Capacity and Financial Performance of Nepalese Microfinance Institutions

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ABSTRACT

Ensuring access to financial services to the poor and excluded people living in inaccessible hills and mountain has remained to be a challenge in Nepal since time immemorial. Large number of commercial banks and development banks in general don't lend to these people due to asymmetric of information, high credit risk perception, lack of acceptable collateral and high transaction costs of processing small loans. Under such circumstances the government's response has been to design and implement a number of credit programs intended to provide the poor with access to financial services. Over dozens of microfinance programmes implemented in Nepal target to boarder line poor, poor and ultra-poor failed and proved to be counterproductive for the growth and development of financial sector. Despite significant effort from the government, inadequate access to micro-financial services to the poor persists. The private sector approach remained to be use of MFIs such as microfinance development banks (MDBs), and financial intermediary non-government organizations (FI-NGOs) to reach the poor, however, due to MFIs' weak institutional capacity, lack of a viable and extensive delivery system, a small financial base and start-up cost on client preparation hampered their attempt to reach a greater number of target clientele. In the short it is apparent that MFIs are able to expand their present reach, but because they are not viable and sustainable financial institutions, the effort cannot be sustained. Under this reality, this paper attempts to address four key areas such as (a) outreach and impact; (b) viability and sustainability; (c) resource mobilization; and (d) policy that will enable MFIs to be self-sustaining financial institutions to meet the financing need of the poor.

Expanding outreach

Despite low outreach, MFIs in Nepal targets to the boarder line poor and poor households leaving the majority of the poorest of the poor as their clients. The weak institutional capacity, lack of an extensive and viable delivery system and a relatively small financial base prevent MFIs from reaching a greater number of clients. The principal problem faced by most MFIs on expanding their outreach is the lack of legal personality and authority to act as real financial intermediaries which results in a very limited capacity to develop and legally offer innovative financial products. More importantly, an extensive and viable financial delivery system that has substantial focus on the poor is absent. While community based MFIs such as SCCs and SFCLs have a nationwide delivery system through branches and unit entities, they have yet to consider micro-financial markets as profitable opportunities and commercial microfinance services

providers such as MDBs and FI-NGOs with relatively high market penetration have confined their outreach in the Tarai and accessible hills.

In general, MFIs' staff lacks motivation to work with poor clients and encounter the problems of rapid staff turnover. Training of the potential clients represents a sizable investment cost that MFIs may not be able to absorb, which makes a point that training of clients has some public good characteristics which makes it worthy of government and donor assistance. Matching government/donor funds with MFI funds on client preparation is the most profitable and win-win situation to expand their outreach. Community based MFIs such as SCCs and SFCLs are in a comparatively better position compared to community oriented MFIs to expand the outreach in remote areas. Further, thousands of savings and credit groups promoted under different integrated rural development programmes are not used properly due to lack of vision and provision methodologies.

Expanding the outreach of microfinance services requires concerted efforts to enhance the capacity of the community based MFIs and proper use of the existing savings and credit groups. Implementation of this effort need to promote the linkages of banking sector with commercial microfinance service providers, commercial banks, development banks and apex institutions for microfinance services by upgrading their institutional capacity through increased investment on training on best practiced microfinance technologies. The training costs on social mobilization need to be externalized by providing MFIs access to grants and government financial assistance by following the principle of matching grants with MFI own funds and staff training and continued development of career paths for capable workers, as well as upgrading the pay scales and incentive schemes to retain good personnel. Rationalization of the government credit programs and reallocation of existing funds for livelihood projects to capacity building and training of existing MFIs will act as a catalyst to expand the microfinance services.

MFI viability and sustainability

In order to continue providing financial service to the poor on sustained basis until the indefinite future, MFIs must be viable and sustainable. Most Nepalese MFIs have yet to achieve this goal. The set of internal financial policies and organizational practices / procedures observed by the MFIs is the one of the major factors determining viability and sustainability. Internal financial policies and practices requires improvement on financial reporting and monitoring systems, portfolio management, operational risk assessment and management, product packaging and pricing, management of loan arrears and strategic business planning. This requires upgrading and institutionalizing performance standards, particularly in loan repayment, appreciation of loan default and

aging of delinquent loans and installation of appropriate accounting and internal audit systems. In addition, the capability for governance, leadership and management affects their performance. Improvement of management skills and professionalization of staff, appropriate market-oriented pricing of financial products and services and greater effort in loan recovery are needed to make MFIs viable and sustainable. This implies that having an appropriate organizational form; a strong equity and financial base; and suitable systems and procedures are the requisites for building a sustainable financial institution.

MFIs' viability and sustainability requires, among other, building an equity base by infusing more capital from existing owners and new investors; diversifying products (loans, savings, etc.) and services consistent to the client demand; maximize savings mobilization opportunities; and promote training in financial operations, resource mobilization, portfolio management, risk assessment and management, product packaging and pricing, management of loan arrears, strategic and business planning. There is a need to improve systems/procedures through automation, upgrading and institutionalizing performance standards, setting up internal audit systems, conducting periodic management audits, installing updated and standardized accounting and reporting system; and professionalize the management and staff of MFIs.

Resource mobilization

The MFIs have attempted to mobilize resources and are in process to raise substantial deposits and develop various instruments, especially for the small savers, which will help them build up their financial base. In addition to mobilizing the traditional deposits, they are broadening and deepening the financial products and services to meet existing demand at the lower end of the financial market. Broadening and deepening mean the development of new product lines and services, the design and implementation of new microfinance technologies, and practices which will strengthen their financial base. In order to promote resource mobilization, MFIs need to expedite deposit mobilization, raise equity capital and offer various financial products/services and invest in the development of new product lines and services, new microfinance technologies, application of the "best practices in microfinance" etc. On the other hand government should reallocate resources in various livelihood programs for the broadening and deepening of micro-financial services. Donor assistance should focus on allocating the resources for broadening and deepening of micro-financial services and enhancing the capacity instead of providing loanable funds to MFIs.

Policy context

The need to bring all the microfinance operation under a supervisory and regulatory framework cannot be overemphasized in order to address problems such as absence of performance standards, lack of uniformity and dilution of standards of credit evaluation, lack of portfolio supervision leading to poor loan recovery and deterioration of its quality and absence of prudential regulations over such activities as deposit taking. The installation of a supervisory and regulatory framework complements the building MFIs' institutional capacity that will no longer operate in a policy vacuum. The alternative to a formal supervisory and regulatory framework is self-regulation on community based microfinance operation. The argument goes that maintaining an informal self-regulatory framework will provide them flexibility and room for initiative on various financial innovations to reach the poor. Furthermore, there should not be any danger of losing focus on their target clientele through such self-regulation mechanism. There is however the need to set performance standards, prudential regulations and a supervisory framework to ensure their safety and soundness and integrity of their transactions.

In general, an organization's vision, mission and goal are not dictated by the organizational structure (i.e. banking firm), but by the people manning it and the policies being pursued, hence, transformation into format financial institutions may not be of interest to all the institutions. There will be some which are interested to transform while there are others that opt to remain as a development agency and organize a bank with a distinct charter, character and function. The important outcome of this strategy is the unbundling of banking and development social preparation functions which will increase efficiencies in the financial markets for the poor as this will enable them to exploit their respective comparative advantage. From the public policy perspective, it becomes clearer that provision of microfinance services encompasses social intermediation costs and financial intermediation costs. While the first set of costs may be subsidized or given access to grants in view of the externalities present in social preparation of the poor clients while the latter should be covered by appropriate pricing of the financial product.

Creating an enabling policy environment by setting an appropriate supervisory and regulatory framework is one of the priority needs in Nepalese microfinance sector. Further support to manage the costs for social preparation is required through budgetary assistance and this need to be matched by private sector funds. Donors should continue assisting social preparation activities, development of microfinance products and services, innovation and training, and upgrading of performance standards, operating systems and procedures. Frequent dialogue between MFIs and government is required to institute an appropriate supervisory and regulatory framework for MFIs.

1. INTRODUCTION

Capable and well performing microfinance institution is a pre-condition for the sustainable expansion of microfinance services for the poor in remote areas. Unless MFIs become viable and sustainable financial institutions, they can never fully realize their objective of reaching a greater number of poor people, much less sustaining the effort. In view of this, this paper attempts to assess performance of the leading Nepalese MFIs through a review of the policy environment under which they operate, outreach and operational and financial performance analysis, and operational modalities and mechanisms, determines issues and constraints affecting their capacity and performance; and recommend measures to strengthen them.

The analysis, conclusions and recommendations of this paper are based on the information collected from both primary and secondary sources. Secondary sources of information includes both published and unpublished information obtained from NRB and MFIs while primary information are collected through consultations with key stakeholders and survey of microfinance both commercial oriented (7 MDBs and 3 FI-NGOs) and community based (14 SCCs and 7 SFCLs) and they are analyzed in terms of age of operation, products, services, operational policies, pricing, leadership and management capabilities to ensure homogeneity and make appropriate comparison. In this context, the first best alternative could have been the drawing of a larger and random sample of some MFIs like FI-NGOs, SCCs and SFCLs which has been prevented due to time and budget constraints. It should be noted that despite these limitations vis-à-vis available data and information set, the analysis, conclusions and recommendations included in this paper have a great degree of validity as the these MFIs covers over 50% of the operation in Nepalese microfinance market. Thus, it can be assumed that their performance largely reflects the general experience of MFIs. Information collected from secondary sources was used to assess their performance in terms of outreach, operational and financial performance analysis, operational modalities and mechanisms, determines issues and constraints affecting their capacity and performance; and recommend measures to strengthen them. Further, the product and service delivery methodologies, outreach, cost structure, efficiency, productivity and portfolio quality of selected MFI's typology was analyzed to assess their comparative advantages to expand the boundaries of microfinance services in remote areas.

The paper has four sections. The next section is a brief description of the context and realities of microfinance operation in Nepal. Section III analyzes the main findings and analysis of the issues and constraints affecting their capacity and performance. The last

section concludes and recommends policy and institutional measures to strengthen MFIs and implement microfinance programs.

2. CONTEXT AND REALITIES

2.1 Poverty Situation

The Nepalese economy positively responded to the economic liberalization and reforms initiated in the mid 1980s with per capita income growing at the rate of 2.5% per annum between 1986 and 2001. The opening up of the economy doubled the share of trade in GDP and agriculture's contribution to GDP declined from 70 to 40% (World Bank 2004). Access to infrastructure and services also improved quite significantly as shown in Box 2 (CBS 2004).

2.1.1. Poverty and Human Development

Nepal has made progress in human development and poverty reduction after the restoration of democracy in 1990. The Nepal Living Standards Survey II (2003/04) shows significant improvements in poverty levels between 1995/96 and 2003/04 with average real per capita income and expenditure growing at around 4.5% during that period. As a result, the incidence of poverty declined by 11 percentage point from 42 to 31%, and the proportion of people earning less than one dollar a day decreased from 34 to 24% during this period (CBS 2005a). The trend shows that Nepal is only 7% point away from the MDG target (17%) of halving the proportion of people's earning less than one dollar a day. This clearly indicates that Nepal is on track towards achieving the poverty target. Moreover, the human development index (HDI) increased from 0.466 to 0.526 during the period, and Nepal graduated from low to medium level of human development ranking at the 136th position on the HDI ladder (UNDP 2005). In the year 2004, however, the country dropped by two steps ranking at the 138th position in the ladder despite the slight increase in the HDI of 0.527 (UNDP 2006).

However, the past advances have not been able to address the root cause of poverty in Nepal – primarily inequality, social exclusion and discriminatory practices. There has not been significant improvement in production relations, socio-economic structure, gender relations and status of women. Thus, both incidence of poverty and level of human development varied inequitably, manifesting themselves in gender, caste, ethnic and geographical disparities. In fact, Gini Coefficient, a measure of income inequality, increased from 34 in 1995/96 to 41 percent in 2003/04 (CBS 2005a). Moreover, there

was a mismatch between political, social and economic empowerment with larger political whereas smaller economic empowerment (UNDP Nepal 2004). Thus, people's awareness and aspirations increased tremendously after the restoration of democracy in 1990 without concurrent expansion of economic opportunities. These factors were instrumental in fueling the decade long conflict in Nepal (UNDP Nepal 2004).

The recent comprehensive peace agreement between the Seven Party Alliance and Communist Party of Nepal (Maoist) on 21 November 2006 auger well for deepening democracy, but the situation is still fluid. There is risk of conflict relapse unless well designed recovery and reconstruction plan is implemented by the government to manage people's expectation – peace dividend – and recover the political, economic and social infrastructure of the country. Collier and Hoeffler (1994) found that there is 39% risk of conflict relapse in the first five years and additional 32% risk in the next five years. This risk is higher than such a risk in a normal country, which is just 14% in the first five years.

2.1.2. Poverty, Inequality and Exclusion

Although the incidence of poverty decreased at national level and in all the NLSS regions except Eastern Hills – from 3% in urban Kathmandu, 13% in other urban areas to 45% in Mid Western Development Regions (CBS 2005a). Between the regions, the variation in poverty incidence is wide, ranging from 28% in Tarai to 35% in Hills and overall 35% in rural and 10% in urban areas[2].

Inequality is severe among economic groups as the poverty incidence ranges from 2 to 54% with major incidence on agricultural wage earners (53.8%) and self-employed agricultural operators (32.9%). Moreover, caste and ethnicity has been found as a significant factor influencing poverty (DFID and World Bank 2006). Variation in poverty by caste ranged from 14% in Newar to as high as 45% among Dalits (CBOs, WB, DFID and ADB 2006). Households with larger dependency ratio or larger number of children, with smaller landholding, or with uneducated or less educated household heads, have also been found to be poorer. Apart from the incidence, the depth and severity of poverty is also highest among Dalits and certain Janajatis.

Thus, poverty in Nepal varies by geographical, economic and social factors. They have become the basic factors explaining poverty. On the aggregate, although poverty has decreased over the 8 year period, from 1995/96 to 2003/04, the decrease was not

[2]Refer Annex A for the details.

proportional across regions, castes and ethnic groups. For example, the decrease was higher in urban areas than rural areas, and among upper castes compared to disadvantaged castes including Muslims (Annex A).

At the intra-household level, the brunt of poverty is especially felt by women and children. Gender related differentials exacerbate intensity and depth of poverty for the affected groups. NLSS data show that, on an average, female-headed households had only 0.5 ha compared to 0.8 ha of farmland with male-headed households. In terms of purchasing power parity, women's earned income is only half of that of men (PPP $949 versus 1,868). Moreover, females of less than one percent of households own all the three assets – house, land and livestock (CBS 2001).

The root causes of high variations in poverty are economic and social exclusion of women, disadvantaged ethnic and caste groups, powerlessness and risks, which mainly derive from socio-economic and natural characteristics, and atypical location of the country. They give rise to the underlying causes of discrimination, high cost and in efficient delivery, with discrimination in provision of services and ineffective targeting leading to misuse of limited public resources. These factors, in turn, inhibit growth, particularly agricultural sector – the mainstay of majority of the poor. This results in poor quality growth, manifesting in high poverty, perpetuating inequality and ultimately leading to conflict and its negative consequences.

The fundamental reasons for the discrimination between men and women is the patriarchal society which gives rise to gender differentials, and thus differences in the access to services and opportunities. In spite of efforts made by the Government of Nepal (GON) to make pro-women acts and rules, there are several barriers against women in existing legal provisions, which need to be corrected. The law discriminates against women in the areas of citizenship, inheritance rights, education, employment, health, sexual offences, marriage and family relations, court proceedings and identity (DFID and World Bank 2006).

2.2 Macroeconomic Considerations

Over the past seven years, Nepal's annual real GNP growth averaged at ..... % (Table 1). Per capita GNP, however, hardly grew as population over the same period grew faster than GNP growth at.....%. The country's GDP for 2005 was valued at $ ..... billion. Per capita GDP was posted at $ ..... Year-end average inflation rates have been single-digit (ranging from ..... percent to ..... percent) after a fluctuating single and

double digit average of ..... percent in 1999. For 2005, the average inflation rate was .... percent. The policy and structural reforms under albeit decade long conflict have put the economy in the growth path even such a crisis period. Investor confidence in the Nepalese economy came back, together with domestic capital which took off for foreign shores during the Marcos regime. The renewed vigor of the economy led owing to sound planning and government's commitment towards poverty reduction strategy paper.

Table 1: Selected Macroeconomic Indicators, 1998-2005

Particulars	Unit	1999	2000	2001	2002	2003	2004	2005	% annual growth
Gross national product	million US$								
▪ At current price	million US$								
▪ At constant 1990 price	million US$								
Per capita GNP	$								
▪ At current price	$								
▪ At constant 1990 price	$								
Gross domestic product	million US$								
▪ At current price	million US$								
▪ At constant 1990 price	million US$								
Per capita GDP	$								
▪ At current price	$								
▪ At constant 1990 price	$								
Population	million								
Inflation									

Population projection based on 1990 Census of Population and Housing.

Source: National Statistical Coordination Board.

In the financial sector, owning to financial liberalization initiatives started since mid 1980s strengthened the formal financial system. The financial liberalization initiatives pursued financial reforms started in 1980s, and recently, it relaxed the rigid bank entry and branching policy that it strictly implemented in the past. The financial sector was further liberalized by allowing the entry of foreign banks. The recent reforms created a more competitive financial market, stimulating increase in the number of banking establishments and introduction of many innovative financial products[3]. Gross real savings over the last five years have been increasing at an average rate of 5.8 percent per annum (Table 2). A significant increase in real savings was noted after ..... as the economy started to recover from stagnation in ..... The increase, however, was mainly attributable to the growth in savings of government and corporations. The savings of households and unincorporated enterprises were at a high level in ..... but slowly

[3]For example, there is now a growing home mortgage market to meet the demand for middle class housing.

declined in the following years. The savings to national output ratio over the last five years averaged at about 20 percent.

Table 2: Savings Trends, 1998-2005

Particulars	Unit	1999	2000	2001	2002	2003	2004	2005	% annual growth
GNP growth rates	%								
Nominal savings	Million $								
Real savings	Million $								
▪ HHs and un-incorporated enterprises									
▪ Private and government corporation									
▪ General government									
▪ Depreciation									
Gross savings									
Savings as a % of GNP									
▪ HHs and un-incorporated enterprises									
▪ Private and government corporation									
▪ General government									
▪ Depreciation									
Gross savings									

Population projection based on 1990 Census of Population and Housing.

Source: National Statistical Coordination Board.

Deposits and lending rates appear to have stabilized starting in ..... (Table 3). Nominal savings rates, while significantly higher in recent years (averaging ... percent) than in ..... (close to .... percent), are still not very different from inflation rates; thus, negative or near zero real savings rates have persisted. Real time deposit rates have also been low, particularly in the last two years, averaging only at about 1 percent per annum. On the other hand, lending rates have been decreasing (Table 3). Weighted average interest rates on loans granted by commercial banks averaged at .... percent per annum in the last three years compared to .... percent and .... percent in 1991 and 1992, respectively.

Table 3: Selected Interest Rates, 1998-2005

Particulars	Unit	1999	2000	2001	2002	2003	2004	2005	% annual growth
Savings deposits									
Time deposits (all maturities)									
Secured loans (all maturities)									
Treasury bills (91 days)									
Inter-bank call loan rate (IBCL)									

Sources: 1993 Nepal Development Report and Bangko Sentral ng Pilipinas

2.3 Financial Sector Reform and Cost of Capital

The financial system reforms started after the liberalization of interest rates in 1984 when commercial banks were given autonomy to fix interest rates over and above the central bank rates by 1.5 percentage points on saving and 1 percentage point on term deposits. The interest rates were fully liberalized in 1989. Likewise, foreign investment was accepted in the banking sector for the first time in 1984, with the establishment of the Nepal Arab Bank Limited, as a oint venture bank. Since the early 1990s the financial sector reform has been intensified**.**

Removal of entry barrier, enactment of Finance Companies Act 1985 and its amendment in 1992, abolition of pre-emption of bank resources in the form of statutory liquidity requirement, establishment of prudential norms of Basle Accord, enactment of Nepal Rastra Bank Act 2002 granting autonomy to the central bank and introduction of Loan Recovery Act 2002 are the key reform measures introduced in the financial sector. Reforms in the conduct of monetary policy are also carried out. Removal of credit ceilings, differential interest rates, margin requirements and deregulation of interest rates are the key reform measures introduced in the realm of monetary policy conduct. Nepal has been emphasizing on indirect monetary policy instruments such as bank rate, variable cash reserve requirement and open market operations.

Along with the initiation of financial sector reforms, quite a few joint venture banks have come up in the private sector. The number of commercial banks has increased to 16 from 5 in early 1990s. The number of financial institutions reached 136 by 2000. These financial institutions, mostly concentrated in urban areas have now begin to diversify their products and services. The number of finance companies has grown from 9 to 48

within ten years. They accept fixed term deposits, usually at higher rates of interest, attracting the shallow fund in the informal market.

Among the semi-formal financial institutions, Savings and Credit Cooperative Societies have most prominent role. As per Nepal Rastra Bank Report (2000), they numbered 1574, of which, 34 were authorized by the NRB for limited banking transactions. Others operate among their own members without NRB permit, which are allowed under the Cooperatives Act. There are about 25,000 NGOs promoting savings and credit groups. They lend limited amounts to such groups. Among the NGOs, only 25 were licensed by NRB as of July 2000, to operate banking transactions. There are 116 Postal Savings Bank outlets for collection of deposits. Besides these, 17 insurance companies, Rural Micro Finance Development Centre (RMDC), Employees Provident Fund and Pension Fund, one each, are operating in the economy. Consequently, the financial deepening has intensified during the post liberalization period of 1990s. The ratio of all financial assets, which was 32 percent of GDP in 1990, reached to 76 percent of GDP in mid-July 2000. This ratio was about 29 percent in 1985. These figures thus clearly indicate that the role of financial sector in the economy has increased a lot. Likewise, deposit/GDP ratio rose to 44.1 percent in mid-April 2002 from 10 percent in 1980 and 22 percent in 1990. The growth in credit/GDP ratio, which was slower during the 1980s, began to increase subsequently. This ratio reached 27.8 percent in mid-April 2002 from 12 percent in 1980 and 15 percent in 1990. At the same time, unlike the 1980s when out of total credit the government overtook one third, in the 1990s the private sector credit has accounted for the biggest share. The purpose wise lending pattern of the commercial banks also show some shifts. The biggest borrowers now are industries followed by trade and businesses. The share of credit to the agriculture sector has gradually decreased (NRB, 2004).

Despite these positive developments, there are some serious problems persisting in the financial sector. On the one hand, the share of non-performing assets in the investment portfolio of the two government owned commercial banks and Agriculture Development Bank has still remained very high, ranging from 29 to 40 percent (NRB, 2004). This has had adverse effect on loan expansion as well as narrowing down the spread between lending and deposit rates essential for reducing the cost of capital, which is the key for raising efficiency, and competitiveness of the economy. In the midst of this, urban households enjoy disproportionately larger access to the organized sector credit. A comparison of figures shows that small and marginal farmers have lesser access to formal sources of borrowing than the average rural households. Majority of the targeted credit programs have failed to cater the need of the bottom 20 percent of the

households. Micro credit programs have left the bottom twenty percent of the income ladder untouched (NRB, ibid).

In order to examine the effect of financial sector reform on the cost of capital and access to the credit, private investment equation was estimated. The real interest rate variable representing the cost of capital was found not only showing negative sign but also highly insignificant. This meant that the predominance of non-performing assets in the banks portfolio has had negative effect in a way to reducing the cost of capital in the reform process. Similar result was obtained for the government's infrastructure investment variable. In the private investment equation, even the accelerator (change in GDP) was found to be insignificant. As a result of this, the equation was again re-estimated dropping real interest rate, government's infrastructure investment and accelerator variables, which is reported below:

LOG(GFPCF) = 3.084759618 + 0.1678432343*LOG(CPS) +0.4923339458*LOG(GFPCF(-1)) + [AR(1)=0.4923339458]
(3.88) (1.50) (4.29)
R2 = 0.92 Adj. R2 = 0.90 DW = 1.99 N = 17

Where,
GFPCF = Gross Fixed Private Capital Formation
CPS = Credit to Private Sector
GFPCF (-1) = Gross Fixed Private Capital Formation Lagged One Year
AR (1) = Auto Regressive

The equation has a good fit. It explains 92 percent of the total variations in the dependent variable. The credit variable is significant at around 15 percent. It thus indicates the importance of financial deepening in the Nepalese context. The lagged private investment variable is highly significant. On the whole, the results show that the reforms have not been expedited to the extent that could ensure reduction in the cost of capital considerably for creating favorable environment to the private sector. Similarly, the government investment in the infrastructure has not played a complementary role to the private investment. Low level of significance of only lagged variable additionally reveals that more widening economic reforms are needed to create enabling environment to the private sector.

2.4 Access of the Poor to Financial Services

Over the past 20 years Nepal's financial sector has become deeper and the number and type of financial intermediaries have grown rapidly. In addition, recent reforms have made banks more stable. Still, access to financial services remains limited for many people in many parts of Nepal and in recent years has been declining. In general commercial banks Commercial and development banks rarely lend, if at all, to the poor, mostly because of information problems, the lack of acceptable collateral, and the high

transaction costs of processing small loans. Formal creditors view lending to the poor in agriculture as a high risk because of risks associated with agricultural production[4]. Furthermore, banks and other non-bank financial intermediaries are mostly concentrated in Kathmandu and other urban areas such as Biratnagar, Pokhara, Chitwan, Birgunj and Nepalgunj, leaving many of the regions without adequate banking facilities. The bulk of the low-income families who did not borrow from formal sources cited burdensome bank requirements, high interest rate and lack of collateral as well as ignorance of possible credit sources as major reasons for not borrowing. In general, it can be said that the poor's lack of access to formal financial services may be partly explained by the very structure of the financial system which is biased against the poor.

2.4.1. The Supply of Financial Services

For much of the past 50 years Nepal's government has tried to increase access to formal financial services for small businesses and low-income households[5]. The government has introduced directed lending programs for small businesses and low-income households, required banks to open branches outside the Kathmandu valley, created specialized wholesale and retail institutions, and lowered market entry requirements to foster the development of different types of financial institutions.

Despite government efforts, access to formal financial services is declining. Financial intermediation is stagnating, the number of bank deposit and loan accounts per inhabitant is falling, and lending targets for low-income households have generated excess liquidity among microfinance institutions without significantly increasing their outreach. And despite 40 years of government mandates to lend to small businesses, banks have been withdrawing from this segment as these requirements have been lowered. Access to bank infrastructure has also decreased.

Moreover, as a result of the government's efforts to increase access, the central bank (Nepal Rastra Bank) now has to supervise 180 institutions. Even the large foreign remittances received by Nepalese households—mostly from migrant workers—seem to be a missed opportunity for increasing access to formal financial services. Despite the entrance of money transfer operators and the growth in formal remittance flows they have generated, the bulk of remittances enter the country informally.

[4]NRB Rural Credit Survey 1993/94
[5]This report defines low-income households as those in the three bottom spending quintiles.

2.4.2. The Demand for Financial Services

The findings of the 2006 Access to Financial Services Survey—conducted by the World Bank and Total Management Services in cooperation with Solutions Consultant as background for this report—confirm that use of banks is limited, financial NGOs and cooperatives play a large role in providing both deposit accounts and loans, and informal borrowing far exceeds formal borrowing.

Only 26 percent of Nepalese households have a bank account and banks' procedures are perceived as being the most cumbersome among financial institutions. Accordingly, clients prefer not to save in them. Banks dominated in urban areas and among the wealthiest. Financial NGOs and cooperatives run a close second as largest provider of deposit accounts, serving 18 percent of households. These institutions are the preferred provider for low-income households, but are close to banks even for wealthier households. Microfinance and regional rural development banks are a distant third provider of deposit accounts, serving only 4 percent of households— mainly poor, rural ones. About 38 percent of Nepalese households have an outstanding loan exclusively from the informal sector, 16 percent from both the informal and formal sector, and 15 percent from only the formal sector (that is, a bank, finance company, financial NGO or cooperative, or microfinance or rural regional development bank). Family and friends are by far the largest informal providers of loans to households—and, contrary to common belief, family and friends often charge interest. Most households who borrow from informal providers do not bother trying to borrow from financial institutions, mainly because formal institutions cannot meet their financial needs on time. Informal providers also require less physical collateral. Even among the wealthiest households, half of those with a bank account prefer informal lenders because of their rapid delivery. Similarly, informal lenders are the preferred providers of working capital for small businesses, again because they are faster at sanctioning loans than are formal financial institutions. Of households that borrow from the formal sector, financial NGOs and cooperatives are the largest provider of loans (except for the wealthiest households).

They dominate the market for loans under NRs 50,000, even for households with a bank account. Banks are the second largest provider—mainly in urban areas and for loans larger than NRs 50,000. Microfinance and regional rural development banks are the third largest providers, serving mainly in rural areas and in the Terai. Finance companies are the least preferred formal lenders, and operate mainly in the Kathmandu valley.

Nepal's payment system is virtually unused for retail domestic transactions and little used for international ones. An estimated 69 percent of foreign remittances come through informal channels—usually family and friends—even among households with a bank account. Just 6 percent of remittances are saved in financial institutions. The bulk of foreign remittances are used for consumption and to repay loans—loans most likely incurred by workers to migrate to other countries.

In sum, both supply and demand indicators show that, despite government efforts, formal financial institutions do not serve the needs of most of the Nepalese population. And while access to and use of formal financial services are limited in general, the problem is more acute for small businesses and low-income households. Indeed, both access and use are closely correlated with business loan size and household income.

2.4.3. Limitations of Governments' Efforts to Increase Access

Government efforts to increase access to formal financial services have not achieved their goals because they have focused on the symptoms of limited access—not the root causes. For example, the priority sector lending program, requiring banks to make loans to small businesses, has not addressed the sustainability of such lending. Similarly, the deprived sector lending program for low-income households has not addressed the microfinance sector's capacity to extend large volumes of loans.

Increasing financial access for small businesses and low-income households requires that financial institutions be able to serve these segments in a financially sustainable manner. Lending profitably to small businesses requires a high level of efficiency, while operating microfinance institutions with large outreach requires high levels of professionalism and technical skills. Nepal's financial institutions have struggled to meet these requirements.

2.4.4. Constraints to Scale up Lending to Small Businesses

Small businesses have very different features from large corporations—the traditional clients of Nepalese banks. To serve small businesses profitably, banks need to minimize transaction costs and generate large numbers of high-quality loans. But for many reasons, Nepal's banks find it difficult to serve small businesses profitably:

- Bank procedures for small business loans are too complex, making such lending unnecessarily long and expensive for both the businesses and the banks.
- The most popular bank product, overdrafts (lines of credit), is inappropriate for many small businesses, which do not deposit their revenues in banks.

- The interest rates that banks charge on loans to small businesses do not adequately reflect the costs of serving them.
- Banks require high levels of immovable collateral, while small businesses tend to have only movable assets.
- Although Nepalese banks have sophisticated management information systems, they generally do not use them to measure staff and loan performance—which is crucial for profitable small business lending.

Although the legal and regulatory framework is not a binding constraint on bank lending to small businesses, it could be improved to facilitate such loans. Obstacles include:

- The absence of a registry to record liens on movable assets, which makes such assets almost unusable as collateral.
- The credit bureau only covers loans larger than NRs 1 million, and does not provide accurate and timely information.
- Loan loss provisioning rules—especially for short-term loans—are too lax and do not provide the right incentives for stringent monitoring of small business loans. At the same time, provisioning requirements for loans secured only with unregistered movable collateral and personal guarantees are too stringent, discriminating against small businesses that cannot offer immovable assets as collateral.
- The method used to calculate fines for not meeting priority and deprived lending targets discourages banks from charging appropriate interest rates for small business loans. (Fines are calculated by multiplying the shortfall amount against the highest interest rate that the bank charges its clients.)

2.4.5. **Microfinance Services for Low-income Households**

Nepal's formal microfinance institutions could play a key role in delivering financial services to low-income households. Yet many potential clients of microfinance institutions prefer to save with and borrow from informal sources. The microfinance sector's limited ability to serve low-income households is reflected in its narrow outreach, sluggish growth, high liquidity, and low profitability. Several factors explain the disappointing state of Nepal's microfinance sector, including:

- A complicated geo-political environment.
- Weak technical capacity in key areas, such as accounting and auditing, strategic planning, financial analysis, and human resource management.
- Lack of commercial orientation and slow professionalization—mainly because microfinance is often considered a charitable activity.

- Distortions arising from the government's deprived sector lending program that generate high liquidity among many microfinance institutions, as these institutions are encouraged to borrow beyond their needs and invest these low-cost funds in other financial institutions.

Although often cited as an obstacle, Nepal's legal and regulatory framework is not a binding constraint on the growth of the microfinance sector. Still, the framework for microfinance is convoluted and confusing. Although this framework is not hampering microfinance growth per se, supervision of the sector is problematic.

Small institutions that pose no systemic risk are supervised, while larger ones are not— and supervisory capacity is weak. As a result microfinance consumers can be misled, and supervisors cannot ensure the sector's stability.

2.4.6. **Remittance Market**

Since 2001, when money transfer operators were allowed to enter Nepal's remittance market, formal remittance payments have increased and improved considerably— with formal remittances being delivered in a day or two at relatively low cost, even in remote areas. Thus it seems that the widespread use of informal channels is due to limited familiarity with the formal financial sector and a perception that family and friends are a safer delivery mechanism, rather than to a lack of alternatives. Moreover, India is the largest source of migrant remittances and, given its proximity and ease of entry, migrants tend to move quite often between it and Nepal. Finally, there appear to be legal and regulatory constraints in the India-Nepal corridor for money transfer operators.

The government's response was to create a number of credit programs intended to provide the poor with access to financial services. There are over two dozens of credit programs targeted to boarder-line poor, poor and ultra-poor. One nationwide program designed specifically for women is the Production Credit Programme for Women (PCRW) and for both men and women in Small Farmer Development Programme (SFDP). These programmes focus on promoting self-employment opportunities by promoting income generating activities. To achieve this objective, these programmes provided them with livelihood activities and harnessed their entrepreneurial abilities. These are the programmes targeted to men and women from household below poverty line. Both these projects organize eligible members (men and women) who will then undergo social preparation, entrepreneurship and other appropriate training and, eventually, receive credit assistance for their entrepreneurial/income generating endeavors. These people

were entitled to borrow up to NRs. 40,000 from two state-owned commercial banks and Agricultural Development Bank, Nepal at the subsidized interest rate.

Another program that encourages lending to poor women is the Micro Credit Project for Women for women from boarder-line poor, poor and ultra-poor households. They has supported the development of Financial Intermediary NGOs and Savings and Credit Cooperatives in addition to providing immediate support to access the financial services to them.

2.5 Public Policy and Microfinance Initiatives on Poverty Reduction[6]

The seriousness of the poverty situation in Nepal cannot be overemphasized. In formulating its strategies to address poverty, the Nepalese government recognizes that: (1) the nature and intensity of the needs of the different poor groups are diverse, as are the causes of their problems; hence, solutions for them vary; (2) appropriate macroeconomic and sectoral policies induce vigorous and sustained economic growth which will have a powerful impact on reducing poverty, although not all poor people will benefit as much because they do not have the means to do so; and (3) the responses of different poor groups to government interventions targeted at poverty alleviation differ.

The government believes that direct intervention in the form of intensified delivery of basic services will be necessary to improve the lot of the subsistence poor. In addition, community organization will be indispensable in building capabilities, together with livelihood projects which can provide diverse sources of income to poor communities.

Nepalese government[7] has identified five major strategies to address poverty problems as discussed hereunder.

1. Promote and sustain economic growth to create employment and livelihood opportunities: At the macroeconomic level, the goal is to attain and sustain rapid pro-poor economic growth at 5 to 7 percent annually in order to reduce the number of families living below the income poverty line from 42% in 1990s to 21% in 2015. Thus, the government will undertake the following: (a) embark on a massive infrastructure program directed primarily at the rural areas and in areas with the greatest capacity to provide jobs; (b) improve revenue collection; (c) encourage investments by reducing interest rates to borrowers, and raise the interest rate on savings by reducing the

[6]Drawn from the document "A National Strategy to Fight Poverty" prepared for the Presidential Commission to Fight Poverty by the Philippine Institute for Development Studies, 1995.
[7]PCFP was subsequently replaced by the National Anti-Poverty Commission in 1997 through an act of Congress.

government budget deficit, issuing small-denomination government notes for small savers, and removing unnecessary impositions on financial transactions; (d) emphasize voluntary arbitration on the resolution of industrial disputes; (e) continue reforms that will compel the large monopolized and protected sectors of the economy to become more competitive globally and reduce the biases against small and medium enterprises through tariff restructuring, liberal foreign investment rules and the passage of antitrust laws; and (f) ensure adequate national and local government funding for specific sectors such as education, health and housing.

2. Sustain growth based on people-friendly strategies: Economic activities must be made accessible to those who are poor while at the same time being efficient and productive enough to yield better incomes. This requires the following activities: (a) promotion of new labor-intensive industries with higher domestic value added, better export potential, and stronger links with agriculture, for example, food processing; (b) pursuance of policies that are consistent with efficiency, improve prices for agricultural products, lower prices for agricultural inputs, and promote diversification into products that have higher value, use more labor and make more efficient use of land; (c) active use of an exchange rate policy to promote agriculture and export-oriented industries while at the same time generating financing for safety nets to stem inflation and a wage-price spiral; (d) conservation and management of natural resources by entrusting these to their immediate communities, formulating and implementing policies on resource use and imposing higher taxes on the use of natural resources and on pollution; (e) protection of the gains under the Agrarian Reform Program while reassessing the pace of its future implementation; (f) revival of rural financing by wholesale lending to SCCs and transformation of microfinance NGOs into FI-NGOs, which should then retail the credit to farmers, marginal borrowers and people's organizations at market rates; consolidation of all resources currently used in the government's livelihood programs that are not focused on the core poor into a credit facility for the poor; strengthening and full development of cooperatives and NGOs as efficient retail credit institutions; keeping of commercial interest rates at low levels; and (g) allocation of more funds to agricultural research and extension, with continuing training for devolved extension personnel.

3. Expand social services to provide minimum basic needs: Minimum basic needs of the poor such as primary health care and family planning, elementary education, supplemental feeding, housing, water and sanitation is being addressed through the use of packages of services.

4. Foster sustainable income-generating community projects: Greater emphasis on livelihood projects with components such as skills and technology training, credit and livelihood assistance, and technical extension is required so as to accomplish: (a) consolidation of lending programs for the core poor, or those which include a subsidy element (i.e., those charging submarket interest rates) under the PCFP, and designation of such programs exclusively for the use of the poorest of the poor; (b) design of credit schemes according to the capabilities of poor groups; in general, credit should be extended at commercial rates exclusively and without collateral to the poor; (c) coordination of efforts in providing training for the poor in livelihood and income-generating projects, particularly by improving the quality and relevance of the training provided, as well as the quality of training facilities; (d) dissemination of information on available livelihood services and decentralization or expansion of access of existing training programs.

5. Build capabilities of the poor to help them-selves: The most important element in a strategy to fight poverty is not what it can provide or do for the poor but whether that strategy ultimately enables the poor to do something for themselves. The process of building capabilities among the poor may be done in the following ways: (a) rely on local governments as the main implementers of antipoverty projects in the critical municipal and barangay levels, so that local leaders may become directly accountable to the poor communities that are supposed to benefit from them; (b) mobilize NGOs and people's organizations (POs) as equal partners in planning priorities and selecting projects; (c) promote the formation of POs in poor communities to articulate their needs, design self-help programs, mobilize their own resources as well as outside resources, implement projects, and monitor and evaluate their own progress; and (d) keep track of the overall progress of poverty alleviation through a community-managed monitoring system in each barangay administered through local government units.

2.6 Regulatory Framework for Financial Institutions

The Nepalese financial system is divided into a formal sector under the regulation and supervision of the NRB, and an informal sector which is neither supervised nor regulated by any government agency. The formal financial sector consists of a wide array of banking and non-banking institutions performing various financial intermediation services. Following the financial reforms instituted over the past decade and a half, these financial institutions have engaged in a number of activities and have offered various financial products targeted to specific clientele in the formal financial markets. They have also expanded rapidly. In terms of resources, the formal financial system has been

experiencing double-digit annual growth since 1987. All these institutions are under NRB supervision and/or regulation, with the exception of credit unions/credit cooperatives which are under the Ministry of Agriculture and Cooperatives. However, the regulation of NRB is less strict compared to that of banks, one reason being that the latter are in the strict sense fiduciary institutions.

The NRB started a series of financial reforms for more efficient financial markets in the 1980s, and this is being continued till today. The reforms improved the financial policy environment and strengthened the supervisory and regulatory framework of financial institutions. Interest rate ceilings were removed; the Central Bank's subsidized rediscount window was made market-oriented; priority sector lending programme is gradually being phased-out, bank entry and branching policy was liberalized and the areas of allowable equity investments of universal banks were expanded. Since mid eighties, the government liberalized the entry of foreign banks into the domestic financial market, allowing over half dozen foreign banks to set up bank in the country. The aim is to intensify competition in the domestic financial market[8].

The financial sector reforms have created a more competitive financial marketplace, driving financial institutions, regardless of bank type, to compete with each other. Banks compete in deposit taking by offering a wide range of deposit instruments with diverse features and varied rates of interest. The innovative deposit products target different income groups. With extensive branch networks and automated teller machines, commercial banks have been able to mobilize majority of the deposits in the banking industry. On the other hand, credit unions and cooperatives offer members deposit instruments in the form of fixed deposits which earn interest but cannot be withdrawn until membership ends. They also offer savings and time deposits which pay interest and are withdrawable. Cooperatives and credit unions are outside the NRB's regulation and supervision, but they are supervised by the Department of Cooperatives under Ministry of Agriculture and Cooperative. These institutions have no minimum capital requirement, no reserve requirement on deposits and are exempted from taxes imposed on financial institutions. Their recent performance shows a remarkable ability to mobilize deposits from small savers[9]. The NGOs are mainly to position themselves as a facilitating agency.

The strict financial and credit policy framework of banking institutions since mid 1970s encouraged the establishment and growth of development banks, finance companies and

[8]Alongside this formal system exists an informal credit market which caters to the credit needs of low income groups, small and micro enterprises, small farmers and fisher-folk, and other marginal borrowers who were unable to access the formal financial market among others.
[9]See Linto (1994) for a more extensive discussion of Philippine credit unions/ cooperatives.

microfinance institutions. All these institutions will be subject to Central Bank control under the 1972 financial reforms. Financial institutions do not engage in deposit-taking activities but rely on their own capital for funds. Non-bank thrift institutions, pawnshops and investment companies follow the same practice. In terms of regional distribution, most of the financial institutions are located in concentrated in Kathmandu valley and plains and accessible hills. The inaccessible hills and mountains are mainly served by lending investors, pawnshops and, to a smaller extent, finance companies.

Cognizant of the need to provide access to credit to the basic sectors of the economy, e.g., small-scale agriculture, small enterprises, etc., the government put in place several policies on credit allocation and deposit retention. These are the following: (a) requiring 75 percent of the deposits generated from a regional grouping to be invested in that area; (b) mandating banks to set aside 25 percent of their net incremental loanable funds for agricultural lending, 10 percent of which is to be lent to agrarian reform beneficiaries and 15 percent for general agricultural lending (agri-agra loan quota); (c) mandating all lending institutions to lend at least 10 percent of their total loan portfolio to small enterprises whose total assets amount to P10 million and below; (d) liberalizing bank branching regulations; and (e) implementing various directed credit programs for the basic sectors.

3. FINDINGS AND ANALYSIS OF ISSUES AND CONSTRAINTS

This study uses a purposive sample of seven leading microfinance development banks (MDBs), six financial intermediary NGOs (FI-NGOs), five Savings and Credit Cooperatives (SFCLs) and ten Savings and Credit Cooperatives (SCCs). The MDBs and FI-NGOs has successfully used the Grameen technology in reaching the poor. This section used case studies of these MFIs to analyze their performance, issues and constraints. Information on the legal identity, organizational history, objectives, etc., of individual sample MFIs are presented in their respective case studies. The entire analysis has been divided into four subtopics: (1) outreach to the poor; (2) viability and sustainability; (3) resource mobilization; and (4) policy environment.

3.1 Outreach to the Poor

Outreach to the poor depends on a variety of factors, namely: (1) effective targeting and exclusivity of focus; (2) institutional capacity; (3) range of financial services provided; (4) technical assistance for poor clients; and (5) regular or periodic impact evaluation of credit programs for the poor. Each of these topics aspects are discussed hereunder.

3.1.1. Targeting and Exclusivity

Mostly sample MFIs target to the poor women using the Grameen Bank technology. On the other hand, some FI-NGOs, SCCs and SFCLs target their services to both poor and non-poor borrowers with a common argument that the profits from loans to the nonpoor are used to subsidize the (losing) less profitable services to the poor. In general, Nepalese MFIs identify the poor through a means testing, an examination of their asset ownership, a housing index which reveals the income or wealth status of the prospective client and participatory wealth ranking techniques. Interviews and home visits complement these targeting techniques. They also conduct a general assessment of the clients' incomes and ownership of simple assets such as farming implements, farm animals, home furniture, as well as of the types of houses, building materials used in house construction, access to or availability of water and sanitation, and educational attainment of the household head and family members.

The methods followed by the leading MFIs for implementing the microfinance programme include the following: (a) area scanning to identify the area with a large percentage of families living below the poverty line; (b) orientation screening to introduce their programme, orient and train the groups on the value of discipline and team responsibility; and (c) individual background investigation to effectively target clientele. Tables III-I and III-2 show the sample MFIs' outreach to poor borrowers and savers, respectively.

Table 3.1: MFIs' Outreach to Poor Borrowers

Table 3.2: MFIs' Outreach to Poor Savers

In sum, the poor borrowers and savers predominate, indicating an almost exclusive focus on the poor. This shows the effectiveness of the targeting mechanism used by the MFIs in identifying poor clients[10]. The credit NGOs and the private bank replicating the Grameen technology use an effective means to identify and reach the poor. However, their outreach is still limited to a few thousand poor borrowers[11]. The credit NGO

[10]It could also be that, by the very nature of these MFIs, the poor would naturally be drawn to them as potential clients-a case of self-selection.
[11]Even the largest credit NGO which has been in operation for the past 10 years had less than 20,000 clients and most transformed into MDBs.

community, composed of about 500 individual institutions, estimates their outreach to cover some 30,000 borrowers[12].

3.1.2. Institutional capacity

The 1994 Rural Credit Survey showed that only about 20 percent of ultra-poor families had access to credit. Some .... percent of credit came from friends and relatives, ... percent from private moneylenders, and 13 percent from cooperatives. Only very few of the poor were able to get a loan from government specialized banks and private banks[13]. Table 3.3 shows more recent estimates of MFIs' outreach. The community oriented MFIs like SCCs and SFCLs have fairly large outreach compared to commercial oriented MFIs such as MDBs and FI-NGOs. This is partly due to their more extensive delivery network and relatively larger financial base[14].

Various livelihood/credit programs implemented by the government to address poverty problems include a micro-credit component. Over two dozen integrated rural programmes targeted to the border line poor, poor and ultra-poor (Table 3.4) implemented through various government agencies and specialized government banks has significant outreach. For example, the Ministry of Local Development has promoted thousand of Savings and Credit Groups (SCGs) to promote livelihood of the rural poor using the funding from UNDP and from budgetary allocation. As of December 2006, the seven UNDP supported programmes with micro-credit component has cumulative outreach of 1033,000 households organized into over 40,000 SCGs.

Despite all significant attempts of the government both through private, government and non-government sector, the overall outreach to poor borrowers has been very limited due to gross inefficiency and high costs of extending microfinance services in inaccessible hills and mountains. Recent research has shown the un-sustainability of government supply-led credit programs, the likelihood of leakage of the benefits of government credit programs to the non-poor, the duplication and overlapping of a number of credit programs leading to gross inefficiencies, the distortion of the financial market, and the weakening of private sector incentive to innovate[15]. On the part of the private sector, the private banks, except for some rural banks and cooperative rural banks, have not serviced the financial requirements of the poor because of the high

[12]NPC, "Poverty Reduction Strategy Paper", 2002.
[13]A more recent set of estimates noted that the "basic sectors" composed of rural residents and farmers, operators of small enterprises and the self-employed and the ultra poor had great difficulty in accessing the formal financial system (Dhakal 2007).
[14]Number of SCCs and SFCLs is 2959 and 190 as of July 2006.
[15]This has been documented in various research on the implementation of agricultural credit programs.

transaction cost, the lack of information to and understanding by the poor, and the absence of a financial delivery *m*echanism suitable for delivering financial services to the poor.

The MFIs use a variety of funds, namely: (a) donor funds; (b) concessional loans from the government agencies and specialized government banks; and (c) credit lines from the private banking sector for their lending operations to the poor.

The commercial oriented MFIs (MDBs and FI-NGOs) almost exclusive focus on the poor but they are hampered by their weak institutional capacity. In interviews conducted by these authors, the inadeq*u*ate institutional capacity of MFIs in handling microfinance emerged as the principal reason for the slow availability of the credit lines. The non-formal character of their organization partly explains this weakness. Without a legal personality as full-fledged financial institutions, most MFIs can neither raise sufficient equity nor tap deposits to sustain their operations. Lending funds are available from many sources but the weak absorptive capacity of MFIs such as MDBs and FI-NGOs appears as a binding constraint to a greater outreach to the poor.

The problem is further compounded due to the absence of an extensive and viable network for delivering financial services to the poor. The nationwide branch network of various types of commercial bank having potential for banking with the poor has not been properly used for extending the microfinance services in rural areas. The main drawback lies in the apparent reluctance of these banking networks to deal with this type of clientele. The great potentials of the community based oriented MFIs have not been properly used. In fact, there is renewed interest to use SCCs and SFCLs into microfinance programs. Perhaps, as more information on the profitability of banking with the poor is made available to them, and as more of the experience with banking with the poor is shared with private MDBs, the rural banking system will in time pick up the challenge. Table 3.5 presents the situation of the Nepal NGO in Nepal. There are more than 40,000 registered NGOs and more than 20,000 are affiliated with Social Welfare Council as "development NGOs" of which some 100 are the so-called "credit NGOs," and 47 employ commercial lending obtaining license on microfinance operation. These NGOs partly cover their costs. On the other hand, the community based MFIs like SCCs and SFCLs have a nationwide viable delivery network[16]. However, little is known yet about their actual outreach to the poor through micro-financial services, except the information gathered through several quick field appraisals. However, despite the more extensive

[16]The rural banking system was weakened by [he high default rates and non-repayment of loans under the government's s*u*bsidized agricultural credit programs during the 1970s and 1980s. The BSP had to implement several rehabilitation programs to revive and strengthen the system.

network of SCCs and SFCLs, they lack the same familiarity with and substantial exposure to the poor as do the FI-NGOs. Those institutions with almost exclusive focus on the poor do not have institutional capacity to reach a greater number of the poor.

The MFIs provide their field staff with basic training to identify target clientele, loan processing, appraisal and recovery. The existing lending technology for the poor (e.g., Grameen, group lending and various adaptations of these approaches) is labor-intensive, requiring great patience, dedication and technical skills on the part of field staff. Field staff is carefully selected based on their high motivation in helping the poor, educational background and willingness to work with the poor.

Staff turn-over is one of the problems among Nepalese MFIs due to relatively low salaries scale and level of efforts demanded on delivery of microfinance services. In general, after 1-2 years of continued experiences in the sector, they become eligible for related jobs in various livelihood programs implemented by government, non-government sectors and private banking sector. The high turnover of field staff and the difficulty of retaining present staff prevent buildup of capacity to provide efficient and effective microfinance services to the poor.

*In sum, both the weak institutional capacity and t*he *lack of an extensive and viable delivery system prevent MFIs fro*m *reaching a greater number of clients*. *The principal problem faced by MFIs is the lack of legal personality and authorit*y *to act as real financial intermedia*ri*es as well as lack of an extensive and viable financial delivery system that* ha*s substantial focus on t*he *poor*. *Motivation of MFIs' staff to work with poor clients is lacking while t*he *MFIs face problems of rapid staff turnover*.

3.1.3. Range of Financial Services Provided

Nepalese MFIs in general provide simple loans and savings facilities for poor clientele. This is consistent with the nature of the demand of the poor for financial services. Most MFI provides loan facilities bulk of which went to poor clients. It is to be noted that not all of the sample MFIs have the poor as their exclusive clientele, except those practicing the *G*rameen technology[17]. The MFIs also provide "savings" facilities[18] to poor clients. Because MFIs are required to confine savings mobilization among their target clients only, they have invented several innovative products such as the "mutual aid fund", "the

[17]Most community based MFIs like SCCs and SFCLs provides loans both to poor and non-poor clients.
[18]Technically, the credit NGOs are not authorized to accept deposits. The "savings" deposits mentioned here refer to the obligatory or forced savings deducted from the loan amounts granted to borrowers. Also, the groups mobilize savings from among the members and deposit them in a bank through the representation of the NGO. The exception is the cooperative rural bank which is authorized to mobilize voluntary savings.

capital buildup," and the "group fund" which includes some features of savings mobilization.

Loans extended by the MFIs carry short-term maturities and are used primarily for working capital and immediate consumption needs. The community based MFIs (SCCs and SFCLs) try to offer competitive rates on deposits, usually I to 2 percentage points above those offered by commercial banks in addition to offering innovative "savings" products to mobilize savings from their clientele. The immediate constraints to most NGOs involves in financial intermediation is low capital base (poorly capitalized) that deter them to offer more innovative financial products with longer term maturities, and the lack of information regarding financial services/products that will satisfy target clientele. As the economy develops, there will be an increased demand for more varied (and ultimately, sophisticated) financial services and loans with longer maturities in order to address certain investment needs such as purchase of more modern farm implements, basic equipments, etc. Thus the MFIs must strive to improve their limited capacity to supply innovative financial products. The estimated amount of total financial services as of 1995 provided by the sample MFIs is shown in Table 3.8. The average loans outstanding and the average savings mobilized are shown in Tables 3.9 and 3.10. This indicates the potential of sample MFIs to provide a full range of financial products and services once the limitation of the NGO organizational structure has been overcome.

In sum, the limited capacity to develop and offer legally innovative financial products hampers the cause of most Nepalese MFIs. This limitation arises from their limited experience or lack of familiarity and experience in product development and innovation. More importantly, the informality of their organization makes any attempt to mobilize deposits, develop various financial products and offer them to the public illegal.

3.1.4. Technical assistance for clients

On the part of the target clientele, training consists of orientation in the value and use of credit, the need to have credit discipline, group cooperation and organization, and the handling of the savings fund of group members. Table 3.11 shows the range of technical assistance provided to beneficiaries. The use of peer pressure and the threat of cutting access to future credit in case of loan default are important motivational strategies employed by the MFIs to ensure high loan repayment rates. The problem is not the lack of interest on the part of the poor clientele to train and acquire various skills related to credit and savings, but the cost of training incurred by the MFI.

Training or social preparation is a significant component of the transaction cost of lending to the poor. A social mobilization cost to a microfinance programme is as much as Rs. 0.11 for each rupee loan granted (Dhakal 2004). The case studies of MFIs also confirm this observation. An estimate of the unit cost of various training programs is shown in Table 3-11. At present, social preparation or training is conducted mostly at the own initiative of the MFIs. Except for some insignificant financial assistance coming from government agencies[19], the MFIs have to rely either on their own meager funds or external donors to cover the costs of training.

The current issue is who will finance the training of clients, i.e., social preparation. One view is that this is a public good whose production must be shouldered by the government. This view states that subsidies for training must be made available to MFIs which implement microfinance programs for the poor. The contrary view states that the cost of training should be incorporated in the lending rate charged by the MFI or absorbed by the MFI itself as part of the cost of doing business. This is practiced by most MFIs which charges a training and monitoring fee of 2 percent of the loan amount.

It seems that there is some capacity to transfer the burden of the training costs to the clients themselves who have no alternative but to absorb them. However, this view might lead to underproduction of social training because the MFIs may not want to increase the cost of lending to poor clients; they may not want either to absorb the cost of social training. This could lead to a suboptimal level of social preparation / training. The benefits of having "trained clients" will not be totally appropriated by the MFI which initially trained them because clients shop around for the lowest borrowing cost. It is also possible that over time the "trained client" will need to go to another lender who can satisfy his increased demand for credit because his old MFI can no longer meet that demand. Thus, some amount of shirking of the training responsibility may occur, leading to a social loss.

In sum, training of potential clients represents a sizable investment cost that the MFIs may not be able to absorb. While the government and donors may be willing to provide funding for training, a compromise solution lies in asking the MFIs to shoulder part of the training costs. Thus, a matching of government funds with MFI funds for training may lead to better performance because of the risk-sharing involved.

[19]The ACPC provided the Grar*a*een replicator with a grant covering the initial year's salary and training expenses of field staff who will handle the replication.

3.1.5. Impact evaluation

The MFIs do not, in general, conduct formal internal impact evaluations of their credit programs for the poor because of the attendant costs. However, they do make informal and quick evaluation of program implementation which guides their decisions such as retraining of field staff, expansion of coverage, etc. Some MFIs have conducted impact evaluation of their operation through grant funding from donors, but in general lack the features of the independency. In general, the periodic impact evaluation is vend important because the information generated will be useful in measuring the success of microfinance programs, addressing various problems, improving the project / program supervision, and designing future projects.

3.2 Viability and Sustainability

3.2.1. Financial policies, delivery mechanism and management

The MFIs' viability and sustainability are critically linked to their financial policies, delivery mechanism and loan collection techniques. With respect to financial policies, adherence to "sound credit practices and response to market signals" (Sacay and Randhawa 1995) is practiced by the sample MFIs. They lend at market-based interest rates and are aware that they must at least cover their operating costs. A nominal rate of 18% percent per annum exclusive of a service charge (typically, 1 percent of the loan amount) and application fee is common[20]. The sample MFIs employ sound credit screening and appraisal techniques and provide non-collateralized loans to the poor. The non-conventional loan security instruments used consist of joint liability agreement, peer pressure and pledging of group savings. Thus, loan repayment rates are generally high usually on the order of 95 percent.

The MFIs have used a variety of incentives to ensure loan repayment and financial discipline. Forced savings have been extracted from the borrowers which serve both as a pool of funds to be used for emergency purposes and as collateral to the loans extended by the MFIs. While credit policies, loan screening, appraisal and collection techniques appear sound, the sample MFIs have inadequate financial reporting and monitoring practices which make it difficult to determine (a) past due loans; (b) proportion of nonperforming loan portfolio; and (c) the extent of the arrear problem. Without an adequate financial reporting and monitoring system, the MFIs will find their liquidity

[20]For example, one credit NGO charges a nominal rate of 30 percent per annum or 3.5 *p*ercent per month and requires a *s*ervice fee of 1 percent of the loan amount--P10 for the (loan) record book and P10 application fee.

severely constrained and their capital impaired by nonperforming loans. The monitoring system that tracks loan delinquencies and arrears and evaluates aging of problem loan accounts to give timely advice to management is totally absent. The lack of adequate and uniform performance standards is evident among the MFIs. For example, the Grameen replicators are urged to use as benchmark for "on-time" repayment rate the ratio of "interest and principal collected during the year" to "interest and principal due during the year." This definition is too lax and grossly underestimates the severity of the loan collection problem.

Similarly, defining "default rate" as the ratio of "principal and interest not paid at the end of the loan term" to "total loans outstanding at the end of each year" also encourages laxity in loan collection and unnecessarily creates a credit risk because management loses sight of the need to take immediate remedial action on nonperforming loans. Thus, at any given time, the MFIs cannot determine accurately what proportion of their loan portfolios will be at risk given the incentive for financial indiscipline.

The absence of adequate and sound performance standards and of a standardized accounting and reporting system also makes it difficult to evaluate relative performance of MFIs. A commercial bank or donor which is willing to invest in microfinance programs will find it very difficult to assess the financial position of the MFIs. This will result in underinvestment in potentially rewarding enterprises.

In sum, internal financial policies and practices need a lot of improvement, particularly in the installation of sound financial reporting and monitoring systems, portfolio management, assessment and management of risks, product packaging and pricing, management of loan arrears and strategic business planning. Related to these will be the need to upgrade and institutionalize performance standards, particularly in loan repayment, appreciation of loan default and aging of delinquent accounts, and the installation of appropriate accounting and internal audit systems.

3.2.2. **Management and administration**

Management and administration of MFIs exert a great influence on their viability and sustainability. Huge overhead expenses relative to financial services delivered erode their profitability and sustainability. Most MFIs are generally inefficient and not cost-effective. They have high management and overhead expenses relative to the number of clients served and volume of business generated.

In 2005/06, the gross return on average loans outstanding ranged from 8 percent to 36 percent (Table 3.12). The performance results are somewhat mixed, with some MFIs even showing a deterioration as shown by the big drop in this figure overtime. The cost per average rupees loan outstanding is relatively very high, especially for the credit NGOs but with the exception of member based MFIs i.e. SCCs and SFCLs (Table 3.13). A more complete picture of the cost of delivering the financial services (i.e., loans and savings facilities) is shown in Table 3.14. Community based MFIs are relatively more efficient and cost-effective than the commercial oriented MFIs. Available information on relative overhead expenses is captured in Tables 3.15 (number of field staff to head office staff), 3.16 (salaries as a percentage of total financial services) and 3.17 (administrative cost per rupees of assets).

The huge overhead expenses would have been offset by a greater number of clients and a wider range of financial products; but with a weak institutional capacity and a small financial base, this is just not possible at the moment. It is also important to note that a reason for the cost-ineffectiveness of community based MFIs is the lack of consistency between the perceived vision and mission of the MFI and the actual requirements of the business of delivering financial services. While top management is conscious of the need to be cost-effective and promote financial discipline in the organization and the clientele being served, the field staff has difficulty reconciling social orientation of their organization's vision and mission with business side of financial services delivery. Thus, the field staff gives a lot of emphasis to training and community organizing rather than the development and packaging of financial products, and other profit-making activities. Because training and community organizing costs are generally activities that generate costs instead of revenues, overhead expenses increase unless these costs are absorbed by an external donor or by a government grant.

In sum, the MFIs must streamline their operations by a conscious cost reduction policy, develop new clientele and innovative financial products, and expand their financial base and outreach capacity.

3.2.3. Degree of self-sufficiency

In general sample MFIs are operationally self-sufficient while very few are financially self-sufficient. In 2004/05, only one commercial oriented MFI was operationally self-sufficient, although two of them nearly posted operational self-sufficiency with ratios of 0.66 and 0.67, respectively (Table 3.19). The financial self-sufficiency ratio shows that only the community based MFIs became financially self-sufficient, a result which is

hardly surprising, given our analysis of the constraints faced by non-formal financial intermediaries such as the FI-NGOs (Table 3.20). Attaining full self-sufficiency takes time, and the constraining impact of the organizational form of the FI- NGOs makes this task arduous. While they effectively target and reach the poor clientele, they could not be as effective and efficient given their weak institutional capacity and financial position. These institutions seem capable of continuing with their delivery of financial services to the poor only because of access to grants and concessional loans. However, as earlier pointed out, grants and concessional loans are becoming scarcer as hen's teeth as time goes on[21].

3.3 Resource mobilization

Viability and sustainability are conditional on the ability of the MFI to mobilize substantial resources which can be leveraged. Despite sound credit practices and management, the lack of resources, be it in the form of equity capital, borrowings and deposits, spells the difference between a self-sustaining MFI and one which is subsidy dependent[22]. There are several creative and innovative ways by which MFIs could mobilize resources but the lack of legal personality and authority hampered the effort. The absence of prudential regulations to safeguard interest of depositors and shareholders also makes it untenable for creative ways to mobilize resources.

The inability to mobilize deposits is offset by the access to cheap funds from external donors and government concessional loans. Grants and concessional loans are disappearing phenomena in an era of budgetary crunches. The emerging policy and institutional framework in the country now leans toward reliance on private resources to deliver goods and services to the public as much as possible, and to the use of scarce grants/government funds to create an enabling framework for private institutions to operate more efficiently. It is in this context that the mobilization of private deposits assumes an important role in the viability and sustainability of MFIs.

The immediate results of the dependence on grants and concessional loans are the unwarranted bias for lending and the failure to develop deposit instruments suitable to poor clients. It has been argued by some researchers that demand for savings and other financial services may even exceed the demand for credit; thus, an excessive emphasis

[21]Only myopic politicians and bureaucrats believe that the barrel of goodies such as concessional loans is bottomless, but at the expense of taxpayers and depositors.
[22]The subsidy comes either as grants or concessional loans from government / donors.

on loan provision may be a disservice to poor people[23]. Consequently, most commercial oriented MFIs have not developed as "full service" financial institutions that could have provided the poor with better and more financial services. From the point of view of the MFIs' interest, it can be argued that "self-sustainability of (rural) financial institutions is based on the ability to mobilize resources and attain financial viability[24]." Indeed, while MFIs appear free to craft appropriate financial and credit policies, they are hamstrung by their meager financial resources which limit their leverage capacity. Thus, most commercial oriented MFIs (especially FI-NGOs) depend very much on grants, subsidies and concessional loans which ultimately undermine their viability and sustainability. The dependence on donor grants makes their financial and credit programs donor-driven, i.e., serving the objectives of the fund source. An immediate effect is the practice of using scarce management and technical resources for preparing proposals that solicit donor assistance. Some MFI even employs two staff members who do nothing but prepare project proposals which target particular donors. The ultimate result is that the financial and credit programs become too sensitive to the biases of project finance to the neglect of real financial intermediation.

In sum, the MFIs have all attempted to mobilize resources but the informal character of their organization hampers the effort. Resources used are mostly grants and subsidies coming from donors and the government which ironically stunt their growth into viable and sustainable financial intermediaries.

3.4 Policy, Macro Factors and the Environment

A growing economy and a more competitive financial marketplace is a pre-requisite to stimulate the demand for more micro-financial services. A conducive financial policy environment is essential for improving the efficiency and effectiveness of MFIs in reaching a greater number of poor people (see Annex A for a list of recent financial sector reforms). The prevailing growth trend of the economy and the liberalized economic and financial environment doe not augur well for microfinance programs and the MFIs.

With interest rate deregulation and a liberal bank entry and branching policy, there is room for the creation of more MFIs/branches of MFIs or the transformation of the micro

[23]This paraphrases Dale Adams, for example, who pointed out that poor people cannot be made better off with more indebtedness, and that there exists evidence (e.g. ownership of jewelry and other tangibles) that demand for savings services outweighs demand for credit.
[24]See Sacay and Randhawa (1995). They argue that BAAC attained financial viability and eliminated subsidy dependence when major steps were taken to generate more deposits. BAAC found that deposits were a cheaper source of funds than borrowings.

credit NGOs into MFIs and other form of financial institutions. Another tack is to maintain the NGO's social development thrusts and to leave financial intermediation to a separate organization, i.e., a formal financial institution that will be organized by the NGO. Alternatively, the NGO can buy into an existing formal financial institution. This paper is not intended to evaluate each of these transformation strategies. However, we would like to think that this strategy seems to be a realistic approach to the problems of lack of outreach, viability and sustainability of microfinance services to un-served.

Under the present legal and regulatory framework, a NGO involved in microfinance can either be FI-NGO or transform its activities into MDBs. These options take advantage of laws already in place. As formal financial institutions, the credit NGOs will be private and autonomous institutions that can generate their own equity, mobilize deposits and offer a wider range of financial products to the target clientele. More specifically, as a bank, they can mobilize deposits from the public; as a credit cooperative or credit union, they can gather deposits from members.

A common and mistaken argument raised against the proposed transformation of NGOs into formal financial institutions, e.g., as private banks or finance companies duly supervised / regulated by the NRB is that they run the risk of losing their sense of mission for the poor[25] which will not necessarily result from such transformation. On the contrary, doing so would put in place the legal structure to deal with different clientele, generate additional capital and mobilize deposits, thereby strengthening their capacity to serve the poor. At this point there is a need to make a distinction between the organization and the individuals managing the organization. Thus, losing one's sense of mission for the poor during or after the transformation only magnifies what has been there all along - an empty commitment to the poor.

At present, most NGOs operate microfinance in a policy vacuum[26]. There are no clear policies and no supervisory/regulatory framework governing their credit intermediation activities. Since credit NGOs are not duly authorized banking entities, they cannot legally mobilize deposits[27]. There is no oversight body to supervise/regulate their financial activities. Thus, there are neither performance standards that will be important for monitoring financial standing of those organizations nor prudential regulations to protect depositors, creditors, etc. Either the banking or the credit cooperative route could

[25]One member of the Board of Trustees of a credit NGO which submitted an application for a banking license resigned on the ground that the NGO has lost its moorings, i.e., focus on the poor, by attempting to organize a bank.
[26]This paragraph is drawn-from Llanto and Agabin (1996).
[27]Cooperatives and credit unions can only mobilize deposits from their own members. NGOs are reported to have an informal "deposit-taking" relationship with "members." This is like skating on thin ice because of potential legal sanctions against this illegal activity.

eliminate the need to reinvent the wheel of supervision and regulation since the oversight authorities are already in place, namely, the NRB for banks and the Cooperative Development within MOAC for credit cooperatives.

There are pressing arguments on why NGOs involved in microfinance operation should consider converting themselves into formal financial entities. The present deregulated and financial environment has made financial markets more dynamic and competitive. There are greater numbers of financial institutions with new and innovative products and financial technologies than the Nepal has ever seen before. Over time many small unit banks such as present FI-NGOs, SCCs and SFCLs will have grown and transformed themselves into bigger entities which will cater to a different set of clientele and offer different financial products. The promise of potential profits and the impact on development will undoubtedly attract new formal and informal institutions into the financial markets. In this context, the FI-NGOs are potentially the formal financial institutions which will address the demand for financial services of the poor. They can do a better job by being formal financial institutions, with full powers and authority to engage in real financial intermediation activities.

The lessons of experience from other countries (e.g., Grameen in Bangladesh, BancoSol in Bolivia) show that the transformation of NGOs into full-fledged formal financial institutions was a necessary condition for them to be viable and sustainable in the long term. Lessons from the transformation suggest that to do otherwise is to continue operating through donor or government subsidies. In an era of declining subsidies, the choice seems clear. How many local credit NGOs are ready to transform themselves into formal financial institutions is currently unknown. Presently, four NGOs have already become rural banks. Current government policy uses the specialized government banks to wholesale loans to MFIs, and mandates the Rural Microfinance Development Centre, Rural Self Reliance Fund and Sana Kisan Bikas Bank to assume the responsibility of providing loan funds and technical assistance to improve and strengthen both commercial oriented and community based MFIs based on performance criteria. While the loan quotas for intended beneficiaries are still binding on financial institutions, this legal mandate is currently under review[28]. The NRB and MOF is leading efforts to rationalize the credit component under existing integrated rural and urban development programmes which have been criticized for being inefficient, highly politicized,

[28]The ACPC and the Bankers' Association of the Philippines argue that the loan quotas, together with other impositions on finarIcial institutions, e.g., gross receipts tax, serve only to increase the financial intermediation cost, and thus must he scrapped. Congress has a different view of loan quotas, i.e., those imposed by PD 717 (agri-agra loan quota) and RA 6977 (mandatory lending to small and medium enterprises). Several bills have been filed to retain them and to eliminate the purchase of government securities as an alternative mode of compliance with the loan quotas.

uncoordinated and unsustainable. The presence of these credit programs sends a confusing signal to MFIs and clients alike. While ostensibly the government promotes savings mobilization and equity buildup for sustainability, making available highly subsidized credit funds to MFIs erodes the resource mobilization effort and promotes financial dependence on government.

Government of Nepal has also put in place a Social Reform Agenda with a particular focus on poverty alleviation. It has also recognized the use of microfinance as an instrument to alleviate poverty and diverted its attention towards more pro-poor growth and development. In addition, the government budgets also include a poverty alleviation budget which is used for livelihood, potable water development and sanitation, health and nutrition, basic child care, environment resource management, basic education, resettlement and housing.

The commercial banks admit their limitations in regard to microfinance programs. However, the private banking sector can help create an enabling environment for microfinance. It can finance rural infrastructure projects; it can also encourage corporate clients to locate their projects in the countryside[29]. On the other hand, the private sector has also responded by creating the apex financing facility through a pool of private funds intended for the capability building of credit NGOs. Likewise, the two networks of credit NGOs have successfully worked with donors in raising capability building funds. The donor community has also provided assistance to MFIs capability building. The Asian Development Bank, together with the International Fund for Agricultural Development (IFAD) and World Bank, has provided the government with a concessional loan and grant funds for the replication and expansion of the Grameen approach.

4. CONCLUSIONS AND RECOMMENDATIONS

The conclusions and recommendations address four areas that will enable MFIs to be self-sustaining financial institutions serving the poor. These four areas are as follows: (a) outreach and impact; (b) viability and sustainability; (c) resource mobilization; and (d) policy.

4.1 Outreach and impact

[29]In March 1996 the World Bank sponsored a seminar on innovations in micro-financing at the AIM. An official from BAP said that "big banks do not have the skills nor the temperament to deal with the inherent risks that do with micro-financing."

Most MFIs are able to reach the poor because of an effective targeting mechanism which rules out the leakage of benefits to the nonpoor. A highly motivated field staff also contributes to effective targeting. The MFIs seem to satisfy their poor clients' demand for short-term loans (e.g., working capital); and some even provide the clients with savings facilities. However, their outreach is limited to a few thousand clients because of their weak institutional capacity, small financial base, high turnover of staff, and high cost of training clients (or social preparation). A comparison of the performance of the sample MFIs indicates that only the community based MFIs like SCCs and SFCLs has the capacity for full financial self-sufficiency. This is not surprising given the advantages and authority given to a formal financial institution such as SCCs and SFCLs. To address outreach problems and the lack of a viable and effective delivery system, it is argued that huge investments to support the emergence and growth of SCCs and SFCLs must be made. A common sensitivity model employed by SCCs and SFCLs indicates that to reach 400,000 borrowers over a five-year period, capacity of hundreds of SCCs/SFCLs must be strengthened. Because of the labor-intensive nature of microfinance lending technology such as the Grameen approach, sizable number of workforce must be trained. This will require tremendous efforts on capacity building of SCCs and SFCLs and human resource development. In order to expand the outreach of microfinance services to a larger number of people in a shorter period of time, sizable resources for developing the viable and sustainable financial institutions, such as SCCs, SFCLs and FI-NGOs on microfinance technologies. This in our mind is a more cost-effective approach to the problem of outreach and sustainability of microfinance programs. As Table 3.3 shows the actual outreach of community based MFI is far greater than those of commercial oriented MFIs.

Investing in the creation of new MFIs (be it community based or community oriented) appears to be more costly and risky than investing in training of existing formal financial institutions in microfinance technologies. The FI-NGOs will forever be in a disadvantaged position compared to other financial institutions. They cannot exercise the full range of financial intermediation activities. For example, they lack the legal authority to mobilize deposits and can only leverage to a very limited extent their meager fund balances. Because they are neither finance companies nor non-stock savings and loans associations nor credit cooperatives/credit unions, their borrowing capacity is limited, making them very dependent on grants and soft loans from the government. This also adversely affects their viability and sustainability.

With respect to the problem of motivation and attitude, the MFI staff must deal with traditional attitudes that regard credit to the poor as "social credit[30]" leading to inappropriate pricing of loans, laxity in collection and unsustainable lending programs (Llanto and Agabin 1996). This view of credit as "social credit" is an invitation to non-repayment of the loan because it is "government money" to which everyone else is entitled.

This view is reinforced by a proposed law that seeks to create a network of "community banks of the poor" to be capitalized by the government. The proposed law only serves to strengthen the attitude that government has to be heavily involved in micro-financial markets to ensure the poor's access to financial services. Citing as reasons the imperfection of the financial market and market failure, proponents of the "community bank of the poor" have tried very hard to convince government and the legislature to pass the proposed law.

This naive view of the appropriate role of the government in the financial market ignores the failure of past government intervention in the credit markets through subsidized credit programs, and the inefficiency and waste of scarce public resources arising from the present overlapping and duplication of at least 20 government credit programs. Indeed; government intervention may be warranted only if the government can demonstrate that it can do better than the imperfect market, and that the net social benefits of government intervention are positive.

Based on the above findings and conclusions, it has been recommended to transform NGOs involved into micro-finance into full-fledged formal financial institutions (e.g, private MDBs or Fi-NGOs), or alternatively, such NGOs can organize or invest in formal financial institutions, upgrade the institutional capacity of the MFIs interested to promote linkage banking with private banks interested in providing microfinance services for the poor, invest in training existing rural banks, cooperative rural banks and credit unions / credit cooperatives in microfinance technologies; externalize the training costs of the poor by allowing MFIs access to grants and government financial assistance, but following the principle of matching grants with MFI own funds; continue staff training and the development of career paths for capable workers, upgrade pay scales and incentive schemes to retain good personnel; and rationalize government credit programs and reallocate existing funds for livelihood projects to capacity building and training of existing MFIs.

[30]This is quite prevalent among politicians who unabashedly promote patronage and continuing dependence of the poor on them.

4.2 MFI viability and sustainability

To continue providing financial services to the poor on a sustained basis, the MFIs themselves must be viable and sustainable. The study shows that many of the MFIs are far from attaining this goal. The MFIs' viability and sustainability depend first and foremost on the nature of their organization and the business and investment activities which they are allowed to undertake within the legal and regulatory structure of the country. Any limitation on their investment and business activities (e.g., prohibition to mobilize deposits from the public, investment in allied undertakings) constrains profitability and growth. The MFIs have relatively little financial resources which limit their leverage capacity. The dependence of the NGOs involved in microfinance on grants and subsidies also undermines their viability and sustainability. Thus, they have to raise more funds and become more efficient credit intermediaries.

The second major factor which determines viability and sustainability is the set of internal financial policies and organizational practices and procedures. In addition, the capability for governance, leadership and management affects their performance. Improvement of management skills and professionalization of staff, appropriate market-oriented pricing of financial products and services, and greater effort in loan recovery are needed to make the MFIs viable and sustainable. Thus, the key issue is building sustainable institutions by having (a) the appropriate organizational form; (b) a strong equity and financial base; and (c) suitable systems and procedures.

Based on above findings and conclusions, it has been recommended to build up the equity base of MFIs by infusing more capital from existing owners and new investors; diversify loans, savings and other financial products/services according to client demand; maximize savings mobilization opportunities; promote training in financial operations, resource mobilization, portfolio management, risk assessment and management, product packaging and pricing, management of loan arrears, strategic and business planning, among others; improve systems and procedures such as automating systems and operating procedures, upgrading and institutionalizing performance standards, setting up internal audit systems, conducting periodic management audits, installing an updated and standardized accounting and reporting system; and professionalize the management and staff of MFIs.

4.3 Resource mobilization

The "forgotten" half of finance is deposit mobilization[31], and this is conveniently forgotten in the face of donor grants, subsidized credit funds from government, and other dole-outs. To stay competitive and viable, the MFIs must raise substantial deposits and develop various instruments, especially for the small savers, which will help them build up their financial base. Thus, they not only have to mobilize traditional deposits but also seek to broaden and deepen the financial products and services offered to meet existing demand at the lower end of the financial market. Broadening and deepening mean the development of new product lines and services, and the design and implementation of new microfinance technologies and practices which will strengthen their financial base.

Based on above findings and conclusions, it has been recommended to invest in the development of new product lines and services, new microfinance technologies, adaptation of the "best practices in microfinance " etc., with counterpart funding from donors and the government by the MFIs; reallocate its resources in various livelihood programs for the broadening and deepening of micro-financial services by the government; and allocate resources for the broadening and deepening of micro-financial services instead of providing loanable funds to MFIs by to the donors.

4.4 Policy issues

The necessity of bringing all the actors involved in microfinance operation under a supervisory and regulatory framework cannot be underestimated[32]. Problems like absence of performance standards, lack of uniformity and dilution of standards of credit evaluation, lack of portfolio supervision leading to poor loan recovery and deterioration of its quality and absence of prudential regulations over such activities as deposit taking persist on the absence of such a framework. The installation of a supervisory and regulatory framework complements the building of the institutional capacity of MFIs, especially the NGOs involved in microfinance operation. In this way, we will have strong MFIs which will no longer operate in a policy vacuum.

The alternative to a formal supervisory and regulatory framework is self-regulation by such NGOs. The argument goes that maintaining an informal self-regulatory framework will provide them with flexibility and room for initiative on various financial innovations to reach the poor. Furthermore, there will be no danger of losing focus on their target

[31]Dale Adams, Ohio State University.
[32]The rural banks and cooperative rural banks, finance companies, and credit unions/cooperatives are already supervised/regulated by the pertinent government agencies.

clientele which will be brought about by their transformation into formal financial institutions. However, the review made by this study points to the glaring need for performance standards, prudential regulations, etc., in short, a supervisory/ regulatory framework that will ensure the safety and soundness of those institutions and the integrity of their transactions. The argument on losing focus on the poor, as pointed out earlier, does not hold water. It is because an organization's vision, mission and goal are not dictated by the organizational structure (e.g., banking firm) but by the people manning it and the policies being pursued.

The transformation into formal financial institutions may not be everybody's cup of tea. It is not for every NGO. There will be some which will opt for transformation, but there will be others who will choose to remain as a development agency and, perhaps, organize a bank with a distinct charter, character and function. The important outcome of the latter strategy is the unbundling of banking and development/social preparation functions which will increase efficiencies in the financial markets for the poor because the (NGO) development agency and the NGO-organized bank/financial institution can exploit their respective comparative advantage. From the public policy perspective, it becomes clearer what activities in microfinance programs for the poor properly constitute the "social development costs" and what should rightly be considered "cost of providing the financial service," i.e., the cost of doing business. The first set of costs may be subsidized or given access to grants in view of the externalities present in social training / preparation of poor clients while the latter should be covered by appropriate pricing of the financial product. For the social development costs, the present thrust of raising private monies must be supported.

The above conclusions implies to recommend that the government should provide for an appropriate supervisory and regulatory framework for MFIs, especially credit NGOs; and support the costs of social preparation/ training through budgetary assistance that will be matched by private sector funds; while NGOs should maintain a dialogue with the government on the installation of an appropriate supervisory and regulatory framework for MFIs, and donors should assist on social preparation activities, development of microfinance products, training in microfinance technologies, and upgrading of performance standards, operating systems and procedures.

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