MICROFINANCE INDUSTRY IN NEPAL: CURRENT STATUS, RECENT TRENDS AND SOME THOUGHTS FOR THE FUTURE

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Abstract

This paper reviews current status and recent trends; and provide some thoughts for future. The paper has uncovered a significant paradigm shift on Nepalese microfinance industry since 1990's and assumed to be an industry, which benefit thousand of the poor people, poor women, micro-entrepreneurs and peasant farmers. At present the market share of Nepalese microfinance industry is 37% with services concentrated in accessible areas and virtually no or limited access in inaccessible hills and mountains. Existing trend implies that expansion of microfinance services to a large number of un-served and under-served micro-entrepreneurs and poor households living in remote districts is yet a challenge. While commercial MFIs are quite successful to penetrate their services in urban and densely populated peri-urban areas, the community based MFIs have comparatively better penetration in relatively inaccessible areas. On the other hand, thousands of Savings and Credit Groups promoted by government and non-government sectors exist throughout Nepal irrespective of remoteness, but not fully used up to the potential level. in future the industry need to gradually adopt emerging international best practice standards and norms and corrects likely distortions. This will transform the industry as a lucrative business providing financial services for the poor.

1. INTRODUCTION

About 2.4 millions out of 4.84 millions (49%) total households of Nepal are estimated to be boarder line poor, poor and poorest of the poor. These households live both in rural and urban areas. The majority of them, however, live in rural areas. Mostly rural poor are engaged in agricultural activities as laborers or small scale farmers or in a variety of microenterprises to supplement their merger and volatile incomes from other sources while their urban counterparts are engaged in a variety of non-farm activities including petty trading. In general a poor HH possess very low assets other than their labour and they have little access to formal financial services such as savings, credit and insurance. Access to formal financial services from different microfinance service providers are estimated to be 33% implying that a majority of them rely on self finance, informal sources or combinations of these two to meet their demand for financial services. Self-finance has obvious limitations[2] and that of informal sector have limited capacity to fully meet the demand of these people efficiently.

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[2]McKinon, R.I. 1973. *Money and Capital in Economic Development.* The Brookings Institutions: Washington DC. p. 13

Historically Nepal witness microfinance as an anti-poverty and development tools and demonstrated a significant paradigm shift on the sector beginning late 1990's and it forward departure as an industry, which benefit thousand of the poor people, poor women, micro-entrepreneurs and peasant farmers and anticipate that the industry should transform further as a lucrative business providing financial services for the poor. The industry has grown significantly in the recent decades, there are many challenges at present and further more are expected to emerge in future. In this context, this paper briefly analyzes current status and recent trends of Nepalese microfinance industry and provides indicative forecast of its future.

2. CURRENT STATUS OF MICROFINANCE INDUSTRY

Nepal is highly heterogeneous in terms of population density, per capita income, poverty incidence, economic structure and social development. Great variations exist across development region and ecological belt in term of physical and financial infrastructure facilities; macroeconomic stability and policy environment for growth in general and microfinance in particular. These factors together with legal framework have a significant bearing on existing state of outreach and operational and financial self-sufficiency of actors in Nepalese microfinance industry.

There exists a very good indication that poor and low-income households and their microenterprises have a strong demand for deposit services as indicated by couples of behaviors. First, there is positive response of the poor to voluntary savings products provided by microfinance service providers and growth in deposits is quite significant. Second, poor rely on various informal mechanisms, such as Dhukuti, Dharam Bhakari, savings and credit groups, etc. to save money and practice of hoarding cash at home is evident. Third, in most areas the poor are inclined to a safe place to accumulate savings and they even pay deposit collectors in informal sector for their services. Finally, poor keep a substantial proportion of their savings in non-financial assets and such saving is still ever-present among the poor.

There is a large but heterogeneous demand for micro-credit in rural Nepal. The poor households demand microcredit for consumption smoothing, to meet their expenses related to life-cycle events such as sickness in family, death of family members, education of children and for investment purposes. They also demand other financial services such as insurance, money transfer and leasing. Provision of insurance, money transfer and leasing services is quite uncommon among Nepalese microfinance service providers and even the access to savings and loan services is very much limited as the industry has been able to achieve a very shallow penetration of 36% savings clients and 30% loan clients. Further, distribution of microfinance services is not equitable with access concentrated in Tarai and accessible hill areas. There are very few people in inaccessible hills and mountains that have accessed financial services. Thus, demand for financial services of boarder line poor, poor and poorest of the poor has not been adequately addressed by microfinance industry..

Two main categories of microfinance service providers exist in Nepal. First, commercial microfinance service providers and community based microfinance service providers. While the former categories include the commercial banks, microfinance development banks (MDBs); and financial intermediary non-government organizations (FI-NGOs), the later categories includes savings and credit cooperatives (SCCs), small farmers cooperatives limited (SFCLs) and informal savings and credit groups (SCGs).

The commercial microfinance service providers are important suppliers, have commercial orientation and there outreach and services are concentrated in plains and accessible hills. They are operating with mixed success and their current status castes serious doubts about their ability to sustain operations without continued injection of subsidies on a regular basis. Few private sectors promoted MDBs and FI-NGOs are in comparatively better position than commercial banks and government promoted MDBs in terms of delivery of quality services. FI-NGOs are the actors that entered lately and are positioning gradually in Nepalese microfinance market.

The community based microfinance service providers (SCCs, SFCLs and SCGs) are gradually emerged and are in process to position in Nepalese microfinance market. Both SCCs and SFCLs are major actors to provide microfinance services in inaccessible hills and mountains. Although cooperatives in Nepal are believed to be dominated by non-poor, a significant number of poor households are also shareholders of these cooperatives. The scale of government involvement in provision of subsidized microcredit is perhaps the most disappointing characteristic of microfinance industry in Nepal. There are over two dozens of micro-credit and/or integrated rural and urban development projects with microcredit components promoting thousands of SCGs with a built-in component to savings mobilization and provision of loan capital or revolving loan fund to meet the supplemental financial needs of the SCGs. However, very few are operating at their potential level.

A major feature of current landscape of institutional microfinance industry in Nepal is insignificant involvement of profit-seeking private sector financial institutions with private-risk capital. Despite the significant growth of the microfinance industry during the last two decades, Nepalese policy makers and practitioners continue to believe that microfinance services should not aim at profit because its clients are poor households. This myth proved to be very much counterproductive in developing sustainable microfinance industry in Nepal. While many MFIs around the world charge interest rates high enough to cover costs and some explicitly take inflation into account in determining interest rates, most of the Nepalese MFIs show a strong reluctance to charge cost recovery interest rates. Rarely any MFI takes note of inflation in their decisions concerning interest rates on credit. Easy access to subsidized funds from Governments and funding agencies has indirectly contributed to this notion to be deep-rooted. In the past, ceilings on interest rates on microcredit are based on explicit assumption that "poor are too poor to bear cost recovery interest rates" and such legacy still prevails in Nepalese microfinance industry.

Outreach of Nepalese MFIs has increased significantly since the beginning of the millennium, however most of them have yet to reach financial self-sufficiency and very few have achieved operational self-sufficiency. More importantly, most community based MFIs lack desire, interest and commitment to achieve a reasonably high level of operational and financial self-sufficiency that has overshadowed commendable efforts of few MFIs on attaining self-sufficiency. Industry standards are yet to be set and there is no mechanism to enforce industry best practices among MFIs. Accounts of most MFIs cannot be analyzed meaningfully without major adjustments. Most MFIs do not measure and report loan recovery rates in a meaningful way. Loan loss provisions are neither made in accordance with industry best practices nor complying with legal and regulatory provisions. Under-provisioning is the rule rather than the exception. Many MFIs include non-operating income in their operating income and overstate their operational self-sufficiency and profits. Subsidies received from various sources are not accounted in an appropriate manner.

Continued high degree of dependency on concessional funds available from their apex institution is another major characteristic of Nepalese microfinance industry. In general, such funds accounted for over 80 percent of loanable funds of the industry at the end of 2006. A corollary to this dependency is low reliance on commercial borrowings and public voluntary deposits. The low reliance on public deposits as a source of funds is directly related to several weaknesses on acts governing commercial microfinance service providers that inhibit them to mobilize public savings.

The industry is largely supply-driven. Despite massive demand for array of financial services, industry continues to have a significant credit bias and include limited savings services. The notion that credit is more important for the poor households than savings services and there is lack of significant effort on deposit management and mobilization.

In their efforts to standardize their products and services, Nepalese MDBs and FI-NGOs in general pre-fix initial loan amounts and subsequent increases and apply uniformly to all borrowers. In other words, they adopt the **one size fits all approach** and the menu of credit products is not diversified to reflect diversity on demand for financial services. Loan term is heavily biased toward loans with a maturity of one year or less. In many cases loans are not given for purposes such as housing, education and consumption. The savings services are still confined to compulsory savings, with little or no insurance and money transfer services. Leasing services is yet to be introduced.

The industry is focused on rural areas. Most MFIs, including government programs providing microcredit target rural poor. The industry continues to rely heavily on group-lending technology for service delivery. Mostly MDBs and FI-NGOs have adopted Grameen Bank's group lending technology with some variations and continue to use this as dominant technology. While such methodology have some advantages at initial stages of development, its limitations have become increasingly clear over time. Lack of flexibility, pre-determined loan sizes, locked-in savings, regular meetings and joint liability impose high transaction costs to the group members and raise effective interest rates on borrowing. As a result, client desertion has become a significant problem for many Nepalese MFIs, although the actual incidence of the problem yet to be established.

Finally, Rural Microfinance Development Centre (RMDC), Rural Self Reliance Fund (RSRF) Sana Kisan Bikas Bank (SKBB) and Cooperative Bank (CB) are four different apex institutions active in Nepalese microfinance market. As an individual entity, target client institutions of these apexes are fairly clear, it is apparent that they are competing with few institutionally and financially viable institutions.

3. RECENT TRENDS IN MICROFINANCE INDUSTRY

The supply-driven characteristics of Nepalese microfinance industry are in process to gradual change. Need to adopt more market driven approach to new product development has been felt by a small number of a leading Nepalese MFIs. Some leading MFIs both commercial oriented and community based have recently introduced voluntary savings products. Similarly, some larger MFIs have lately introduced loan products for graduated clients to facilitate microenterprises development adding some diversity to their menu of credit products. Micro-insurance is also being looked at as a possible institutional service by some institutions but yet to be scaled-up. The trend is toward a more diversified scope of services in the industry. MFIs making an effort to diversify the scope of their services have gradually realized limitations of their institutional designs, culture and institutional capacity, particularly skill levels of staff as well as need to make drastic institutional changes to ensure the diversity in scope of their services.

Although many MFIs are still adopting group-lending technology, there is increasing awareness among them on limitations of this technology and its actual effectiveness to ensure high repayment rates, particularly when their clients' economic status improves over time. As a result, some MFIs are beginning to introduce individual loans for microenterprises and to clients who require larger loans.

In recent years, there are considerable concerns about the fact that microfinance industry has not reached the poorest households. At the same time, the strong demand for financial viability of MFIs coming primarily from funding agencies is putting increasing pressure on microfinance industry. This is really a recent development in Nepalese microfinance industry. Many operated with the assumption that access to concessional external funds will continue because their mission is essentially a social and they have to serve the poor. The increasing pressure to reach the poorest is forcing some MFIs to take a fresh look at composition of their clients and a wide array of issues involved in increasing depth of outreach and possible trade-offs between depth of outreach and sustainability.

Level of competition in Nepalese microfinance industry is gradually increasing leading to penetration to a significant proportion of potential market. In some villages, clients are able to choose between as many as seven microfinance service providers to access microfinance services which have driven many clients into over-indebtedness due to absence of institutional mechanisms for sharing credit information among MFIs and issue of encroachment or un-fair competition is gradually emerging as an issue. Owing to limited number of suppliers, similar problems are yet to emerge in hills and mountains and there are areas where poor are desperately looking for microfinance services.

There are significant innovations to establish apex institutions due to felt need and realization. Issues related to their operational efficiencies and need of four different apexes have been raised at different flora and this needs careful attention. Viability of most apex is at a verge of question.

Nepalese MFIs are also attracting attention of central banks and policy makers on their supervision and regulation. Such attention is attributable to several factors. First, lack of a proper legal charter to mobilize public deposits has constrained many leading MFIs to expand their services in rural areas. Second, various stakeholders have become more concerned than in the past about safety of poor people's savings being mobilized by NGOs who in fact do not have a legal charter to do so and who are currently not subject to supervision and regulation by monetary authorities. Third, some funding agencies believe that regulation and supervision is essential to ensure significant outreach on a sustainable basis. While interest on regulation and supervision is increasing, appropriate institutional and legal framework for this purpose is yet to be increased. Many issues associated with effective supervision and regulation is yet to be resolved.

4. THOUGHTS FOR THE FUTURE

The future direction of Nepalese microfinance industry will depend on a number of factors. First, speed at which financial liberalization will proceed and depth of financial liberalization. Second, extent at which funding agencies supporting MFI demands adoption of international best practices by the governments and MFIs. Third, extent of support provided to MFIs for capacity building and improvement in policy, legal, regulatory and supervisory framework. Based on current status and emerging trends, a number of predictions on future of Nepalese microfinance industry have been made.

Trend on dominance of commercial oriented MFI against community based MFI is likely to be reversed as long as they do not introduce significant innovations to expand their services in inaccessible hills and mountains. Community based microfinance service provider such as SCCs and SFCLs have comparative advantage to legally mobilize deposits from members and use these funds for lending purposes. This is likely to enable them to increase their market share in the industry. Increased professionalism on microfinance operation will force government microfinance programs to demise their involvement overtime due to increasing budgetary constraints on continued injection of fresh capital; gradual decline of support from funding agencies to such programs and series of re-alignment efforts. Improvement on policy and legal environment over time will enable MFIs to properly use private sector risk-capital.

Although it is unlikely that commercial banks will play a significant role in expanding microfinance service over the next decades or so, it is more likely that MFI with good track records will be able to access funds from them on an increasing scale and intensify their service in plain and accessible hills. These MFIs will increase their reliance on domestic market resources to meet demand for loanable funds, but they have to increase their capacity significantly to tap the international capital markets as well.

The increasing knowledge of potential and existing clients about market will exert pressure to leading MFIs to improve quality of their services. This will lead to increase diversity of MFIs in terms of scope of services such as voluntary deposit services and a more diversified menu of credit products. Micro-insurance services and money transfer services will demonstrate more encouraging trend in terms of resource mobilization. The approach **one size fits all** of many service providers will shift towards more professional and market led approaches to microfinance service delivery.

The number of commercial oriented MFIs in the market is likely to decrease as funding agencies themselves increasingly adopt international best practices and demand firm commitment towards their financial sustainability. Leading MFIs will be compelled to pay more attention on design aspects and use of information technology to reduce their operating expenses at a reasonable level while responding to rapidly changing market. MFIs that will pay more attention to financial and institutional innovation to address critical issues of transaction costs and risk in pushing frontier out will obtain an obvious edge over those who do not. Those who do not adopt such strategy will be increasingly marginalized over time and shut down.

Issues of encroachment and unfair competition gradually is increase in a foreseeable future and there will be gradual realization of the need to develop a means of information sharing amongst MFIs whereby lists of clients/members of each MFI are shared among each other and allow MFIs to determine their most appropriate target market and corresponding products and services. It is more likely that a credit bureau will gradually emerge in Nepalese microfinance industry.

The rationale for four apex institutions to provide wholesale loans to MFIs will be reviewed. It is expected that industry will making wholesale lenders to be more commercial and work related to merging/amalgamation of these apex will be started to scale up operation, increase efficiency and contribute to financial viability.

The outreach of services to the poor will expand in future together with quality of services. It is expected that industry will move towards more commercialization and such an effort will result in a transitory decline in outreach mainly because of demise of many government programs, but over the short to medium term, outreach will pick-up gradually towards more saturation. However, unevenness of pace of change will continue, but such changes will not come about automatically. There should be some concrete initiatives to realize these changes.

5. CONCLUSIONS

Historically Nepal witness microfinance as an anti-poverty and development tools. There is a significant paradigm shift on microfinance sector beginning late 1990’s and it witness the movement forward as an industry, which benefit thousand of the poor people, poor women, micro-entrepreneurs and peasant farmers. At present the market share of Nepalese microfinance industry is 37% with services concentrated in accessible areas and virtually no or limited access in inaccessible hills and mountains. Existing trend implies that expansion of microfinance services to a large number of un-served and under-served micro-entrepreneurs and poor households living in remote districts is yet a challenge. While commercial MFIs are quite successful to penetrate their services in urban and densely populated peri-urban areas, the community based MFIs have comparatively better penetration in relatively inaccessible areas. On the other hand, thousands of Savings and Credit Groups promoted by government and non-government sectors exist throughout Nepal irrespective of remoteness, but not fully used up to the potential level. The industry is gradually adopting emerging international best practice standards and norms and corrects the likely distortions in the market. This will enables the industry to transform further as a lucrative business providing financial services for the poor.

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