance the quality of life. The survey data on the purchase of assets in the previous two years reveal significant differences among clients and non-client HHs on productive and physical capital formation. Assets range from small tools, fans, gas-stoves, animals, push carts, handloom, gold, TV, housing improvement including white wash, roof repairs and additional room – even a new small house. A high proportion (56%) of client HHs had acquired assets in the last two years before the survey. The comparison with non-clients is more significant for productive assets, reflecting substantial use of micro-credit for IG/MEA. Both clients and non-clients have

[10]The non income dimensions consist of financial capital (savings), productive and physical capital and human capital formation.
[11]For details refer Dhakal, N. H. 2004, "Microfinance Services for Urban Poor" Kathmandu.

borrowed at comparable levels for housing and HH assets. However, client HHs are more likely to have borrowed for productive activities. Analysis by wealth rank indicates a higher acquisition of productive assets by borderline and poor clients and higher purchase of HH assets by non-poor and borderline clients. Survey data showed the non-poor to be less likely to use borrowed funds for HH assets. A positive correlation exists between the value of assets acquired and HH wealth ranks.

Human capital formation

Across all levels of society, people are interested in sending their children to school. The ability to do so depends on the access to education facilities and their cost. Access is related to the location of the school in the vicinity and also includes access of dalit and Janajatis to schooling facility. The cost of schooling includes the direct (travel, uniform, stationary, fees) and indirect (whether the family needs a daughter or son to help out in home-based tasks or to contribute directly to HH income) costs. In all the sample clusters, primary schools are located in the village or nearby urban areas while secondary schools are usually located in a nearby area at a distance of up to 5 km. Both low cost and high cost schools co-exist in the localities run by the local government and the private sector respectively. Contribution of the access to the microfinance services on human capital formation was evident in terms of increased investment on education and increased evidence of sending children to school. A small contribution from microfinance (e.g. internal group loans from SHG) in meeting schooling costs exist; school enrolment of clients' children is significantly higher than non clients' at the primary level, but there is no differences at the secondary level and gender imbalance at all levels of schooling is similar for both clients and non-clients.

One of the first things poor people do with new income from income generating/micro activity is to invest in their children's education. Greater access to financial services and increased incomes has enabled the poor people to invest in their children's education. Children of microfinance clients are more likely to go to school and stay in school longer. Student dropout rates are much lower in these HHs. To support this priority, some SCCs and FI-NGOs have introduced new credit and savings products specifically tailored to school expenses while the DDB, PGBB and Nirdhan make reading and writing by clients mandatory.

Table 13: Microfinance and Education Improvement

Particulars	Unit	Value
Sending children to school	%	70
Increase investment in children's future	%	59
Increase in children's schooling rate	%	19
Increase in literacy rate of family members	%	15
Sample size	No.	1067

Source: Dhakal, N. H. 2002b.

Information from an extensive study has revealed that about 70% of MCPW clients are sending their children to school while over 59% have used their increased income in children's education. Children's schooling rate has been increased by 19% in 2002 compared to 1996 while the literacy rate of the family members has been increased by 15% during this period. Thus, greater access to financial services and increased incomes has allowed clients to invest in their children's future. Nearly all girls in client HHs have received schooling. Thus, there exists ample evidence of access to microfinance services helping clients to take advantage of educational opportunities for their children.

4.7.2. **Income Related Effects**

Income related effects of microfinance services on poverty reduction is evident in terms of the increase in number of income sources, HH dependency burden, reported trend on overall HH income and eradication of extreme poverty and hunger.

Diversification of the income sources
The number of livelihoods (or earner) is not by itself a determinant of economic status, instead its stability and level of earnings are more important. In general, it is the relatively irregular and low-earning opportunities of the poor, which keeps them poor. Enabling HHs to undertake more diverse economic activities is one option for promoting their security and income growth. Thus, better-off HHs have more diversified income sources, amongst non-clients: 62% of the non-poor have two or more sources of income, compared to 38% of the poor and 16% of the very poor. Amongst the clients, the proportion is higher for all wealth ranks, from 28% for the very poor up to 82% for the non-poor increasing further for high involvement clients in poor and border categories. There exist some differences across ecological belts. The difference is at least partially attributable to the role of micro-credit role in promoting income generating/micro-enterprise activities.

Reduced dependency on causal labor
Casual labour is a common employment option for the poor, but one, which is usually seasonal and low-paid (below the minimum wage, especially for women). Microfinance is often seen as a means of at least reducing client dependency on casual employment if not shifting it out altogether. A slightly lower proportion of clients (22%) compared to non-clients (31%) still reported casual labor as their main income source. Income diversification has enabled clients to reduce their dependency on casual labor.

A lower dependency ratio
The higher number of income sources leads to a lower dependency ratio among client HHs in comparison to non-clients for all wealth ranks. The lower dependency ratio in very poor client HHs compared to non-clients is due to a higher number of clients children engaged in family owned enterprises. In addition, fewer children working in very poor non-client HH is probably due to lack of opportunity than anything else. The number of very poor non-client children '*doing nothing*' is much higher (25%) compared to children of the client HHs (13%), while at the same time, a lesser proportion (51%) of non-client children are attending school compared to very poor client HHs (77%).

Reduced cost of borrowing
The effective interest rate (EIR) charged by MFIs for micro-credit ranges from 18-24%. Though these rates are higher than bank rates (12-18%) they compare favorably with informal moneylender rates, which range between 36 and 96%. The normal development banking rates are 12-18% that can be 36% effective, depending on the time, visits, bribes etc. Moneylenders charging over 36% per annum are categorized as '*costly informal sources*'. Thus, the interest rate charged by the MFI has been significantly lower than the one charged by the informal sector, which is the preferred option for poor clients. Lower effective interest rates through MFIs and reduced dependency on more costly informal sources of finance are clearly evident among the clients surveyed. Thus, the cost of borrowing has been reduced significantly among MFI clients compared to non-clients and this is one of the impacts that is valued greatly by clients who lack other sources of borrowing.

Eradication of Extreme Poverty and Hunger
The microfinance services have enabled poor client HHs to protect, diversify, and increase their sources of income, which has evolved into an essential path out of poverty and hunger. Such services have been instrumental in increasing income and employment

(self and wage) reflected by changes in weekly sales and profits that could be used to pay for school fees, or to bridge a cash-flow gap that has been instrumental at times to break the poverty cycle. The use of safe and convenient savings accounts by clients has enabled them to accumulate enough cash to buy assets for general well being.

Table 14: Eradication of Extreme Poverty and Hunger through Microfinance Services

Particulars	Unit	Value
Increase in income	%	78
Increase in employment		
▪ Self-employment	%	79
▪ Self and wage employment	%	13
Change in weekly sale and cash flow	%	79
Change in weekly profit	%	58
Increase in duration of works	%	91
Increase in food security	Months	5
Improve in food security	%	85
Improvement on food intake	%	60
Sample size	No.	135

Source: Dhakal N. H. 2001a.

Thus, microfinance services have assisted client HHs to safeguard against extreme vulnerability as loans and savings help smooth out income fluctuations and maintain consumption levels even during lean periods. These services have acted as a buffer for sudden emergencies, business risks, seasonal slumps, or events like a flood or a death in that family that can push a poor family into destitution. About 28% have graduated out of poverty and the weekly income of 58% of the clients has increased while 85% of the clients were able to increase food security by an average of five months, with 60% availing better food (Dhakal 2001a).

Overall increase in income

A survey of the perception of clients on the trends in different income sources and dynamics on overall HHs income during the previous two years has revealed that income trends varied across the economic sector and that it was affected by local conditions and HH abilities. An increase in income was reported for 118 (85%) clients in a total of 139 using microcredit on IG/MEA through for example, the use of working capital to diversify or improve the quality of goods or to take advantage of seasonal bulk purchase. On total 56% of the borrowers are benefiting from increased income through micro-credit services. The average incremental income from micro enterprise was Rs. 11,335 per year.

HHs most likely to report income increases from IG/MEA are mainly those involved in non-farm enterprises, followed by dairy cattle farming. In comparison, less than 40% of HHs engaged in agriculture or wage labour is likely to increase their HH income. HHs not benefiting from microcredit services is those borrowing for consumption purposes and/or whose IG/MEAs have failed due to management and technical reasons.

Client's HHs is more likely to report income increase than non-clients, especially among those who have used micro-credit for investment in IG/MEA. An income source can be supported by increasing the ability to acquire a productive asset. The contribution of microfinance to income increase is greatest in case of poorer HHs. MFI supported enterprises are the main HH sources in 59% of client HHs, secondary sources in 28% and tertiary sources in 13%. Thus, microfinance can mainly enhance income by supporting an income source and by increasing the ability to acquire a productive asset.

The incidence of reported income increase in the previous two years is higher for those who acquired a productive asset (62% overall for clients and at the level of poor and borderline clients). It is the highest for client who used micro-credit to support their main income source.

Table 15: Status of Income Generation from Credit Financed Income Generating/Micro-enterprise Activities

S.N.	Particulars	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Sample size	No	60	60	30	30	30	210
2	Clients adopting credit financed income generating activities/ enterprise	No	42	39	19	22	17	139
3	Adoption rate	%	69	65	63	73	57	66
4	Enterprise experiencing increased income	No	36	35	15	17	15	118
5	Benefiting client ratio	%	60	58	50	57	50	56
6	Increase in income							
	< Rs. 2000	No	7	7	4	5	2	25
	Rs. 2000 - Rs. 6000	No	17	15	5	4	7	48
	Rs. 6000 - Rs. 10000	No	9	8	4	6	3	30
	> Rs. 10000	No	6	2	2	2	3	15
7	Increase in income	%						
	< Rs. 2000	%	100	100	100	100	100	100
	Rs. 2000 - Rs. 6000	%	19	20	27	29	13	21
	Rs. 6000 - Rs. 10000	%	47	43	33	24	47	41
	> Rs. 10000	%	25	23	27	35	20	25
8	Average income increase	Rs.	12752	9068	11316	11513	13042	11335
	< Rs. 5000	Rs.	3825	3421	3658	3829	3742	3679
	Rs. 5000 - Rs. 10000	Rs.	7520	8234	8327	7728	8142	7935
	Rs. 10000 - Rs. 20000	Rs.	15925	14928	16245	15896	15241	15628
	> Rs. 20000	Rs.	26854	25247	24250	25147	28478	26390

Source: Field Survey 2004

4.7.3. **Reduction in Incidence of Poverty**

A cross-section analysis of client wealth ranking is one way of exploring whether there may be a '*shift*' or '*graduation*' of the clients into a higher level of wealth ranking depending on their involvement in MFI services. Such a *shift/graduation* can only be taken as indicative and not conclusive. Available evidence indicates that there is a shift of MFI clients from the lower and higher strata of wealth ranks due to microfinance services. Though microfinance services may not have reduced their poverty completely, they may have reduced its severity, providing a "*protective*" rather than "*promotive*" role in a vulnerable situation. Available information indicates that the "p*ath out of poverty is slow and uneven*". About 42% of high involvement clients are below the poverty line

(including 14% very poor). The survey findings provide ample evidence that it is probably easier to push the less poor out of poverty, and the poor to be less poor, than to reduce the poverty of the very poor. For the poorer HHs the role of microfinance can be more "*protective*" than "*promotive*"

4.8 **Wider/Indirect Impact on Poverty Reduction**

The wider/indirect impact of microfinance services is evident in the promotion of IG/MEA, risk/vulnerability management, economic empowerment, the effect on other financial services and the effect on other public infrastructure.

4.8.1. **Promotion of Income Generating/Micro-enterprise Activities**

Type of income generating/micro-enterprise activities
In general MFI's clients are expected to invest the money borrowed for increasing IG/MEAs. There has been substantial use of micro-credit for direct investment. Clients of different wealth ranks have used micro-credit across sectors, though poorer clients are more likely to use it for animal husbandry and the non-poor for non-farm activities. The difference in wealth ranks lies both in the sector as well as the scale of enterprise. The poor are usually engaged in small scale, low investment activities with low entry barriers. These are often supplementary '*income generation/microenterprises activities*' contrast to more established small enterprises established, especially by the non-poor, with higher investment and revenue levels.

Table 16: List of Credit Financed Income Generating/Micro-enterprise Activities

S.N.	Sector	IGA/Micro-enterprise type
1	Agriculture	Vegetable farming, banana farming, ginger farming,
2	Animal husbandry	Milk animals, goat, pig, poultry,
3	Trade	Small provisional shops (food items, confectionary, vegetables), Hawking (non-perishable such as bangles, cloths, etc. and perishable such as milks, vegetables, bitten and puffed rice, etc.)
4	Services	Tea stall/tiffin centre, repair units (cycle puncture, radio), transport (rickshaws, bullock carts), barber.
5	Manufacturing	Mainly HH based such as leather works (shoes), handlooms, hand fans, metal accessories, bags making, sweater weaving, etc.

Source: Field Survey 2004

Status of income generating/micro-enterprise activities
Microcredit has been mainly used as working capital in trade, small manufacturing and agricultural activities. In animal husbandry and services (viz. repair units, tea stall, transport), it is used mainly as fixed capital (such as animal/shed or space/furniture/ vehicle/equipment) as well as working capital. The pattern of use differs by sector, and does not vary with the wealth rank of the HHs. The Survey has uncovered that about 66% (139) of HHs have been using micro-credit for over 150 productive activities or assets. The sectoral distribution is evenly balanced in the rural sample between agriculture, animal husbandry and non-farm activities. In the urban samples, services and trade are the main activities.

A majority of the IG/MEA were non-farm enterprises (51%), followed by animal husbandry (35%), cash crop production (17%) and finance for overseas employment

(5%). Micro-credit has also helped in restarting some enterprises that had earlier closed down. These were mainly trade activities (in borderline and poor HHs) that had lapsed due to shortage (or diversion) of working capital and some animal husbandry units following the sale or death of animals.

Table 17: Status on Credit Financed Income Generating/Micro-enterprise Activities

S.N.	Particulars	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Sample size	No	60	60	30	30	30	210
2	Enterprise development	No	42	39	19	22	17	139
3	Adoption rate	%	69	65	63	73	57	66
4	Enterprise mix	No	46	41	22	24	17	150
	Animal husbandry	No	14	12	11	9	3	49
	Cash crop production	No	5	3	7	8	0	23
	Non-farm enterprises	No	27	23	3	4	14	71
	Oversees employment	No	0	3	1	3	0	7
5	Adoption to total enterprise	%	111	105	116	109	100	108
6	Enterprise mix	%	100	100	100	100	100	100
	Animal husbandry	%	34	31	58	41	18	35
	Cash crop production	%	12	8	37	36	0	17
	Non-farm enterprises	%	65	59	16	18	82	51
	Overseas employment	%	0	8	5	14	0	5

Source: Field Survey 2004

Employment generation

The micro-credit financed IG/MEAs have been quite effective in generating self-employment or wage employment to a limited extent. These enterprises are mainly small scale and family based enterprises generating slightly more than one employment (full employment and part-time) per enterprise with a total of 178 employments generated by 150 IG/MEAs established by 139 clients. Men (34%), women (49%) and children (17%) are employed in these activities. Although loans have been taken in the name of women clients, men and children are also employed in these activities.

Table 18: Employment Generation through Credit Financed Income Generating/Micro-enterprise Activities by the Client Households

S.N.	Particulars	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Enterprise developed	No	46	41	22	24	17	150
2	Full-time employment	No	48	43	19	20	18	148
	Animal husbandry	No	8	9	7	5	1	30
	Cash crop production	No	4	3	6	6	0	19
	Non-farm enterprises	No	36	28	5	6	17	92
	Oversees employment	No	0	3	1	3	0	7
3	Part-time employment	No	29	39	17	19	15	119
	Animal husbandry	No	4	10	5	5	3	27
	Cash crop production	No	2	4	8	10	0	24
	Non-farm enterprises	No	23	25	4	4	12	68

S.N.	Particulars	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
	Oversees employment	No	0	0	0	0	0	0
4	Total employment	No	55	53	23	25	22	178
	Animal husbandry	No	9	12	8	6	2	37
	Cash crop production	No	5	4	8	9	0	25
	Non-farm enterprises	No	42	34	6	7	20	109
	Oversees employment	No	0	3	1	3	0	7
5	Employment composition	No	55	53	23	25	22	178
	Men	No	18	17	8	9	8	60
	Women	No	28	27	12	11	10	88
	Children	No	9	9	3	5	4	30
6	Employment composition	%	100	100	100	100	100	100
	Men	%	33	32	34	36	37	34
	Women	%	51	51	52	44	46	50
	Children	%	16	17	13	20	18	17

Source: Field Survey 2004

About 29% of employment is new, representing an increase in employment as a result of the use of micro-credit on IG/MEAs. There has primarily been an increase in family labour in new enterprise started with micro-credit in the DDB and PGBB. The overall profile of supported enterprises indicates a fairly even distribution across the main wealth rank categories. The employment figures show that the main increase has been in family self-employment in new enterprises – the majority of which have been started by poor and borderline clients. Assuming that hired labour (approximately 23% of new employment) is likely to be from poorer wealth ranks, it is estimated that about 61% of net increase in non-farm employment is a result of micro-credit financed income generating / microenterprise activities. This also represents an expansion of employment opportunities for the poor.

Problems encountered by income generating/micro-enterprise activities

IG/MEAs are susceptible to a variety of risks relating to both endogenous and exogenous factors. The problems mainly correspond to illness in HHs, especially for the poor and very poor (52%). The health of the main worker is obviously critical for the management of IG/MEA. Illness can also divert and run down the working capital as it gets used to meet medical costs.

Table 19: Problems Encountered by Clients on Credit Financed Income Generating/Micro-enterprise Activities

S.N.	Particulars	Unit	DD Bank	PGBB	SFCL Dumarbana	SFCL Sundarbazar	Urban SCCs	Total
1	Type of problems							
	Illness of HH members	No	25	27	27	15	16	110
	Cash crunch	No	26	22	17	11	13	89
	Seasonal marketing problems	No	21	19	12	9	7	68
	Loss/damage of assets	No	26	31	12	19	12	100

2	Type of problems	%	120	128	170	143	117	132
	Illness of HH members	%	42	45	90	50	53	52
	Cash crunch	%	43	37	57	37	43	42
	Seasonal marketing problems	%	35	32	40	30	23	32
	Loss/damage of assets	%	43	52	40	63	40	48
3	Sample size	No	60	60	30	30	30	210

Source: Field Survey 2004

Cash crunch is a common problem (42%) for small traders who usually have to pay for their supplies up front, but they can try to build relations with their customers by providing goods on credit. Competition affects small service and trading units when they compete against each other for a limited market. The clustering of too many petty shops in small urban centers following the success of a few is the characteristic feature of the study area. In rural areas, too, the habit of purchasing services is not established like in urban areas – though some entrepreneurs have been able to reach a wider market by locating their establishments on highways just outside their villages. In urban areas, especially in slums, income generating / microenterprise activities face wider competition from bigger traders in the same or nearby areas and limited purchasing power in their immediate area.

A seasonal marketing problem (32%) is another risk encountered by clients managing IG/MEAs. It is not quite so serious in the case of animal husbandry. In general, milk marketing is quite active in many clusters whether through private collection agents who collect from the door step for urban sale or through direct sales to local HHs. However, animal productivity depends critically on the quality both of the animal and the feed. Poor HHs, especially when starting animal units for the first time, may not be successful in selecting good quality animals (poultry, goats, milch animal) as they can be vulnerable to illness. There have been cases of loss or injury of goats while grazing. Similarly, if a dairy animal needs treatment, vets may not be available or HHs may lack resources to pay for their fees and treatment costs. Thus, there are problems related to loss / damage of an assets such as a broken push carts or rickshaws, a sick animal, death of animals (48%).

Cases of income generating/micro-enterprise activities closure/failure

About 21 (10%) of the clients reported that closure or failure of income generating/micro-enterprise activity pursuant to the problems described above. A distribution of the closure or failure of IG/MEA across wealth ranks shows that such incidences are very likely for poor and very poor clients in new and ongoing activities. The case of closer/failure is higher in animal husbandry due to the risks of animal illness as well as because once the milk cycle is over, poorer HHs prefer to sell the animal rather than continue to bear the cost of its maintenance.

Environmental effects

Given the micro-scale of most micro-credit supported IG/MEAs and their continuation of existing practices, the possible effect of these activities on the environment is not perceived to be an issue either by the MFIs or by their clients. The main clustering of activities, which could together have an effect, is partly in dairy and trade and services in semi-urban clusters in market towns. Observations have been made of widespread use of plastics and medical additives to boost milk production in dairy animals. Clearly, there are issues that affect the informal or un-organized sector in general; and certain sectors in particular; these are practices that are perceived outside the scope of MFIs.

Constraints on income generating/micro-enterprise activities

MFI's operations are confined to providing financial services to women with limited skills on entrepreneurship, marketing, and distribution process. The main problems of the microcredit financed IG/MEAs of these MFIs are a result of these basic characteristics of their clients. Most clients need initial loans on activities such as consumption (health, education, repayment of older loans) and consumer durables (house repairs) that gradually graduate towards borrowing on IG/MEAs. Developing the entrepreneurship of the very poor and poor clients is one of the key challenges of these MFIs for promoting IG/MEAs.

MFIs in general lack the capacity to link their loan clients with local business development service (BDS) providers so as to develop the required entrepreneurship. Providing BDS to build confidence among the shareholders to borrow for IG/MEAs is one of the most fundamental challenges for these MFIs.

The sample clients were exposed to a combination of problems encompassing technology, finance, raw materials, price/marketing and scale of production/services. MFIs have provided only one of the services required for promoting IG/MEA. The promotion of IG/MEAs is a complex phenomenon and should focus on creating an enabling environment with a holistic perspective encompassing aspects such as entrepreneurship development, new technology and finance (no under-financing). Clients managing agro-based enterprises (cattle, pig and poultry) were exposed to technical and management problems as they had started these activities without adequate technical know-how and management expertise. For instance there exist cases of death of animals and low productivity, which result in loan repayment problems. The inability to establish linkages by such clients with the existing government and non-government BDS providers was the main problem in achieving benefits at the intended levels. Adequate coordination and networking with the existing services providers is almost a pre-requisite for continuity and sustainability.

4.8.2. **Vulnerability Management**

The approach to conventional poverty assessment is static as it refers to levels of income, consumption and well-being but not to their fluctuations; while as a dynamic concept vulnerability[12] tries to capture movements (especially downward) in income and well-being resulting from a variety of risk situations. Vulnerability is intrinsically linked to poverty as the cause, symptom and constituent of poverty.

Risks and copping strategies
HHs face a variety of risks which are specific to them (illness, loss of husband/main income earner, alcoholism, loss of livestock/asset), and/or the community (covariate risk such as droughts, floods, sudden policy changes). Major life cycle events such as marriage and death also impose enormous financial stress on the HH. Though the risk involved is predictable in the case of an event like marriage, the need for cash often far exceeds HH income flow. In the case of illness or death in the family, not only does the cash need escalate almost suddenly, but also they also cause loss of income if the main income earner is affected. The covariate risks that emerge from structural factors affect the HHs in a community or specific clusters though with varying impacts. There are instances of such covariate risks affecting a community's livelihood system (local faming and dairying, cottage industries, etc.) due to continuing drought conditions, technological changes and a depleting natural resource base.

Drawing on FGDs and case studies, Table 18 summarizes the type of risks faced especially by client HHs along with their likely effect on HHs.

[12]Vulnerability is defined as *susceptibility to risk, risk being understood as the chance of a loss (in income, livelihood, health, etc.) or loss itself.*

Table 20: Risks and Their Effect on Vulnerable Households

Risk categories	Risk type	Impact on HHs
Household specific	▪ Ill health in the family/accidents	▪ Loss of income, ▪ Need for extra resources
	▪ Major family events – marriage, death, birth	▪ Expenditure much in excess of income to meet social expectations and comply with traditional customs like dowry
	▪ Alcoholism and gambling among men and boys	▪ Gradual depletion of resources, ▪ Diversion of HH income, ▪ Increased expenditure on health, ▪ Violence against women, ▪ Neglect of children
	▪ Loss of husband/main income earner	▪ Sudden loss of income, ▪ Need for extra resources to start a livelihood activity, ▪ Difficulty in meeting day to day HH expenses
	▪ Recall of outstanding debts by moneylender	▪ Sudden resource depletion – may involve drawing down on assets and savings
Enterprise/ employment	▪ Loss of enterprise asset (shop burned down, milch animal dies)	▪ Sudden expenses combined with low productivity
	▪ Loss of job (factory closes/labour retrenched/technology change)	▪ Sudden loss of income, ▪ Depletion of savings,
Co-variate	▪ Seasonal difficulties (summer / monsoon)	▪ Reduced income flows – need to borrow to meet regular HH needs ▪ Ill health
	▪ Sector wide risks – technology, policy, environmental change	▪ Uncertain and declining incomes at increasing cost
	▪ Narrow hazards (draught/floods)	▪ Reduced employment opportunities, ▪ Damage to houses/assets, ▪ Depressed markets for business ▪ Ill health

Source: FGDs

There are some protective (*or ex-ante*) strategies that are built into HH survival strategies such as income smoothening through diversifying livelihood base, building physical assets such as livestock and jewellery, financial assets in the form of cash savings, and social assets such as family networks, neighbors, and local institutions. After risk or shock, when a HH faces an immediate need for cash beyond its current income, there are different coping (*or ex-post*) strategies adopted depending on amount of cash needed and the resources option available. These could include consumption modifying by reducing consumption, income raising by liquefying assets or taking up any additional work opportunities available including for example more strenuous casual labour such as breaking stones, illegal opportunities such as brewing illicit liquor,

migration, etc. or using financial intermediation by drawing down savings and borrowing, if necessary from high cost sources.

Relative vulnerability differs among groups with different socio-economic conditions and livelihood systems. For instances, HHs that depend on agriculture in the regions with poor agro-climatic conditions experience greater fluctuations in income and well-being. Sudden crises can exacerbate impact of such downward pressure. The very poor and poor category clients are especially vulnerable due to their limited resources. There are certain types of HHs, which are seen to be especially vulnerable, within the poor such as women headed HHs and dalits/janajatis.

Role of microfinance in risk management

The potential of microfinance has been seen in terms of its '*promotive'* role as contributing to the growth of IG/MEA, income increase, poverty reduction, etc., as well as in terms of its '*protective*' role as assisting clients and their families to maintain their income, and to prepare for or cope with the financial shocks that the poor are especially vulnerable to. Microfinance can assist through supporting more regular or diversified income sources, by increasing savings or liquid assets and by expanding options for credit. But there may be situations such as environmental or long-term risks in which the role of microfinance is limited or in which microcredit may even aggravate vulnerability such as enterprise risk, high indebtedness, etc. Given the product/service range of the MFIs, microfinance could potentially play promotional, protective and provisioning roles to build and contribute to HH coping strategies.

Table 21: Role of microfinance in risk management

Type	Role type	Descriptions	MFI tools
Ex-ante	Promotional (livelihood sustenance/asset building)	▪ Helping poor build assets which can be deployed to increase and smoothen income levels or liquidated/leveraged to raise financial resources when needed; and building women's social capital through group mechanism.	▪ Income generating/micro-enterprise activities, ▪ Group process and dynamism, ▪ Occupational diversification,
	Protective (risk mitigation/insurance)	▪ Financial intermediation to provide an option to save for future needs and to cover risk (for the client, family and their assets).	▪ Micro-savings ▪ Micro-insurance
Ex-post	Provisioning (emergency response)	▪ Providing a low cost option to borrow in terms of emergency	▪ On-lending from MFIs, ▪ Drawing on savings and insurance

Source: Literature review and field study 2004

Micro-credit available from the MFI has helped women to earn independently and to build assets, which may be sold (e.g. animals) at times of financial stress (i.e. *ex-ante impact on risk management*) as well as contributed (60%) to clients borrowing in risk situations. Microfinance services can be an important source of peer support and an example for women facing such a situation (*i.e. ex-post impact on risk management*). Clients' savings are not necessarily an immediate resource since in most MFIs these are non-withdrawable, unless the clients dropout. Insurance product is yet to operationalise among the MFIs surveyed.

Loss of earnings due to illness and health care-related expenses can quickly erode incomes and savings, often forcing the poor to sell of assets and get into debt. Access to financial services allows clients to seek health care services when needed, rather than wait until an illness has reached crisis proportions. Part of the microfinance used for consumption purpose has been used for health care finance. MCPW clients appear to have changed nutrition patterns, health practices, and health outcomes between 1996 and 2002.

Larger and more stable incomes from IG/MEA lead to better nutrition, living conditions, and preventive health care. Increased earnings and financial management options allowed clients to treat health problems promptly rather than wait for conditions to deteriorate. Among the MCPW clients about 41% reported improvement on childcare while about 28% mentioned improvement in health care. The proportion of HHs with toilets has increased by 12% point in 1996/97 (65%) compared to 2002 (77%). A survey has provided evidence of an increased proportion of women clients with information about the use of TT (8.2%), DPT/BCG/Polio (8.1%) and the use of Jevan Jal for diarrhea (9.4%). Fewer clients have suffered from malnutrition while children with diarrhea have responded better to re-hydration therapy and there has been higher rate of DPT immunization for children. This indicates a greater role of microfinance services and the impact the process (basic and skill training) had on the health and sanitation of clients in 2002 (compared to 1996).

Table 22: Health and Nutrition Improvement Impact of Microfinance

Particulars	Unit	Value
Improvement on child care	%	41
Improvement on general health care	%	28
Toilet	%	12
Information on vaccine		
▪ Timely use of TT	%	8
▪ Timely use of DPT/BCG/Polio	%	8
▪ Use of Jevan Jal during diarrhea	%	9
Sample size	No	1067

Source: Dhakal, N. H. 2002b.

Limitations of microfinance services
Microfinance can contribute to client's coping strategies on vulnerability when credit financed IG/MEAs are viable or when clients need small sums to tide over their cash requirements and are seen to be creditworthy. The role of microfinance is constrained in more adverse situations, when a client is not so credit-worthy, when IG/MEAs affect a client's ability to pay loan installments, and in a situation of co-variate risk which undermines the local economy where an MFI is operating. In certain situations of failure or over-indebtedness, microfinance may be seen as contributing to vulnerability. In general, productive assets and diversified livelihoods contribute to coping strategies if they are viable and successful. But if they are not viable, a HH becomes more vulnerable. Not all risks are foreseeable, but some are, and MFIs can reduce these by grounding credit for IG/MEAs with a clearer understanding of local opportunities and risks. For instance, for animal units, a client must select a good quality animal and carry out necessary vaccinations, and for non-farm units similar units must not be supported beyond the capacity of local markets.

4.8.3. Economic Empowerment

Women are the clients of all the MFIs covered in this study except the SFCLs. Women often prove to be more financially responsible with better repayment performance than

men and more likely to invest increased income in the HH and family well being than men. Access to financial services can empower women[13] to become more confident, more assertive, more likely to participate in family and community decisions, and better able to confront systemic gender inequities.

During a series of FGDs and individual interactions, women clients were not easily able to identify what it was that made them feel good about themselves and gave them power. This initially appeared to be a matter of shyness and a lack of recognition of their skills. Most of them defined an empowered woman as: *one that has choices, similar to those available to men, and one that actively decides to develop both individual and family well-being. Empowering experiences are those, which widen a woman's choices and help her to achieve her well-being.*

Women's indicators of empowerment through microfinance
Drawing on FGDs and case studies, the following summarizes the indicators of women's empowerment through microfinance.

- Ability to save and access loans;
- Opportunity to undertake economic activity;
- Mobility i.e. the opportunity to visit nearby villages and towns;
- Awareness on local issues, MFI procedures, banking transactions,
- Skill for IG/MEA;
- Decision making within the HH;
- Group mobilization in support of individual clients: action on social issues,
- Role in community development activities,

Form of Women's Empowerment through Microfinance Services
In general, an empowered woman uses her choices to further her own sense of well-being and that of her family's. There are many ways or sources of well-being for women and they are not devoid of a sense of personal power. Most women clients strongly express a desire for more opportunities to get more empowered. The changes which women desire vary from those which can be initiated by the family (such as training in literacy) to those which require changes to laws and social norms (property rights and social taboos).

Women's empowerment through micro-financial services takes different forms such as making joint decisions with their husbands on loan application, borrowing for stated purposes; purchase from loan finance, allocation of HH money (financial decision), children's education, use of contraceptives and seeking assistance from husband, children and other family members on business management and business handling. MFI clients had made decisions on their own on aspects related to buying and selling of property, sending daughters to school, marrying children and family planning. They have also lobbied for higher wages the rights of women in the informal sector and resolving neighbourhood issues. Clients of some MFIs have contested in the local government election held in the past and some have even won. They are handling HHs and business as well as family responsibility with their husbands and male relatives.

Most women clients feel empowered in having choices to decide how to develop family and individual well-being. Micro-financial services present a number of opportunities to pursue their family oriented goals and enhance their own role in the HH. Women define important elements of empowerment as: contributing to family livelihood; speaking in public; some marketable skills; responsible roles in family and money decision-making, some husband / family support to pursue self-development opportunities. Women felt that there were five main areas which have contributed to their improved personal well-

[13]'Empowerment' has been defined as a process of change by which individuals or communities with little or no power, gain power and ability to make choices that affects their lives (Chesten and Kuhn 2002 and Kabeer 1999.

being or to their role in facilitating family well-being: improved confidence, positive change in social status, greater financial security for family and greater financial security from savings opportunities provided by MFIs.

Table 23: Empowerment Indicators of Microfinance Clients

Particulars	Unit	Value
Sample size	No	135
Decision to borrow in stated purpose		
▪ Self	%	71
▪ Husband	%	22
▪ Family members	%	7
Assistance received for loan application		
▪ Husband	%	49
▪ Other family members	%	16
▪ Outsiders	%	23
Purchase from loan finance		
▪ Self	%	74
▪ Husband	%	16
▪ Other family members	%	10
Financial decisions		
▪ Self	%	79
▪ Husband	%	14
▪ Other family members	%	7
Ownership of enterprise		
▪ Self	%	93
▪ Husband	%	4
▪ Other family members	%	2
Assistance from children and involvement		
▪ Regular	%	13
▪ Occasional	%	30
Handling of both HH and business works		
▪ Sharing with husband	%	7
▪ Using surplus time only in the business	%	87
▪ Hiring labour in business management	%	1
▪ Hiring labour in HH activities	%	4
Assistance from husband/male relatives		
▪ Business management	%	32
▪ Business handling	%	29
Sharing family responsibility with husband/male relatives	%	78
Complain by husband/male relative on involvement in MFI services	%	19
Social capital formation	%	80
Improvement in general well-being	%	93

Source: Dhakal N. H. 2001a.

The role of microfinance services for life and the overall living standard of women clients have been instrumental and effective in increasing access to and control over productive resources and ultimately supporting their social and economic empowerment. The services have been instrumental to address the practical and strategic need of the women clients to a greater extent.

Gender approaches of the MFIs

Positive empowerment impacts the individual and HH levels in terms of savings and access to loans, contribution to HH income and role in HH decision making, especially for women who are directly earning (78% in Bara and 69% in Lamjung). They gain a sense of self-respect and confidence from an opportunity to meet other women in a group, share opportunities and ideas and have the support of common action, more so among self-help groups in SFCLs/SCCs. At the HH level, conventional gender patterns continue such as the ownership of assets and IG/MEA management by men. Women are not necessarily involved in the IG/MEA for which micro-credit is provided in their names. This is most common among SFCL/SCC clients. They are involved in IG/MEA management solely or jointly with men in 78% of supported IG/MEAs in Bara, but just 69% in Lamjung. This field study has uncovered that IG/MEA ownership is not a serious issue among women, for whom ensuring that a credit financed enterprise generates income for the family is more important than their management of the enterprise or ownership of an asset. In essence, the gender approach of the MFIs covered in this study is at best supportive, sometimes neutral and none transformative with a focus on gender relations.

4.8.4. **Effect on Other Financial Services**

Alternative financial services to women clients surveyed includes formal, semi-formal and informal delivery channels. The concentration of formal and semi-formal institutions is relatively high in Bara than in Lamjung. Informal delivery channels include moneylenders, rotating savings and credit associations, friends and relatives etc. Moneylenders still have a strong presence in these districts. Other informal sources such as relatives, neighbors and friends are also sources of credit usually at no or very low cost. Despite having widespread infrastructure, banks are relatively inaccessible to the poor and disadvantaged even in Bara. MFIs are considered to be additional '*semi-formal financial institutions*' providing services that lie in between formal and informal sources in terms of cost and availability.

Low transaction costs collateral-free loans and flexible lending procedures are the main characteristics of the informal sector; it is these characteristics that provide comparative advantage to them in reaching the small and poor borrowers. The formal lending procedure is characterized by high transaction costs, collateral requirements and rigidity. Semi-formal finance services are designed to position in between. This is reflected from the borrowing behavior of the clients surveyed. These clients score microfinance over banks on all parameters barring cost as well as over moneylenders on cost and repayment terms and score less well on credit purpose, timeliness and sometimes on repayment terms. In the context of a local financial scenario, the group mechanism emerges as a preferred option, if the group is properly managed as in SFCLs. For, if a group mature and savings fund accumulate, members are able to obtain internal group loans of varying amounts, quite fast and for whatever they need at a relatively low cost with interest going back into the group fund.

The impact of MFI services is clearly evident in the reduction of the effective interest rate of borrowing from informal sources. About 28% of clients have access to formal financial services as individual savings and credit accounts. Individual access is higher for the better-off and it does not increase with increased involvement in the MFI. In contrast, the incidence of borrowing from moneylenders is lower for the non-poor, who access credit from relatives or neighbors (personal sources) at little cost. Apart from the non-poor, microfinance has reduced, though not eliminated, clients' dependence to moneylenders thereby having an implication on the informal interest rate. Nevertheless, about 39% of clients HHs continue to borrow from informal sources that constitute about 42% of their source of finance for IG/MEA. Besides, the poor or non-poor clients also borrow large amounts needed for example to meet marriage obligations or for urgent medical costs from informal sources. For the clients surveyed, MFIs are among different credit sources that cater not only to IG/MEA needs but also to a range of other HH

needs. Informal sources continue to play an important role on account of their immediate accessibility and speed, and flexibility in purpose, amount and terms, even though costs may be high.

4.8.5. Investment on Public Infrastructure

Increased earnings lead the poor to invest in improved housing, water, and sanitation. In general, DDB and PGBB provide specific loans for tube-wells and toilets; while Lumanti have linked microfinance services of the SCC to slum improvement projects. Such projects facilitate community infrastructure, paid for by loans from MFIs. About 32% of MCPW clients have created assets (land purchase, house construction/improvement, increasing livestock and other productive assets) while some 15% have purchased land/ constructed new houses out of the accumulated retained earnings from the IG/MEA.

Table 24: Asset and Public Infrastructure Creation by Microfinance Clients HHs

Particulars	Unit	Value
Asset creation	%	32.0
Buy/construct new houses/land	%	15.0
Source of Drinking Water		
▪ Community Pipe water	%	17.1
▪ Well/dug well	%	-6.3
▪ Stream/river	%	-1.9
▪ Private stream	%	-8.9
Sample size	No	1067

Source: Dhakal, N. H. 2002b.

Community pipe water, wells/dug wells, community streams/rivers and private streams are sources of drinking water to women clients served by the MCPW. The proportion of HHs using community pipe water schemes has increased by 17.1% between 1996/97 (59%) and 2002 (76.3%), while the proportion of HHs relying on wells/dug well, streams/rivers and private streams has decreased greatly (Table 24). Women beneficiary HHs access water from reasonable distances that range between 0 and 30 minutes for most cases. There has been an increased impact on drinking water status of the MCPW clients in 2002 compared to 1996. This implies impact of microfinance services for assets and public infrastructure creation gradually.

4.9 Microfinance Services and Millennium Development Goals - Synthesis

4.9.1. Millennium Development Goals

The Millennium Development Goals (MDGs) are an ambitious international initiative that summarizes development goals agreed on at international conferences and world summits during the 1990s. At the end of the decade, world leaders determined the key goals and targets in the Millennium declaration (September 2000). This was a historical achievement, not just because of the scope of the development issues, but because it had committed the global community to a hard and specific agenda for human development. Based on the declaration, the United Nations Development Programme (UNDP) worked with other United Nations departments, funds and programmes, the World Bank, the International Monetary Fund and the Organization for Economic Co-operation and Development on a concise set of goals, numerical targets, and quantifiable

indicators to assess progress[14]. Their attainment calls for focusing efforts and using available resources effectively.

The MDGs are framed as concrete outcomes in areas of nutrition, education, health, gender equity, and environment. Work in these specific areas is geared at any development strategy driven by MDGs. But decades of experience has shown that progress in these areas is affected by other factors such as a functioning government, physical security, economic growth, and basic infrastructure (for example, transportation).

The poorest and poverty reduction have become the object of unprecedented attention at international summits. In most countries, microfinance has proven to be an effective and powerful tool for poverty reduction. As microfinance and the impact it produces go beyond just business loans, income from financial services can be used not only for business investment, but also to invest in health and education, to manage HH emergencies, and to meet a wide variety of other cash needs that they encounter. There is growing interest on the potential role of micro-financial services for the poor for achieving MDGs.

Millennium Development Goal of Nepal

His Majesty's Government of Nepal (HMGN) at the Millennium Assembly in September 2000 endorsed the Millennium Declaration. In order to review the progress made on achieving the MDGs, Nepal prepared the first MDGs Report (MDGR) in 2002[15]. Through the setting of baselines and numerical targets, the report provides a unique opportunity to reflect on Nepal's achievements over the last decade. The report identified the status of the 1990s and 2000 in addition to estimating quantifiable and measurable target for 2015 for 21 indicators, 10 targets and seven MDGs (refer Table 1 in Appendix for details). Over the past ten years, Nepal has made satisfactory progress in the areas of social and human development. More people have access to basic infrastructure and service these days than a decade ago. Nevertheless, poverty remains still a major challenge. Significant gains have been made, within the last decade, in access to education, health, drinking water and a few other sectors. There has been a significant rise in several dimensions of human capability, but the scale of achievement in relation to access remains much less than officially aimed at. Furthermore, the quality of education and health related facilities and services continue to remain low. The HDI for Nepal is low at 0.471 (UNDP 2004a) and its distribution is highly uneven. The distribution of educational, health-related and other opportunities and attainments remains highly unequal along regional, urban, rural, gender and socio-economic dimensions. Other measures such as Gender-related and Development Index, Gender Empowerment Measure and Human Poverty Index, etc. also show a low level of capability as well as an unequal distribution. All established poverty measures show that various forms of poverty are persistent and widespread in nature.

Though over one third of the time has elapsed, progress in each indicator/target related to MDGs is quite low and it seems to be quite difficult to attain these goals and targets by 2015. Assessing the extent to which development goals will be reached, the MDGR states that seven of the targets are not likely to be attained, one can be attained, one will probably be attained while the lack of data makes it difficult to assess whether the target will be attainable, especially the one related to environmental balance. Regarding

[14]The MDGs includes eight goals 18 targets and 48 indicators. The eight goals are to: (1) eradicate extreme poverty and hunger; (2) achieve universal primary education; (3) promote gender equality and empower women; (4) reduce child mortality; (5) improve maternal health; (6) combat HIV/AIDS, malaria, and other diseases; (7) ensure environmental sustainability; and (8) develop a global partnership for development.

[15]HMG/N and United Nations Country Team (2002), "*Progress Report 2002: Millennium Development Goals, Nepal*", Kathmandu, Nepal.

the status of supportive environment, the report identifies the weak environment for four targets, weak but improving for three targets, fair for two targets and strong for one target (refer Table 2 in Appendix for details).

4.9.2. Achieving Millennium Development Goals through Microfinance Services

The analytical findings presented in this report demonstrate a clear and proven link between the access to microfinance services for the poorest of the poor and poverty reduction. Microfinance services can help break the cycle of poverty when it is invested in an economic activity that generates increased earnings. Similarly, saving money in a safe place provides the poor a cushion against vulnerability i.e. sudden shocks, illness, bad harvest, which could easily push them into destitution. Financial services enable the poor to increase and diversify incomes, build human, social and economic assets and improve their lives in ways that reflect the multidimensional aspects of poverty. The poor people choose to invest in a wide range of assets including better nutrition, improved health, access to schooling, a better roof on homes and business expansion. The clients of MFI manage small IG/MEAs that were profitable with a high rate of return on investment. About 56% of the MFI clients surveyed had experienced improved status after receiving microfinance services through asset creation, an increase in income, duration of work, food security, availability of better food, social capital formation, increased weekly cash flow, improvement in general well-being, child care and health and sending children to school.

The financial services have enabled the poor to increase and diversify incomes and build assets, which reduced and mitigated risks, made choices and planned for the future. Access to financial services have a significant impact on clients across a wide range of economic and social indicators, including increased income, improved nutrition, better food intake, better clothing, better housing, lower child mortality, lower birth rate, higher adoption of family planning practices, better health care, better access to education for children, empowerment of women, participation in social and political activities, etc. Nevertheless, financial services for the poor are no substitute for investment in education, health or infrastructure. They act as catalysts for increasing the effectiveness and efficiency of microfinance services.

There is a direct link between microfinance and at least five of the MDGs namely the eradication of extreme poverty and hunger; the achievement of universal primary education; the promotion of gender equality and empowerment of women; the reduction of child mortality and improvement in maternal health. Effectively designed microfinance products and services can be powerful tools for creating an enabling environment for achieving the remaining MDGs such as the combating of HIV/AIDS, malaria, and other diseases; and the ensuring of environmental sustainability.

Available evidence demonstrates that microfinance helps reduce poverty through increase in income, allow the poor to build assets and reduce their vulnerability. Microfinance clients spend more on education than non-clients. Improvements in school attendance and the provision of educational material are widely reported in clients' HHs. Access to financial services from MFIs' has enabled many families to send children to school, and has reduced dropout rates in the primary grades. Over 80% of clients of Nepalese MFIs are women and they have widely credited for empowering women by increasing their contribution to HH income and increasing their access and control over decisions that affect their lives. Microfinance contributes to improved nutrition, maternal and child health and housing, especially among children and women. With strong management and efficient operations, reaching of the millions of people targeted by Nepalese MDGRs is possible through effective financial intermediation through MFIs.

4.10 Feedback on MFI services

Feedback on microfinance services was obtained through FGDs and open-ended questions from clients, dropouts and non-clients. These feedbacks are briefly discussed hereunder.

Feedback from Clients
The field survey provided ample evidence of improved microfinance services at a reasonable rate and time. Typical feedback provided by these clients include reduced interest rates on loans to be calculated in declining balance (52%), making repayment terms consistent to purpose of loans and IG/MEA income flow (43%), larger loans especially for enterprises, and housing (39%), BDS for enterprise growth and development (31%) and microfinance services (26%). This indicates a greater need to introduce a market-led approach on microfinance promotion that is consistent with the client's need.

Feedback from dropout clients
In general, finding out why clients drop out is another form of the feedback on MFI services. It reveals the constraints that the client face, which enables the MFI to do something if it wants to retain such clients. The concept of '*dropping out*' is applicable to all studied MFIs, which aim to retain members and build their transactions (both savings and credit). The reasons for client drop-outs include an inability to save regularly and no savings withdrawal policy (69%), frequent loan terms and the inability to repay the loan in time (42%), high interest on credit (27%), hassles on micro borrowings including the meeting and group process (18%), the availability of other sources of borrowing (12%) and migration (9%). The reasons for client dropouts reinforce a greater need to design microfinance products and services based on clients' needs.

Reasons for not joining the programme by non-clients
All the non-clients surveyed know about the MFI programme in their locality. Over 58% of the clients were interested in joining the programme and the remaining 42% were not interested. The reasons for not-joining the programme by the non-clients include the non-requirement of microfinance services (29%), lack of enterprise/financing opportunities (24%), too small loan size for enterprise establishment (19%), inability to save regularly (15%), dislike to be indebted (15%), barrier to entry – group/MFIs (12%), hassles on micro borrowing including participation in meeting and group process (12%) and lack of trust in the MFI programme (12%). Most of the reasons for not joining MFI programmes are related to design of the products and services that can be addressed through proper market research.

5. CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

Poverty reduction is a frequently stated objective of microfinance. The rationale microfinance has used in poverty reduction is that *micro-credit can directly improve the access of the poor to finance for productive assets and activities that will enable income growth and welfare improvement through enterprise development, increased ability to manage risks and economic empowerment*. Based on the study findings it has been concluded that microfinance is an effective strategy for extending financial services to the poor and disadvantaged groups not reached by the formal sector. Micro-credit is used for both investment purposes and to meet HH consumption needs. It has increased IG/MEA and built the capacity of individuals and HHs to manage risks.

Microfinance contributes to a reduction in the poverty of client HHs. About 56% of clients have reported income increase and have been able to build slightly more financial, physical and human capital compared to non-clients. Micro-credit has served to reduce a dependency on moneylenders, reduce the average interest rate burden especially for the poor and indirectly assisted to promote enterprises that hire non-family labor (usually small enterprises of borderline and non-poor clients). It has led to some increase in income earning opportunities. By improving the terms, conditions and accessibility of other local financial services, MFIs have provided a safe savings mechanism and options for micro-credit, they compare favorably with formal bank loans in terms of accessibility and act as alternative to informal moneylenders in terms of cost. Nevertheless, informal sources continue to be important sources of financial services on account of their speedy accessibility and flexibility.

A clear and proven links exist between the access to microfinance services to the poorest of the poor and poverty reduction. Financial services enable the poor to increase and diversify incomes and build assets, which assist in reducing and mitigating risks, make choices and plan for the future. Access to financial services has a significant impact on clients across a wide range of economic and social indicators, including increased income, improved nutrition, better food intake, better consumption on clothing, better housing, lower child mortality, lower birth rate, higher adoption of family planning practices, better health care, better access to education for children, women empowerment, participation in social and political activities, etc. Thus, there is a direct link between microfinance and at least five of the MDGs namely the eradication of extreme poverty and hunger; achievement of universal primary education; promotion of gender equality and empowerment of women; reduction of child mortality and improvement of maternal health. Effectively designed microfinance products and services can be effective tools for creating an enabling environment for achieving the remaining MDGs such as the combating of HIV/AIDS, malaria, and other diseases; and the ensuring of environmental sustainability.

Nepalese MFIs still lack a market-led approach to microfinance services. The feedbacks from the clients are: reduced interest rate on loans to be calculated in declining balance, making repayment terms consistent to purpose of loans and IG/MEA income flow, larger loan especially for enterprises and housing, BDS for enterprise growth and development and microfinance services. Dropout is a common case in the MFIs surveyed for varied reasons such as the inability to save regularly and no savings withdrawal policy, frequent loan terms and the inability to repay loans in time, the high interest on credit, hassles on micro borrowing including the meeting and group process, the availability of other sources of borrowing and migration. Local people dislike MFI programmes because they do not need microfinance services, because there is a lack of enterprise financing opportunities and the loan size is too small for enterprise establishment. Other reasons are the inability to save regularly, dislike being indebted, a barrier to entry by

groups/MFIs, hassles on micro borrowing including participation in meeting and group process and a lack of trust in MFI programmes indicating a greater focus required on product and services design by the MFI.

5.2 Recommendations

Providing sound financial services for the poor is a specialized activity requiring expertise and a long-term commitment. Microfinance services should be extended in areas where the poor and excluded people live. Achieving large-scale sustainable microfinance requires engaging more MFIs with different objectives, services, and needs for subsidy. Strong MFIs must be strengthened and their successes must be replicated wherever possible.

The poor need a wide array of flexible financial services and a demand-driven approach that encourages portfolio diversity by offering savings, insurance, and cash transfer services in addition to various loan products that are likely to meet such expectation. The role of the government is critical and it should create an environment that encourages large number of MFIs to serve the poor. It should safeguard poor people's money, promote competition and develop technical expertise of the supervisory and regulatory authorities.

Recommendations to MFIs

- Savings is the important component of microfinance services and should be made more flexible in terms of deposit frequency and allowing some with-drawability, with clearer communication about interest benefits.

- Loan products need to be designed with greater flexibility in purpose, amount and repayment terms. Loan products for different types of enterprises must be consistent to loan requirement of the enterprise and this need to be better understood by MFIs.

- Group mechanisms should be revisited. There is a tendency to focus on a group leader for training inputs and skill development. There is scope for spreading leadership responsibilities and widening skill effects by encouraging rotation of group leaders and peer training.

- Insurance services are prime needs, especially for assets and for health. MFIs can link clients to insurance schemes by national agencies.

Recommendations to policy makers

On poverty reduction

- Microfinance by itself is not a panacea for poverty reduction. There is a need to address other issues of development policy and implementation that affect poverty reduction and utility of microfinance at a different level altogether including cost effective medical care and promotive/preventive health and remunerative employment opportunities for the poor and disadvantaged groups.
- Regional balance should be ensured. The inaccessible hills and mountains of the country are under-served. This should be addressed through support to develop appropriate models for those areas complemented with infrastructure development.

- Though almost all the MFIs target the poor, they should do so more systematically. The DDB and PGBB are more likely to have specific criteria to identify the poor, but these are not always applied effectively. Such criteria are less explicit in case of SFCLs and SCCs.

- Gender should be made a part of the microfinance strategy. In general, MFIs target women clients for pragmatic reasons. Being a microfinance client is a good start, but membership by itself may be empowering. In view of this, the MFI should be encouraged to make gender concerns more of a focus in its strategy and approach, especially in the Tarai where cultural constraints to women's mobility and empowerment are very strong.

- Enterprise development should be linked with BDS. In general MFIs should link their clients to BDS providers rater than making it part of microfinance to promote enterprise growth, especially, for example through identifying opportunities, financial planning and helping traditional manufacturing units respond to the changing market demand.

- Some development issues are related to incidences of child labor and environmental consideration. The study has shown some child labour and negative environmental effects of enterprise supported by microfinance. This is not extensive but MFIs should have an avoidance policy.

On Enterprise Promotion

- Since macroeconomic environment affects all enterprises there should be a greater focus on ensuring macroeconomic stability.

- Policy and regulatory framework (fiscal and monetary policies, trade policies and business regulation) can inhibit the growth of enterprises or on the contrary allow them to achieve their full potential.

- Public investment [infrastructure (transport, communication, electrification) development, education and training] plays a major role in facilitating the creation and growth of enterprises.

- The availability of a large pool of educated and trained labour helps contribute to increasing enterprise productivity and competitiveness.

Recommendation to Donors

- Develop a clear and coherent strategy for support in the microfinance sector.

- Establish consensus on when and how subsidies should be used to support MFIs and other instruments that would be more appropriate in addition to taking risks of working with less well-known but promising institutions of all kinds, leaving commercially viable MFIs to graduate to private investors.
- Direct grants or limited subsidies to institutions developing new products or technologies with special efforts directed towards encouraging institutions that develop savings-based products.

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