MICRO-FINANCE AND POVERTY REDUCTION IN NEPAL[1]

By

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ABSTRACT

Nepalese microfinance sector serves slightly more than 40 percent households below poverty line. Services of microfinance institutions are concentrated in accessible areas and very much limited in inaccessible and remote areas. This paper uncovers that clients use micro-credit both for production (66%) and consumption (36%) purposes. About 59% clients have improved income upon receiving microfinance services and are able to build financial, physical and human capital compared to non-clients. In addition, access to financial services has a positive impact on clients across a wide range of economic and social indicators, including increased income and self-employment opportunities, better access to education for children, economic empowerment, and reduction in informal interest rates. There is inverse relationship between depth of poverty and income generation impact of microfinance.

The study emphasizes that the task of reducing poverty is complex, which makes it all the more important to use various tools of poverty reduction effectively. Microfinance, being one such tool, can be very effective in addressing poor peoples' financial constraints thereby improving money management, reducing risk and accelerating investment. The study concludes that microfinance increases the income and welfare of the poor in Nepal by improving their access to productive assets and promoting enterprise development, income growth, ability to address vulnerability and economic empowerment. The study has suggested measures to improve development impact of micro finance services on attacking poverty.

1. INTRODUCTION

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

Poverty reduction has been an explicit goal of plans and programmes implemented by His Majesty's Government of Nepal (HMGN) since the mid 1980s. Poverty reduction is the sole objective of the 10th Plan (2002-2007). A strategy of broad based economic growth focusing on raising agricultural productivity and encouraging private sector led growth is

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emphasized in the plan along with extra efforts to make development inclusive of targeted programmes aimed at poverty reduction (NPC 2002). Despite, greater efforts of the government to address poverty problems, poverty incidence is either increasing or decreasing at a slow pace and over 31% people are still below national poverty line in 2004 (CBS 2004).

Nepal's Gross Domestic Savings is only about 14% of its GDP and the level of rural household savings is even much lower at 7% in 2001/02 (HMGN 2005). Low levels of household income have led to low levels of savings, and a limited extent of self-financing for farm and off-farm employment as well as income generating activities. Since mid 1970s Government has implemented a large number of targeted credit programmes to widen the access of the rural people, particularly the poor, to subsidized credit for promoting growth, savings mobilization and reducing widespread poverty (UNDP 2004b). The sector gained momentum after the restoration of democracy in 1990 when significant efforts were made by the government and non-government sector with or without assistance from bi-lateral and multi-lateral agencies to expand the frontiers of microfinance (DEPROSC and Ledgerwood 1997). Despite the increasing efforts put forward by government and non-government sectors to expand microfinance services, about 41.6% of the total HHs below the poverty line has access to microfinance services in Nepal (Dhakal 2005).

Globally, microfinance sector has emerged to be a dynamic sector, with increased enthusiasm among the donor communities and attracted academic and professional interest in view of its far reaching implications for local economic development (Weiss J. and H. Montogomery 2004). In recent years, there has been a paradigm shift on approaches to provide microfinance services from a "*welfare approach* or *directed credit approach*" to "*institutional approach* or *financial market approach*" based on the logic that subsidized credit programme led to high default rates and transaction costs for lending/borrowing, and act as a barrier to attaining financial viability thereby resulting in the failure of these programmes (Congo 2002). The *institutional approach* or *financial market approach* holds that subsidies are detrimental to the growth and development of the sector. The result of such paradigm shift has been a poorer allocation of financial resources to unsustainable institutions and vice-versa. At present attempts are being made to establish microfinance institutions (MFIs) offering financial services on sustainable and commercial bases with the objective to reach large numbers of the poor in a sustainable manner (Yoron and Charitonenko 1998). Nepal is still in dilemma on promoting microfinance sector where both *welfare approach and institutional approach* co-exist and many MFIs are caught between the twin challenges of finding new sources of external funding to increase their loan portfolio and ensuring financial viability by providing services to clients below the poverty line (Dhakal 2004a).

There exist arguments both in favor and against the "*institutional approach* or *financial market approach*" mainly in relation to the original poverty focus of microfinance operation (Weiss J. and H. Montogomery 2004). Supporters of this argument claim for no further detail analysis to assess their poverty impact of microfinance on the notion that if MFIs are designed to serve only poor clients and if repayment rates are high, ultimate impact will be poverty reducing (Meyer 2002). In contrast, people in opposite camp argue that such a view is not correct and often misleading in at least three fronts. First, there is no guarantee that only the poor will be served unless strong eligibility criteria such as land ownership are enforced. Often the aim is to deter the non-poor by the inconvenience of frequent meetings or the stigma of being a member of a credit group of the poor. Such disincentives and eligibility criteria, where they exist, may not be enforced properly. Second, high repayment rates may

be due to social pressure within a group or family and may not reflect the ability to repay. Finally, even if the poor are genuinely served by MFIs when a public fund is required to finance promotion of their operation, there arise question of its cost effectiveness in reaching the poor when compared with other alternatives (Weiss J. and H. Montogomery 2004).

Prevailing controversy between *institutional approach* or *financial market approach,* has been compounded by less than adequate research on outreach, impact and cost-effectiveness of microfinance services. Of course, design of aid programmes have incorporate evidence on all three points, but most of the research works focuses on one of these criteria such as outreach, impact and cost effectiveness (Weiss J. and H. Montogomery 2004, Hume 1996 and 1999). Some research conducted in the past have shown that although the impact of microfinance services seems to be positive on the working poor, it is less beneficial to the hardcore poor and in some cases even increased hardship by putting them into debt (Morduch, J., and B. Haley. 2001). Further, earlier studies have focused on the impact in terms of increased income, which is not the only indicator of a secured livelihood (Khandker S. 1998 and 2003). These findings further reinforce the need to closely scrutinize mechanism through which microfinance services act as catalyst to poverty reduction. However, the researches assessing the impact of microfinance on poverty reduction are quite rare in Nepal.

This paper attempts to analyze the impact of microfinance on poverty reduction. The specific objectives of this paper are

- To analyze the role of microfinance services on improving access, use and contribution of financial services on improving the livelihood of poor and disadvantaged groups, and
- To assess the contribution of microfinance services on enterprise development, managing risks/vulnerability, economic empowerment of poor and disadvantaged groups, the effect on other financial services and investment in public infrastructure.

This paper is divided into five sections. After the introductory section, section two provides a conceptual and analytical framework. Section three presents the approaches and methodology of the study while section four outlines results and discussions of the study. The conclusion and recommendations of the study are provided in section five.

2. CONCEPTUAL AND ANALYTICAL FRAMEWORK

2.1 Conceptual Framework

Understanding Poverty

In terms of understanding poverty, a simple distinction has been made between '*chronic*' poor and '*transitory*' poor[3]. Within '*chronic*' poor are those who are either so physically or socially disadvantaged that without welfare support they will always remain below poverty line ('*destitute*') or those larger group who are poor because of their lack of assets and opportunities ('*non-destitute*'). Within '*non-destitute*' category, a comparison should be made by depth of poverty (i.e. how far HHs are below the poverty line) with those significantly below it representing the '*hard core poor*', sometimes characterised by irregularity of their income (World Bank 2000/01). Poverty has many faces, changing from place to place and across time. Most often, poverty is a situation people want to escape. So poverty is a call to action - for the poor and the wealthy alike - a call to change the world so that many more

[3]Chronic poor are long-term poor while transitory poor are those who temporarily fall into poverty due to adverse shocks.

may have enough to eat, adequate shelter, access to education and health, protection from violence and a voice in what happens in their communities (World Bank 2000/01).

Microfinance and Poverty Reduction

Growing interest in microfinance is one of the outcomes of the efforts to find scalable anti-poverty approaches pursuant to global poverty crisis and resulting human sufferings, environmental degradation, civil unrest and many other societal ills (Goldberg 2005). Hence, microfinance services for the poor are among many interventions tried to reduce poverty and relate to a wide range of flexible and appropriate financial services provided by MFIs that are tailored to the needs and preferences of the poor. In principal, microfinance services correspond to the *non-destitute* chronic poor and to the *transitory poor* in different ways (Weiss J. and H. Montogomery 2004). The lack of access to credit is readily understandable in terms of absence of collateral that the poor can offer, in addition to various complexities and high costs involved in dealing with small, often illiterate borrowers. The poor have either to rely on loans from moneylenders at high interest rates or friends and family whose supplies of funds are limited. MFIs attempt to overcome these barriers through innovative measures such as group lending and regular savings schemes, as well as establishment of close links between poor clients and the staff of the institutions concerned. The range of possible relationships and the mechanisms employed vary widely (Ziller et al, 1997, Zeller and Meyer 2002 and EDA Rural System (P) Ltd. 2004).

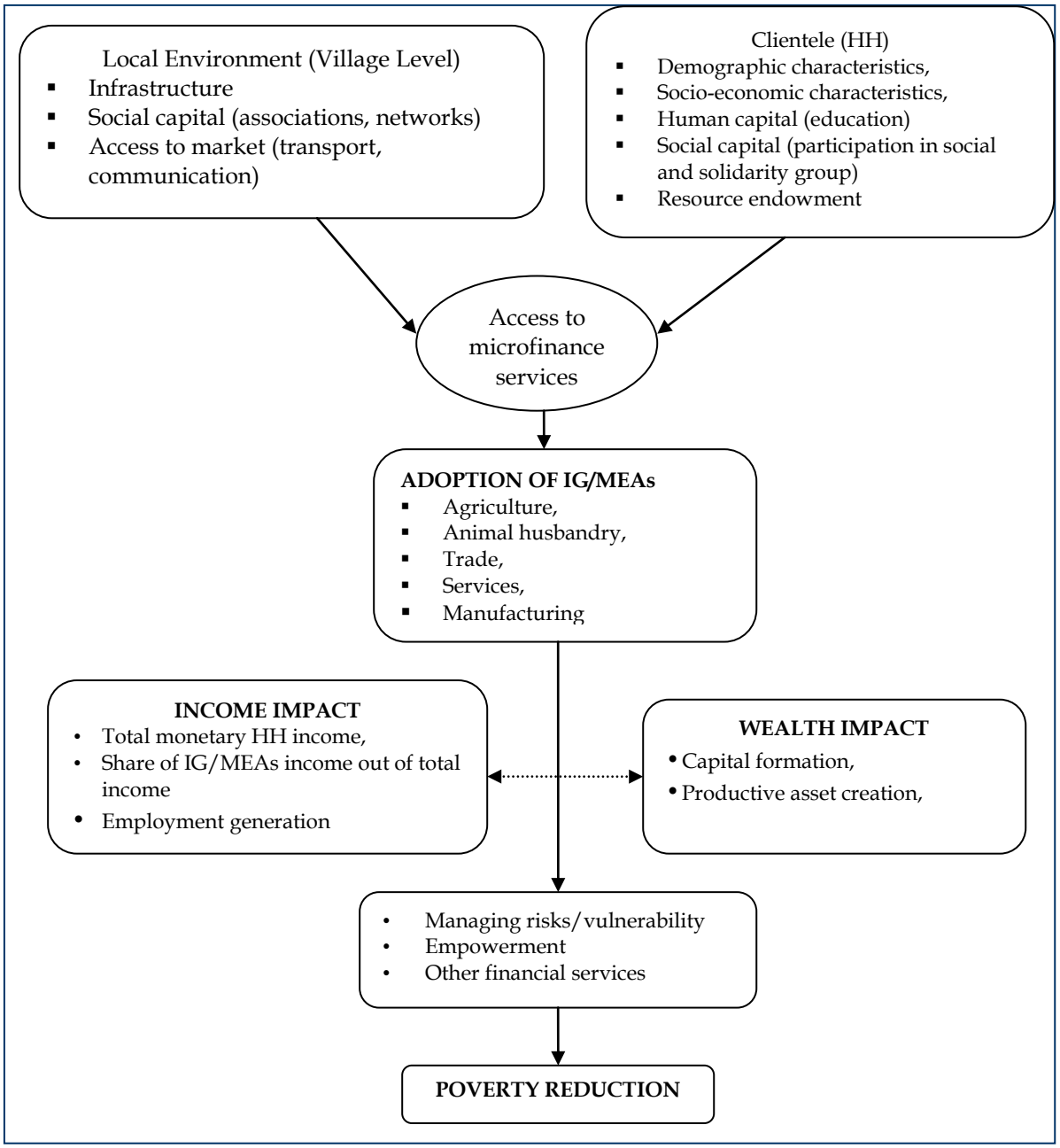
The route out of poverty from microfinance services is simple. If access to credit is improved, the poor can participate in productive activities that will allow income growth, provided there are no other binding constraints. This is a route out of poverty for the *non-destitute chronic poor*. For the *transitory poor*, who are vulnerable to fluctuations in income that bring them close to or below the poverty line, microfinance provides the possibility of credit at times of need. In some schemes the opportunity of regular savings by a HH itself can be drawn on (Weiss J. and H. Montogomery 2004 and Mayer 2002). The avoidance of sharp declines in family expenditures by drawing on such credit or savings allows '*consumption smoothing*'. Such a distinction between the credit needs of the *chronic* and *transitory* poor for '*promotional*' (i.e. income creating) and '*protectional*' (i.e. consumption smoothening) purposes, respectively, is over-simplified since the *chronic* poor will also have short-term needs that have to be met, whether it is due to income shortfalls or unexpected expenditures (medicinal expenses) or social events (weddings or funerals).

In general the poorest of the *chronic poor* (the *core poor*) borrow essentially for protectional purposes given both the low and irregular nature of their income and they are too risk-averse to borrow for promotional measures (i.e. for investment in future) and will therefore be a very limited beneficiary of microfinance schemes (Hulme and Mosley, 1996). Further, interest rates charged by MFIs are close to market-clearing level to ensure full cost-recovery and such high rates are unaffordable to the *core poor* given their lack of complementary inputs. That is, despite having a smaller amount of capital, marginal returns may be lower to the *core poor* than to the *better-off poor*. If the *core poor* cannot afford high interest rates they will either not take up the services or take it up and get into financial difficulties. Also, where group lending is used, other members of the group may exclude the very poor, because they are seen as a bad credit risk, jeopardizing the position of the group as a whole. Alternatively, where professional staff operates as loan officers, they may exclude the very poor from borrowing again on grounds of repayment risk. A combination of these factors, it is felt by many, explains weakness of microfinance in reaching hard core poor (Morduch, J., and B. Haley 2001, EDA Rural System (P) Ltd. 2004 and Goldberg 2005).

2.2 Analytical Framework

Within the conceptual framework discussed above, we develop an analytical framework that depicts the impact of microfinance services on poverty reduction. The interactive factors are depicted Figure 1 with the immediate impact of microfinance services on supporting the promotion of income generating/micro-enterprises activities (IG/MEA) at the center.

Figure 1: Analytical Framework of the Study



Source: Author's own design

In above figure, the boxes at the top show the factors determining access to micro-credit prevailing at the village and HH levels. The effect of adopting IG/MEA can either be direct or indirect as illustrated by the circular box and that follows. The access to microfinance

services can also have a feedback effect on factors at HH levels, for example through the provision of equipments and training. The square boxes at the bottom depict outcomes through the adoption of IG/MEA. This can be observed by the increase in monetary HH income, share of IG/MEA income out of the total HH income and improvement in nutrition. The impact of wealth may be noted by the improvement on productive assets and housing.

2.3 Hypothesis, Variables and Indicators for Assessment

Using the analytical framework, research questions are raised covering the impact areas such as outreach; access, use and contribution; enterprise development, managing risks/vulnerability, economic empowerment and poverty reduction. Each of these research questions are transformed into hypotheses, relevant variables, indicators for assessments considering input variables (MFI services) and moderating variables (client characteristics, programme characteristics, other context factors) into accounts (See Annex 1 for detail on impact areas, corresponding hypothesis, variables and indicators for assessment).

3. APPROACH AND METHODOLOGY

3.1 Approach

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

3.2 Methodology

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

This paper tries to undertake a comparison of before and after situations as well as clients with and without microfinance services covering the clients serviced by the major microfinance service providers[4] in Nepal and collecting information through household survey. Survey was conducted in Bara and Lamjung districts of Nepal and in the working areas of Microfinance Development Bank (MDB); Grameen Bikas Bank (GBB); Small Farmer Cooperatives Limited (SFCL) and Savings and Credit Cooperatives (SCCs). Household

[4]Refer Annex 1 for the overview of microfinance sector in Nepal.

survey was done in 510 clients and 170 non clients (control groups). Survey of non-client HHs was done as a quasi experimental group in the ratio of 1:3 clients HHs (case of intensive survey). Non-clients were purposively selected to match with the wealth ratio of the client sample and secondly, as far as possible, in terms of other features (main livelihood options and social group).

Field survey was conducted during October-November 2004 and all the HH specific information presented in this report corresponds to the period between July 2003 and June 2004. Information was collected using questionnaire based HH survey (quantitative), focus group discussion (FGD), case studies and semi-structured interviews (qualitative) to make a comparison of information collected and find out qualitative justification of quantitative findings. The impacts of microfinance on poverty and other social dimensions are assessed considering situation before and after as well as situations with and without microfinance services by identifying and defining appropriate proxies such as inflation adjusted income level, employment generation and asset creation. HHs is used as the unit of analysis for it determines socio-economic status of clients and use of financial services. Combination of (a) triangulation of methods for poverty assessment[5], (b) formulation of an involvement index[6] and (c) financial landscaping and HH portfolio analysis[7] are used for analysis.

A comparative analysis of the findings of different models such as MDB, GBB, SFCLs and SCCs covered under this study has been done. All clients HH surveyed are given a wealth rank which is used as a basis for analysis for most of the indicators. The impact on key socio-economic attributes is measured through a comparison of the clients with the control group. Information gathered from dropouts is used as a proxy to assess the quality of MFI services and provide feedback on MFI services. Independent means and the chi-square test are used on comparative data, assessing the statistical significance of differences between clients and non-clients and between different categories of clients.

4. RESULTS AND DISCUSSIONS

4.1 Overview of Microfinance Services

All the MFIs surveyed have a stated policy that only one member per family can be a client[8] and this is consistent in practice. All 510 clients surveyed have savings with MFIs and all have received micro-credit services. About 91% of the clients had no access to non-financial services such as health, education, vocational training, entrepreneurship development support, legal awareness, etc. While most clients have received initial trainings in group procedure and transactions, non-financial services offered by the MFI have low coverage or. For instance, just 5% clients have acquired enterprise-related training or support (mainly SFCLs and SCCs clients) and 4% are involved in social development such as health care and child education.

[5]Such as PRA, index scoring, HH income linking local indicators of HH status to standardize wealth rank categories that are comparable across different areas.
[6]An index to measure '*involvement in a microfinance programme*' across entire sample clients, a comparison of 'low' involvement and 'high' involvement clients is done as a basis for cross-sectional analysis.
[7]To explore alternative financial options and relative contribution of microfinance to HH portfolio, using both FGDs and questionnaires.
[8]Clients are women in case of MDB, the GBB and SCCs and either man or woman in the case of SFCLs.

Micro-savings form a major part of total HH savings for all clients, except for non-poor clients as they are more likely to have access to other sources. Micro-savings primarily act as collateral to micro-credit and over time it is also a form of saving-up (Rutherford 1999) although all MFIs (SFCLs and SCCs) tend to 'lock up' savings so that a client may have to leave the programme if she decides to withdraw her savings. The average savings balance of the clients was Rs. 2061, highest being among clients of SCCs (Rs. 5560/-) followed by SFCLs (Rs. 3540) and MDB (Rs. 432).

The clients have used micro-credit both for consumption (34%) and investment (66%) purposes. The use of micro-credit for *consumption purposes* can be grouped into four categories: (i) risk related uses (medical expenses, urgent house repair, debt repayment, food for current consumption, marriage related costs, death/birth ceremonies, etc.), (ii) housing (constructing a new house or room, house improvement such as roof, electricity, sanitation, whitewash, kitchen repair, toilet construction, etc.), (iii) education (school fees, uniform, transport, stationary, etc.) and (iv) other HH expenses (festivals and pilgrimages, purchase of HH assets, clothing, etc.). The *productive use* of micro-credit refers directly to IG/MEAs such as non-farm enterprises (fixed and working capital), animal husbandry, cash crop production and also borrowing for overseas employment. The average initial loan size is Rs. 18,850 (US$ 269) and the outstanding loan balance is Rs. 11,500 (US$ 164). The average initial loan size is high in among clients of SFCLs than MDB and GBB. The clients of SFCLs also have access to micro-credit as an internal group loan from their savings, which represents a reliable significant source of credit especially during emergencies.

About 83% and 72% of the clients surveyed lacked access to bank credit and formal savings respectively prior to joining these MFIs. Those having access to bank credit and formal savings are mainly the clients of SFCLs and SCCs who are relatively well-off with better access in urban areas. The survey findings reveal that these MFIs have provided clients with a powerful avenue for access to microfinance services and have successfully served the un-served. The MDB and GBB have been more effective in reaching the un-reached, than the SFCLs and SCCs. The social profile of the overall sample broadly reflects the population profile in sample clusters, with most MFIs having a mix of social groups or castes. About 57% clients of MFI surveyed are disadvantaged groups.

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

There is inverse correlation between loan size and the depth of outreach i.e. the proportion of the non-poor in recent clients. The correlation between the smaller size of the first loan and the depth of outreach to recent clients (i.e. proportion of the very poor) is positive but less strong. The MDB and GBB with the smallest first size have the highest proportion (79%) of very poor and poor clients. On of the strong findings is that the small loan sizes do not always exclude non-poor who, whilst having larger borrowing requirements, can still be attracted by favorable interest rates, possibility of large loans in the future and opportunities for social capital formation. The findings imply that though the small size of microfinance loans serves to target the poor, the non-poor are also interested in small loans and the poor

sometimes need larger loans. This refutes conventional argument that MFI's self-target the poor due to small size of savings and credit services.

The clients of SCCs/SFCLs' have greater flexibility on loan use and are more likely, across all categories of involvement, to use micro-credit for immediate HH needs. Poorer clients are more likely to borrow smaller amounts for HH expenses than the better off. Micro-credit constitutes about 58% of total HH borrowings among clients surveyed. MFI is one source of borrowing to clients who also borrow from informal sources such as moneylenders, friends, family and relatives[9]. This however suggests a significant reduction in clients' dependency on high cost informal sources. If there were no MFI services, clients would have borrowed half of the micro-credit amount from higher informal sources. The interest payment savings through MFI's micro-credit services has been estimated at Rs. 1,696 ($ 24)/client per year.

There has been similar access of the poor across all wealth ranks in MDB and GBB samples while there has been lower access of the poor in SCCs and SFCLs. Since all clients surveyed represent group based micro-lending methodologies, issue has been raised whether group executives such as chairperson, secretary, treasurer, etc. use their position to influence group decisions, including loan decisions in their favour or not. The answer is both yes or no. In case of SFCLs, in over 95% cases, group executives are better off and more educated (a requirement for handling basic group records and accounts) than other group members and the cases where group leaders influences lending decisions in their favour exists while it is less serious in MDBs and GBBs where more then 40% group executives are either poor or very poor and many are illiterate.

4.2 Characteristics of Microfinance Clients

The average family size of clients surveyed ranges between 4.8 and 5.4 persons with an average of 5.1 members. The average family size is larger among HHs in Bara district than in Lamjung district. The average family size is almost identical across three (clients, non-clients and dropouts) categories of HHs surveyed. The composition of clients in terms of age group is almost identical across all MFIs. The age of the clients surveyed ranges between 21 and 56 years with an average age of 38 years. The average literacy rate of these clients is 36%, with slightly higher literacy rate among clients serviced by SCCs and SFCLs compared to the clients of MDB and GBB. MFIs have effectively reached to women headed HHs[10], who are considered to be vulnerable groups in the local community, constituting 9% of the client HHs (more in urban SCCs and SFCLs compared to MDB and GBB). FGD reveals that the proportion of women headed HHs served by MFIs is slightly higher than their proportion in local community, indicating high preference of women headed HHs to receive microfinance services form the MFIs.

About 28% of the clients surveyed are landless, 56% own less than 0.5 ha and 16% own more than 0.5 ha land. This finding indicates the capacity of MFIs to mainly target land less HHs and HHs with marginal size of land holding. About 58% of the clients live in temporary (Kaccha) houses, 32% in a combination of temporary and permanent (Pakka) houses, and

[9]Informal sources continue to be important sources of borrowing for these clients on account of their easy and speedy accessibility and flexibility in loan amount and terms.

[10]HH head is defined as person who bears chief responsibility for the maintenance and main decisions of the HH and women headed HH are those HHs headed by women who are bringing up a young family by themselves, are widowed or abandoned, or have husbands who are not able to support their families..

10% in permanent houses. Almost all the clients (100%) own basic utensils in house and only 15% have a radio, a TV and modern utensils. About 46% HHs derives their livelihood primarily from causal or wage employment followed by agro-based/livestock self-employment (35%) and non-farm self-employment (17%) activities. There exist differences on HH livelihoods across MFIs, reflecting differences between methodologies such as the targeting approach, credit products and terms, with majority causal labour among MDB and GBB clients while agro-based activities to be the predominant livelihood option and non-farm self employment among clients of SFCLs and SCCs respectively.

4.3 Direct Impact of Microfinance on Poverty reduction

The direct impact of microfinance services comprises of both income and non-income dimensions[11] as discussed hereunder.

4.3.1. Income Related Effects

Income related effects of microfinance services on the clients corresponds to increase in number of income sources, HH dependency burden and reported trend on overall HH income. The better-off HHs have more diversified income sources amongst non-clients: 62% of the non-poor have two or more sources of income, compared to 38% of the poor and 16% of the very poor. Amongst the clients, the proportion is higher for all wealth ranks, from 28% for the very poor up to 82% for the non-poor increasing further for high involvement clients in poor and borderline poor categories. The difference is at least partially attributable to the role of micro-credit in promoting IG/MEAs. The more number of income sources has been instrumental to lower dependency ratio among client HHs in comparison to non-clients for all wealth ranks. The lower dependency ratio in very poor client HHs compared to non-clients is due to a higher number of clients children engaged in family owned enterprises. In addition, fewer children working in very poor non-client HH is probably due to lack of opportunity than anything else. The number of very poor non-client children '*doing nothing*' is much higher (25%) compared to children of the client HHs (13%).

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

The interest rate charged by the MFI for micro-credit has been lower than the one charged by informal sector and slightly higher than the rates charged by formal sector. The effective interest rate charged by MFIs ranges between 18% and 24%. The normal development banking rates are 12-18% that sore to 36% effective rate depending on time, visits, bribes etc. while the interest rates charged by moneylenders is 36% per annum and often categorized as '*costly informal sources*'. The lower effective interest rates through MFIs and reduced dependency on more costly informal sources of finance are clearly evident among clients surveyed. The reduced cost of borrowing of the MFI clients compared to non-clients is one of the impacts that are valued greatly by clients who lack other sources of borrowing.

[11]The non income dimensions consist of financial capital (savings), productive and physical capital and human capital formation.

Of the 510 clients surveyed, 303 (59%) reported an increase in income through use of working capital to diversify or improve quality of goods or to take advantage of seasonal bulk purchase. The average incremental income from credit financed IG/MEAs is Rs. 11,312 per year. In contrast, of the 170 non-clients surveyed, only 67 (39%) reported an increase in income through self-financed IG/MEAs and average incremental income was Rs. 4,875. HHs most likely to report income increases from IG/MEA are mainly those involved in non-farm enterprises, followed by dairy cattle farming while less than 40% of HHs engaged in agriculture or wage labors are likely to increase their HH income. HHs not benefiting from micro-credit services is those borrowing for consumption purposes and/or whose IG/MEAs have failed due to management and technical reasons.

4.3.2. Non-income Related Effect

Capital formation is one of the non-income related effect and highly valued services offered by MFIs to their clients. MFIs are quite effective to build financial capital, productive as well as physical capital and human capital among their clients.

Small and frequent savings on regular intervals as regular savings deposits is a form of financial capital accumulation participated by all the clients surveyed setting aside a part of their current income for future use. SCCs are more innovative to diversify savings products that include housing savings and children savings besides regular savings and voluntary savings[12]. Clients value greatly the savings services provided by the MFIs. The involvement in a microfinance programme has enabled clients to increase their savings. There is a high incidence of savings (financial capital) among MFI clients including the poor but little difference in overall HH savings between clients and non-clients.

MFIs' clients have used incremental income from credit financed IG/MEA for creating productive and physical capital. The survey data on the purchase of assets in previous two years reveal a clear difference among clients and non-client HHs on productive and physical capital formation. Assets range from small tools, fans, gas-stoves, animals, push carts, handloom, gold, TV, housing improvement including white wash, roof repairs and additional room – even a new small house. A high proportion (56%) of client HHs had acquired assets in the two years before the survey. The comparison with non-clients is more pronounced for productive assets, reflecting substantial use of micro-credit for IG/MEA. Analysis by wealth rank indicates a higher acquisition of productive assets by poor clients and higher purchase of HH assets by non-poor. Such correlation is not significant among borderline poor. Survey data showed the non-poor not using the borrowed funds for HH assets. A positive correlation exists between value of assets acquired and HH wealth ranks.

Contribution of microfinance services on human capital formation was observed in terms of increased investment on education, high school enrolment rate and social capital build-up. One of the first things poor people do with new income from IG/MEA activity is to invest in their children's education. Greater access to financial services and increased incomes enabled the poor people to invest in their children's education. Instances showing that a small contribution from microfinance (e.g. internal group loans from SHG) in meeting schooling costs are plenty. Over 88% children of clients' HHs go to school compared to 62% children of non-clients HHs and more 68% of client's children completes the school

[12]For details refer to Dhakal (2004b)

compared to 38% children of non-clients. Student dropout rates are much lower in clients (8%) compared to non-clients (34%). However, there is no difference at the secondary level school enrolment and gender imbalance at all levels of schooling is similar for both clients and non-clients. In order to support human resources and capital development priority, SCCs have introduced new credit and savings products specifically tailored to support the school expenses while MDB and GBB make reading and writing by clients mandatory. Group process and dynamism has been quite effective for social capital formation by developing solidarity and mutual trust.

4.4 Wider/Indirect Impact of Microfinance on Poverty Reduction

The wider/indirect impact of microfinance services has been assessed in areas such as promotion of IG/MEA, risk/vulnerability management, economic empowerment and the effect on other financial services.

4.4.1. Promotion of Income Generating/Micro-enterprise Activities

Clients have used micro-credit to finance investment on fixed (purchase of live animal, space, furniture, vehicle and equipment and shed construction, etc.) and working capital (animal feed, fodder, trade, small manufacturing and agricultural activities). The pattern of use differs by sector, and does not vary with the wealth rank of the HHs. The survey has uncovered that about 66% (337) clients surveyed are using micro-credit for over 364 IG/MEAs, while 74 (44%) non-clients are promoting IG/MEAs under self-finance. The sectoral distribution is evenly balanced in the rural sample between agriculture, animal husbandry and non-farm activities. In the urban samples, services and trade are the main activities. There differences across clients and non-clients are not discernable, except the adoption rate.

The differences on type of micro-enterprises created by clients and non-clients are pronounced and vivid. For instance, the majority of micro-credit financed IG/MEAs managed by the clients are non-farm enterprises (51%), followed by animal husbandry (35%), cash crop production (17%) and finance for overseas employment (5%), while, majority of self-financed IG/MEAs managed by non-clients are animal husbandry (60%), cash crop production (21%) and non-farm enterprises (19%). Further, role of micro-credit to revive some enterprises (e.g. trade) that are earlier closed down due to shortage (or diversion) of working capital and some animal husbandry units following the sale or death of animals was clearly evident.

Employment generation
Both micro-credit financed IG/MEAs managed by clients and self-financed IG/MEAs managed by non-clients are effective to generate self and wage employment to a limited extent. These IG/MEAs are mainly small scale and family based generating slightly more than one employment (full employment and part-time) per enterprise. The 337 clients managed 364 IG/MEAs have employed 443 persons (34% men, 49% women and 17% children) while 74 non-clients managed 78 IG/MEAs have employed 88 persons (56% men, 34% women and 11% children). Although loans have been taken in the name of women clients, men and children are also employed in micro-credit financed IG/MEAs. Differences on composition of employments is quite clear, with IG/MEAs managed by client HHs providing more employment to women and children compared to IG/MEAs managed by

non-clients HHs. About 29% of employment is clients and 35% in non-clients managed IG/MEAs are new indicating an increase in employment generation.

Problems encountered by income generating/micro-enterprise activities
Both clients and non-clients have experiences variety of risks relating to both endogenous and exogenous factors on managing IG/MEAs. The problems experienced by clients and non-clients HHs are related to illness of HHs head, cash crunch, marketing and loss/damage of credit managed assets with the problems experienced by non-clients more concentrated on cash crunch[13].

4.4.2. Vulnerability Management

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

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

Relative vulnerability differs among groups with different socio-economic conditions and livelihood systems. HHs mainly depending on agriculture is experiencing greater fluctuations in income and well-being. Sudden crises can exacerbate impact of such downward pressure. The very poor and poor category clients are especially vulnerable due to their limited resources. There are certain types of HHs, which are seen to be especially vulnerable within the poor such as women headed HHs and other disadvantaged groups.

[13]The problems experienced by clients include illness of HHs head (52%), cash crunch (48%), marketing (32%) and loss/damage of credit managed assets (42%) while the problems experienced by non-clients were same but difference intensity such as illness of HHs head (31%), cash crunch (72%), marketing (28%) and loss/damage of credit managed assets (23).

The potential of microfinance has been seen to play a '*promotive*' role contributing to growth of IG/MEA, diversifying income sources, income increases etc., as well as '*protective*' role assisting clients and their families to maintain their income and to prepare for or cope with financial shocks where poor are more vulnerable. Financial services provided by MFI has supported for more regular or diversified income sources, increased savings or liquid assets and expanded options for credit. However, about 34% clients were exposed to a situation such as environmental or long-term risks of enterprise failure and indebtedness.

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

4.4.3. Economic Empowerment

Eighty seven percent of clients and non-clients surveyed in this study and women and women are clients of all the MFIs covered by this study except SFCLs. Findings of the FGDs conducted especially among the clients of SFCLs revealed that women are more financially responsible with better repayment performance than men and are investing increased income in HH and family well being. Clients are more empowered[14] than non-clients. Clients are more confident, more assertive, more likely to participate in family and community decisions and better able to confront systemic gender inequities. During a series of FGDs and individual interactions, clients were not easily able to identify what it was that made them feel good about themselves and gave them power. Most of them suggested to be empowered as: *one that has choices and one that actively decides to develop both individual and family well-being. Empowering experiences are those, which widen one's choices and help him/her to achieve overall well-being.* Drawing on FGDs and case studies, some of the indicators of empowerment through microfinance are ability to save and access loans, opportunity to undertake economic activity, mobility i.e. the opportunity to participate in group meeting, visit nearby areas; awareness on local issues, MFI procedures, banking transactions, skill for IG/MEA, decision making within HH, group mobilization in support of individual clients: action on social issues, role in community development activities, etc.

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

[14]'Empowerment is defined as a process of change by which individuals or communities with little or no power, gain power and ability to make choices that affects their lives.

Most clients feel empowered in having choices to decide how to develop family and individual well-being. Micro-financial services present a number of opportunities to pursue their family oriented goals and enhance their own role in the HH. Clients define important elements of empowerment as: contributing to family livelihood; speaking in public; some marketable skills; responsible roles in family and decision-making on money management, and pursue self-development opportunities. Clients felt that improved confidence, positive change in social status, greater financial security for family and greater financial security from savings opportunities provided by MFIs are the areas which have contributed to their improved personal well-being or to their role in facilitating family well-being.

The role of microfinance services for life and overall living standard of the clients have been instrumental and effective to increase access to and control over productive resources and ultimately supporting their economic empowerment. The services have been instrumental to address the practical and strategic need of the clients to a greater extent. The positive empowerment impacts especially for women (74%) who are directly earning at individual and HH levels are in terms of savings and access to loans, contribution to HH income and role in HH decision making. They gain a sense of self-respect and confidence from an opportunity to meet other members in a group, share opportunities and ideas and have the support for common action, more so among SHGs in SFCLs/SCCs. At the HH level, conventional gender patterns continue such as ownership of assets and IG/MEA management. Women clients especially in SFCL/SCC are not necessarily involved in the IG/MEA for which micro-credit is provided in their names. Women clients are involved in IG/MEA management solely or jointly with men in 74% cases. Pursuant to this issue, series of FGDs uncovered that IG/MEA ownership is not a serious issue among women, for whom ensuring that a credit financed enterprise generates income for the family is more important than their management of the enterprise or ownership of an asset. Economic empowerment is more fundamental for social and legal empowerment.

4.4.4. Effect on Other Financial Services

Over 90% of the clients surveyed score microfinance over formal sector (banks) on all parameters barring cost and all (100%) the clients score over informal sector (moneylenders) on cost and repayment terms and about 56% criticize MFI services related to credit purpose, timeliness and sometimes on repayment terms less well. There exist evidences that MFI services has impacted to reduce, though not eliminate, clients' dependence to moneylenders as well as informal interest rate. Nevertheless, pursuant to MFI's policy to provide set and small loan size about 39% of clients still continue to borrow from informal sources that constitute about 42% of their source of finance for IG/MEA. Besides, the poor or non-poor clients also borrow large amounts needed for social purposes (e.g. to meet marriage obligations, funeral, etc.) or emergencies (e.g. urgent medical costs, accidents), investment on human capital (school fees, overseas migration, etc.) from informal sources. For the clients surveyed, MFIs are among different credit sources that cater not only to IG/MEA needs but also to a range of other HH needs.

About 28% of clients have access to formal financial services as individual savings and credit accounts. Individual access to formal sources is higher for the better-off and due to structural nature and access factors it does not increase with increased involvement in MFI. In contrast, the incidence of borrowing from moneylenders is lower for the non-poor, who access credit from relatives or neighbors (personal sources) at little cost. Formal, semi-formal

(MFIs) and informal sources exist in financial market of the study areas and it is evident that informal sources continue to play an important role on account of their immediate accessibility, speed and flexibility in purpose, amount and terms, despite high costs.

4.5 Poverty Reduction

Of the total 510 clients surveyed, 173 (34%) are using micro-credit for consumption purposes and micro-credit has some relief impact to these clients instead of any impact on income generation and poverty reduction. Of 337 (66%) clients using micro-credit for productive purposes, 34 (10% of clients using micro-credit on productive purposes and 7% of the total clients) are not experiencing any benefit from credit financed IG/MEAs due to failure of credit financed IG/MEAs owing to lack of entrepreneurial and money managing capabilities. Only 303 (59%) clients are benefiting from credit financed IG/MEAs and level of benefits received by these clients varies greatly. In case of non-clients, of the 170 non-clients surveyed, 74 (44%) were managing IG/MEAs under self-finance, 64 (38%) were benefiting from credit financed IG/MEAs and level of benefits received by these clients varies greatly and 10 (14% of non-clients investing for IG/MEA under self-finance and 6% of the total non-clients) are not experiencing any benefit from their IG/MEAs due to enterprise failure, under-financing and lack of entrepreneurial capabilities.

Average incremental income of clients and non-clients was Rs. 11,312 and Rs. 4,875 respectively and the difference is statistically significant at 1% level. Average employment generated from micro-credit financed IG/MEAs managed by clients is 1.2 persons while that of self-financed IG/MEAs managed by non-clients was 1.1 persons and the differences was statistically significant at 1% level. Higher income and employment generation was possible due to relatively low level of financial constraints experienced by the clients compared to non-clients and technical and managerial supports received from MFIs.

There exist cases where of approximately 34% clients using micro-credit for consumption purposes and not benefiting very much from microfinance services. There are 16% clients who are indebted due to lack of entrepreneurial skills, poor money management capabilities and failure of credit financed IG/MEAs. The incidence of indebtedness is high among clients served by SFCLs (32%), followed by SCCs (21%), GBB (9%) and MDB (8%).

Wealth rankings exercise conducted during this study indicates that microfinance to be effective to shift or graduate its clients from lower to higher level of wealth ranks. As of the survey time, about 24% very poor, 4% poor and 6% borderline poor has graduated respectively to poor, borderline poor and non-poor. Proportion of non-poor has increased by 29%[15]. This has been possible due to income and employment opportunities generated by the credit financed IG/MEAs as discussed above. In general microfinance services have not reduced poverty of the clients surveyed completely however, it has reduced its severity, providing a "*protective*" rather than "*promotive*" role in a vulnerable situation.

Above findings indicates that clients' use of micro-credit in productive purposes is a necessary condition for micro-credit from MFIs to impact on poverty reduction. The sufficient condition for micro-credit to impact on poverty reduction is entrepreneurial and

[15]As of the survey time, proportion of very poor and poor are reduced by 24% and 4% respectively while that of proportion of broader line poor and not-poor has increased by 6% and 29% respectively compared to their situation before obtaining MFI services.

money managing capabilities of the clients. Further, access to micro-credit is not a strong pre-requisite for promoting IG/MEAs but such access will definitely accelerates the promotion of IG/MEAs.

5. CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

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

Contribution of microfinance on poverty reduction depends on clients' use of micro-credit in productive purposes as well as their entrepreneurial and money managing capabilities. Access to micro-credit is not a strong pre-requisite for promoting IG/MEAs but will be a powerful mean to accelerate their promotion. About 56% of the clients and 39% of the non-clients have average incremental income of Rs. 11,312 and Rs. 4,875 and average additional employment of 1.2 persons and 1.1 persons respectively from micro-credit financed and self-financed IG/MEAs and differences is statistically significant. Support of the MFI on financial, physical and human capital formation is accorded high by the clients and non-clients and feels that such support will have sustainable impact on poverty reduction. Capital formation and access to microfinance has served to reduce clients' dependency on moneylenders, reduce average interest rate burden especially for poor and indirectly assisted to promote enterprises that hire non-family labor. Microfinance services are not always good and there exist cases of indebtedness of about 16% clients.

A clear and proven links exist between access to microfinance services to the poorest of the poor and poverty reduction, however, the path of microfinance to reduce poverty is long and uneven. The evidences presented in this paper suggest that whilst microfinance clearly may have had positive impacts on poverty, it is unlikely to be a simple panacea for reaching the hard core poor. Nevertheless, microfinance has reduced severity of poverty, providing a "*protective*" rather than "*promotive*" role in a vulnerable situation and shifted or graduated clients from lower to higher level of wealth ranks through income and employment opportunities generated by credit financed IG/MEAs and other path of wider impact.

5.2 Recommendations

This paper demonstrates microfinance to be a powerful intervention to move towards a mission to fight against poverty, but it is not a magic bullet for poverty reduction. Unless other aspects of development policy and implementation affecting poverty reduction are considered simultaneously, role of microfinance alone will be less significant. Though almost all the MFIs target the poor, they should do so more systematically. For instance, the MDB and GBB are more likely to have specific criteria to identify the poor, but these are not always applied effectively. Such criteria are less explicit in case of SFCLs and SCCs.

Design of products and services are crucial for effective poverty impact of microfinance. For instance savings is the important component of microfinance services and it should be made more flexible in terms of deposit frequency in addition to introducing facility to withdraw savings and clearer communication about interest benefits. Likewise, loan products must be designed with greater flexibility in purpose, amount and repayment terms and be consistent to loan requirement of and cash flow from IG/MEAs. MFIs should insist clients to use micro-credit for production purpose only and use of micro-credit for consumption purposes should be discouraged to minimize the possibilities of further indebtedness of the poor.

Group approaches has several merits on maintaining discipline on microfinance operation, but this need to be revisited to the tune of its implications. In context of a tendency to provide extra focus to group leader for training inputs and skill development that has jeopardized social capital build-up of other members of the groups, possibilities to spread leadership responsibilities and widening skill effects by encouraging rotation of group leaders and peer training need to be explored. Insurance services are prime needs, especially for assets and for health. MFIs can link clients to insurance schemes by national agencies.

State of promotion of IG/MEAs depends on overall development of the economy as well as overall macroeconomic environment and is the most important channel contributing on poverty reduction. Hence, there should be greater focus on ensuring macroeconomic stability. Policy and regulatory framework (fiscal and monetary policies, trade policies and business regulation) either inhibit or prohibit the growth of IG/MEAs to the full potential. Public investment on infrastructure such as transport, communication, electrification; education and training; etc. plays a major role in facilitating the creation and growth of IG/MEAs. Enterprise development should be linked with business development services (BDS) to solve much of the problems on enterprise creation and development. In general MFIs should link their clients to BDS providers rather than making it part of microfinance to promote enterprise growth, especially, for example, through identifying opportunities, financial planning and helping traditional manufacturing units respond to the changing market demand.

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Annex 1: Impact Area, Hypothesis, Variables and Indicators for Analysis

Impact Areas	Hypothesis	Variables	Indicators
Outreach	MFIs are extending financial services to the poor and disadvantaged people not reached by formal sector finance.	▪ MFIs operation in poorer areas;	▪ Concentration of the microfinance services across ecological belts and development regions,
		▪ Reaching MFI services to poor and very poor;	▪ Access to formal financial services before joining MFI, ▪ Proportion of clients below national poverty line, ▪ Proportion of very poor on total clients,
		▪ Reaching MFI services to excluded caste and ethnic groups;	▪ Ethnic and caste distribution of clients,
		▪ Outreach by age groups (18-50 years);	▪ Age range and distribution of the clients,
		▪ Reaching women headed HHs;	▪ Percentage of women headed HH among total clients,
		▪ Loan size;	▪ Loan size by wealth ranks of the clients,
Access, use and contribution	Microcredit is used for meeting production as well as consumption need all income and social groups;	▪ Access to microfinance services by clients of all wealth ranks for production and consumption purposes;	▪ Loan access by wealth ranks, ▪ Loan use composition,
		▪ Microcredit use pattern	▪ Analysis of use of microcredit on consumption and production purposes
Enterprises development	Microfinance increases enterprise activity	▪ Promotion of non-farm enterprise activity;	▪ Micro-enterprise mix promoted under credit assistance,
		▪ Increase in enterprise income;	▪ Incremental income from enterprises,
		▪ Employment creation;	▪ Employment generation from enterprises,
Managing risks / vulnerability	Microfinance builds the capacity of individuals, HHs and enterprises to manage risks;	▪ Protection against risks ahead of time to individuals, HHs and enterprises;	▪ Ability to finance at the time of risk, ▪ Physical and productive capital formation,
		▪ Coping with shocks resulting from risk after they occur to individuals, HHs and enterprises;	▪ Ability to manage finance at the time of risk, ▪ Human and financial capital formation,
Economic empowerment	Microfinance contributes to economic empowerment at individual, HHs and community levels	▪ Increase in access to financial services;	▪ Client composition by sex,
		▪ Increases in economic activity through access to credit for investment;	▪ Gender disaggregated analysis of IG/MEAs
		▪ Increases in awareness, mobility and skill development;	▪ Increase in awareness, mobility and skill development of clients,

Impact Areas	Hypothesis	Variables	Indicators
		▪ Increase in ownership of assets within the HHs	▪ Access and control analysis of asset ownership,
		▪ Increase in enterprises within the HH economy;	▪ Extent of IG/MEAs development,
		▪ Enhancing status in the HH as income contributors and decision makers;	▪ Change in clients' role in the HH,
		▪ Increases empowerment at community level;	▪ Change in clients empowerment at community level,
Poverty Reduction	Microfinance contributes on reducing incidence of poverty	▪ Increase in capital/asset formation at the HHs level;	▪ Financial, productive, and physical capital formation,
		▪ Clients taking advantage of educational opportunities for their children;	▪ Human capital formation,
		▪ Increase in HH income	▪ Number of sources of income, ▪ HH dependency burden, ▪ Reported trend in overall HH income,
		▪ Reduction on cost of borrowing	▪ Change in effective interest rates, ▪ Reduction in informal interest rates,
		▪ Reduction in the incidence of poverty among clients.	▪ Reduction on incidence of poverty, ▪ Diversification of income sources, ▪ Incremental income from credit financed enterprises

Annex 2: MICROFINANCE SECTOR IN NEPAL

The history of formal microfinance services in Nepal is short but eventful. The chain of events seems to be marked by a costly process of trial and error rather than by institutional dynamism. History of microfinance as a poverty reduction initiatives dates back to early 1950 with promotion of 13 credit cooperative primarily intended to provide credit to the agricultural sector. This is followed by the establishment of the Cooperative Bank in 1963. The Agriculture Development Bank of Nepal (ADBN) emerged in cognizance of the shortfall in supply of funds for agricultural loans experienced by these credit cooperatives (Sinha, 2000). A well-structured and specialised programme to cater to the financial needs of the poor was provided further impetus with the launching of the Small Farmer Development Programme (SFDP) in 1975 by the ADBN that focused at organising farmers into small groups and providing credit on a group guarantee basis and institutionalising small farmer groups into the Small Farmer Cooperatives (SFCL).

In 1974, one year before the launching of the SFDP, the Nepal Rastra Bank (NRB) initiated "*priority sector*" programme directing commercial banks to invest 5% of their total deposits in the "*small* (agriculture, cottage industry and service) *sector*" (AsDB, Manila and NRB 1994). The lending requirement for commercial banks to the priority sector was increased to 7% in 1976 and to 12% in 1990. The NRB directed that 25% of these priority sector loans or 3% of the total portfolio be given to the hardcore poor under the "*deprived sector credit*" programme. These schemes were undertaken by all the commercial banks as mandatory requirements.

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

Considering the paramount role of the NGOs for microfinance service delivery, government enacted Financial Intermediary Act 1999 to enable NGOs to acquire financial intermediary (FI) licence. A total of 47 NGOs received FI licence as of July 2005. These NGOs acquire loanable funds from two apex institutions namely the Rural Microfinance Development centre (RMDC) and the Rural Self Reliance Fund (RSRF). Cooperatives established in 1956 gained momentum only upon with enactment of Cooperative Act 1992 and by 2003/04 over 6,000 cooperatives registered under this act which include over 2800 Savings and Credit Cooperatives (SCCs).

In 1992, in an important initiative to augment the supply of microfinance, the first two RRDBs were established with government and NRB funds as replications of the modality adopted by Grameen Bank of Bangladesh. By mid-July 1997, five RRDBs were established. While initially four RRDBs were established under the Commercial Banks Act 1984, the fifth was registered under the Development Banks Act 1996 (Sharma and Nepal, 1999). With the enactment of Development Bank Act 1996, four microfinance NGOs transformed to MDB [Nirdhan Uthan Bank (NUB), DEPROSC Development Bank (DDB), Swabalamban Bikas Bank (SBB) and Chhimeki Bikas Bank (CBB)]. As of May 2005, the Grameen Model has been

replicated through five RRDB, four MDBs, one cooperative and three Financial Intermediary NGOs (FI-NGOs)[16].

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

Within the existing legal and regulatory provisions, Nepalese MFIs are those institutions established and operated under the Cooperative Act 1992 (SCCs and SFCLs), Development Bank Act 1996 (Regional Grameen Bikas Bank (RGBBs), Microfinance Development Bank (MDB), and apex institutions providing wholesale loan to MFIs for promoting retail lending and Act for NGOs involved in Financial Intermediation 1999 (FI-NGOs). As of July 2004, there are five RRDBs, four MDBs, 44 FI-NGOs, over 2800 SCCs, 161 SFCLs and three apex institutions namely the Rural Microfinance Development Centre (RMDC), the Small Farmer Development Bank (SFDB) and the Rural Self Reliance Fund (RSRF) formally active in the Nepalese microfinance sector.

Thus, Nepalese microfinance sector has evolved into a mix of formal and semi-formal sources thereby serving as a laboratory of microfinance based on its geographical diversity with a multitude of different approaches[17], increasing complexity in the structure of the microfinance sector and expanding significantly in terms of service providers (including MFIs) and clients served. Number of clients served by these MFIs has been estimated to be 655,000 members[18] from 5,57,000 HHs (Sharma 2004) implying that about 41.6% of the total HHs below the poverty line has access to microfinance services in Nepal[19]. Technically speaking, this statistics implies that additional 782,642 HHs are yet to be served by the microfinance sector and the breadth of outreach is yet to be expanded to ensure assess to microfinance services to people below the poverty line. Further, an analysis of the concentration of microfinance services reveals that MFIs are concentrated in the Tarai and accessible hills. There is virtually no formal MFI with only limited presence of the SHG and credit union model in the inaccessible hills and mountains. MFI services are more concentrated in rural and peri-urban areas than in urban areas and such services are very much limited for the urban poor.

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

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

[18]This figure does not include the rural clients of ADBN's development banking segment and the clients of NBL and RBB since all three banks are considered to serve the better off clients in rural areas. Further, it has been assumed that about 15% clients have borrowed from more than one source.

[19]Assuming that one member from one households borrows from MFIs, as of July 2004 557,000 HHs have access to microfinance services and according to latest estimates, total population of Nepal has been 242,00,000 and 31% population live below poverty line in 2004 (NPC, 2004). With the average HHs size of 5.6 members per HH, this indicates that there are 1,339,642 HHs below the poverty line in Nepal.

Annex 3: Statistical Tables

Table 1: Outreach of Microfinance Services in Nepal
(As of July 2004)

Financial Institution	Number	Members (No)	Percentage
RRDBs	5	146,000	22.3
MDBs	4	90,000	13.7
SCCs	2650	160,000	24.4
SFCLs	161	88,000	13.4
Government Supported microfinance programmes	1	76,000	11.6
ADBN (SFDP)	1	66,000	10.1
Microfinance NGOs	44	29,000	4.4
Total	2868	655,000	100.0

Source: Sharma S. R. (2004)

Table 2: Sample Size of the Study

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1	Clients	No	148	154	72	68	68	510
	….. women	No	148	154	39	35	68	444
2	Non-clients	No	49	51	24	23	23	170
	…. women	No	49	51	13	12	23	148
3	Total	No	197	205	96	91	91	680
	…. women	No	197	205	52	47	91	592

Source: Data collection 2004

Table 3: Characteristics of Client Households

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1	Sample size	No	148	154	72	68	68	510
2	Clients from women headed HHs	No	5	13	7	9	11	45
3	Clients from women headed HHs	%	3.3	8.3	10.0	13.3	16.7	9.0
4	Access to financial services							
	Savings services	No	148	154	72	68	68	510
	Lending services	No	148	154	72	68	68	510
5	Non financial services	%	0.0	0.0	23.3	16.7	23.3	9.0
	Enterprise training	%	0.0	0.0	13.3	6.7	13.3	4.8
	Health/Education	%	0.0	0.0	10.0	10.0	10.0	4.3

Source: Field Survey 2004

Table 4: Average Savings and Loan Balance of the Client Households

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Mean
1	Average savings balance	Rs.	389	476	2857	4281	5560	1972
2	Average loan size							
	Average initial loan	Rs.	13514	14310	30300	28500	17500	18654
	Average outstanding loan	Rs.	9321	9920	14540	13250	14230	11417
3	Credit use	No	148	154	72	68	68	510
	Consumption	No	45	54	26	18	29	173
	Production	No	103	100	46	50	39	337
4	Credit use	%	100	100	100	100	100	100
	Consumption	%	31	35	37	27	43	34
	Production	%	69	65	63	73	57	66

Source: Field Survey 2004

Table 5: Access to Formal Financial Services of the Sample Client Households

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1	**Reaching the un-reached**							
	Access to bank credit before	No	20	15	12	16	20	83
	Access to formal saving before	No	27	21	36	29	25	138
2	**Reaching the un-reached**							
	Access to bank credit	%	13	10	17	23	30	17
	Access to formal saving	%	18	13	50	43	37	28

Source: Field Survey 2004

Table 6: Socio-economic Groups of Client Households

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Mean
A	**Total Clients**	%	100	100	100	100	100	100
1	Dalits	%	28	20	23	20	7	21
2	Janajatis	%	40	35	33	37	30	36
3	Other	%	32	45	43	43	63	43
4	Sample size – clients	No	148	154	72	68	68	510
B	**Non-clients**	%	100	100	100	100	100	100
1	Dalits	%	25	20	20	20	20	21
2	Janajatis	%	25	40	50	60	40	34
3	Other	%	75	60	50	40	60	66
4	Sample size - non-clients	No	49	51	24	23	23	170

Source: Field Survey 2004

Table 7: Wealth Ranking Results of the Client Households

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Mean
1	Total	%	100	100	100	100	100	100
	Very poor	%	23	18	0	0	0	12
	Poor	%	47	42	20	23	53	39
	Borderline poor	%	28	37	33	37	30	33
	Non-poor	%	2	3	47	40	17	16
2	Average loan size							
	Average initial loan	Rs.	13514	14310	30300	28500	17500	18654
	Average outstanding loan	Rs.	9321	9920	14540	13250	14230	11417
3	Sample size	No	148	154	72	68	68	510

Source: Field Survey 2004

Table 7a: Wealth Ranking Results of the Non-Client Households

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Mean
1	Total	%	100	100	100	100	100	100
	Very poor	%	23	18	0	0	0	12
	Poor	%	47	42	20	23	53	39
	Borderline poor	%	28	37	33	37	30	33
	Non-poor	%	2	3	47	40	17	16
2	Average loan size							
	Average initial loan	Rs.	13514	14310	30300	28500	17500	18654
	Average outstanding loan	Rs.	9321	9920	14540	13250	14230	11417
3	Sample size	No	148	154	72	68	68	510

Source: Field Survey 2004

Table 8: Sources of Finance of the Client and Non-Client Households

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Mean
1	Source of credit - clients	%	100	100	100	100	100	100
	MFI	%	60	60	56	55	60	58
	Moneylenders	%	27	23	19	26	12	22
	Others	%	13	17	26	18	28	20
2	Source of credit – non-clients	%	100	100	100	100	100	100
	MFI	%	0	0	0	0	0	0
	Moneylenders	%	46	50	44	46	43	46
	Others	%	54	50	56	54	57	54
3	Interest cost savings	Rs.	1216	1288	2727	2565	1575	1696
4	Sample size	No.	148	154	72	68	68	510

Source: Field Survey 2004

Table 9: Average Family Size of the Sample Population

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Mean
1	Clients	No	5.1	5.2	5.4	4.9	4.8	5.1
2	Non-clients	No	5.2	5.1	5.5	5.1	4.7	5.1
	Total	No	5.1	5.2	5.4	4.9	4.8	5.1

Source: Field Survey 2004

Table 10: Socio-economic Characteristics of the Client Households

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Mean
1	Age of the respondent	Yr.	37	37	38	39	39	38
2	Literacy rate	%	32	33	40	40	43	36
3	Women headed HHs	%	3.3	8.3	10.0	13.3	16.7	9.0
4	Land holding	%	100	100	100	100	100	100
	Landless	%	27	22	0	0	100	28
	0-0.5 ha.	%	70	70	53	60	0	56
	>0.5 ha	%	3	8	47	40	0	16
5	HH type	%	100	100	100	100	100	100
	Kuchha	%	63	75	27	3	100	58
	Mixed	%	37	25	50	50	0	32
	Pakka	%	0	0	23	47	0	10
6	HHs livelihoods	%	100	100	100	100	100	100
	Agro-based/livestock	%	35	33	50	47	10	35
	Non-farm self employment	%	10	7	23	20	40	17
	Labor (Causal)	%	55	60	27	33	30	46
	Other	%	0	0	0	0	20	3
7	Sample size	No	148	154	72	68	68	510

Source: Field Survey 2004

Table 10a: Socio-economic Characteristics of the Non-Client Households

S.N.	Type	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Mean
1	Age of the respondent	Yr.	38	36	37	38	38	37
2	Literacy rate	%	31	34	39	39	44	36
3	Women headed HHs	%	4.1	7.8	8.3	13.0	17.4	8.8
4	Land holding	%	100	100	100	100	100	100
	Landless	%	29	24	0	0	100	29
	0-0.5 ha.	%	67	69	58	57	0	56
	>0.5 ha	%	4	8	42	43	0	15
5	HH type	%	100	100	100	100	100	100
	Kuchha	%	61	76	29	9	100	59
	Mixed	%	39	24	54	57	0	34
	Pakka	%	0	0	17	35	0	7
6	HHs livelihoods	%	100	100	100	100	100	100
	Agro-based/livestock	%	37	31	46	52	9	35
	Non-farm self employment	%	10	10	29	17	35	17
	Labor (Causal)	%	53	59	25	30	17	43
	Other	%	0	0	0	0	39	5
7	Sample size	No	49	51	24	23	23	170

Source: Field Survey 2004

Table 11: IG/MEAs of Client HHs

S.N.	Particulars	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1	Sample size	No	148	154	72	68	68	510
2	Clients adopting credit financed IG/MEAs	No	103	100	46	50	39	337
3	Adoption rate	%	69	65	63	73	57	66
4	Enterprise experiencing increased income	No	92	90	41	45	35	303
5	Benefiting client ratio	%	62	58	57	66	51	59
6	Increase in income	%	100	100	100	100	100	100
	< Rs. 2000	%	19	20	27	29	13	21
	Rs. 2000 - Rs. 6000	%	47	43	33	24	47	41
	Rs. 6000 - Rs. 10000	%	25	23	27	35	20	25
	> Rs. 10000	%	17	6	13	12	20	13
7	Average income increase	Rs.	12752	9068	11316	11513	13042	11312
	< Rs. 5000	Rs.	3825	3421	3658	3829	3742	3679
	Rs. 5000 - Rs. 10000	Rs.	7520	8234	8327	7728	8142	7935
	Rs. 10000 – Rs. 20000	Rs.	15925	14928	16245	15896	15241	15638
	> Rs. 20000	Rs.	26854	25247	24250	25147	28478	26324

Source: Field Survey 2004

Table 11a: IG/MEAs of Non-Client HHs

S.N.	Particulars	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1	Sample size	No	49	51	24	23	23	170
2	HHs adopting IG/MEAs	No	23	21	10	11	9	74
3	Adoption rate	%	47	41	42	48	39	44
4	HHs experiencing increased income	No	20	19	9	9	7	64
5	Benefiting HHs ratio	%	41	37	38	39	30	38
6	Increase in income	%	100	100	100	100	100	100
	< Rs. 2000	%	61	71	70	55	78	66
	Rs. 2000 - Rs. 6000	%	22	19	20	36	11	22
	Rs. 6000 - Rs. 10000	%	17	10	10	9	11	12
	> Rs. 10000	%	0	0	0	0	0	0
7	Average income increase	Rs.	5165	4698	4483	5221	4558	4875
	< Rs. 5000	Rs.	2765	3040	2631	2959	2878	2870
	Rs. 5000 - Rs. 10000	Rs.	6156	7123	7115	6215	6225	6537
	Rs. 10000 – Rs. 20000	Rs.	12329	12281	12178	14821	14653	12837
	> Rs. 20000	Rs.	0	0	0	0	0	0

Source: Field Survey 2004

Table 12: Status on IG/MEAs: Clients

S.N.	Particulars	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1	Sample size	No	148	154	72	68	68	510
2	Enterprise development	No	103	100	46	50	39	337
3	Adoption rate	%	69	65	63	73	57	66
4	Enterprise established	No	113	105	53	54	39	364
5	Adoption to total enterprise	%	111	105	116	109	100	108
6	Enterprise mix	%	100	100	100	100	100	100
	Animal husbandry	%	34	31	58	41	18	35
	Cash crop production	%	12	8	37	36	0	17
	Non-farm enterprises	%	65	59	16	18	82	51
	Overseas employment	%	0	8	5	14	0	5

Source: Field Survey 2004

Table 12a: Status on IG/MEAs: Non-Clients

S.N.	Particulars	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1	Sample size	No	49	51	24	23	23	170
2	Enterprise development	No	23	21	10	11	9	74
3	Adoption rate	%	47	41	42	48	39	44
4	Enterprise established	No	24	23	11	11	9	78
5	Adoption to total enterprise	%	104	110	110	100	100	105
6	Enterprise mix	%	100	100	100	100	100	100
	Animal husbandry	%	67	65	64	73	11	60
	Cash crop production	%	21	22	27	18	11	21
	Non-farm enterprises	%	13	13	9	9	78	19
	Overseas employment	%	0	0	0	0	0	0

Source: Field Survey 2004

Table 13: Employment Generation through Credit Financed IG/MEAs of Client HHs

S.N.	Particulars	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1	Enterprise developed	No	113	105	53	54	39	364
2	Total employment	No	136	135	56	56	49	433
	Animal husbandry	No	22	30	20	14	4	90
	Cash crop production	No	11	10	19	19	0	60
	Non-farm enterprises	No	103	88	14	16	45	266
	Oversees employment	No	0	8	2	7	0	17
3	Employment composition	%	100	100	100	100	100	100
	Men	%	33	32	34	36	37	34
	Women	%	51	51	52	44	46	50
	Children	%	16	17	13	20	18	17

Source: Field Survey 2004

Table 13a: Employment Generation through IG/MEAs by Non-Client HHs

S.N.	Particulars	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1	Enterprise developed	No	24	23	11	11	9	78
2	Total employment	No	25	25	13	12	13	88
	Animal husbandry	No	16	16	8	8	2	50
	Cash crop production	No	5	5	3	2	1	16
	Non-farm enterprises	No	4	4	2	2	10	22
	Oversees employment	No	0	0	0	0	0	0
3	Employment composition	%	104	109	118	109	144	113
	Men	%	100	100	100	100	100	100
	Women	%	56	52	54	67	54	56
	Children	%	36	36	31	25	38	34

Source: Field Survey 2004

Table 14: Summary Information

S.N.	Particulars	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Total
1.0	Sample size	No	148	154	72	68	68	510
2.0	Credit Use							
2.1	Production	%	70	65	64	74	57	66
	…… Benefiting	%	62	58	57	66	51	59
2.2	Consumption	%	30	35	36	26	43	34
	….. Indebted	%	10	11	32	31	12	16
3.0	Poverty Impact							
3.1	Reduction on							
	Very poor	%	8	10	100	100	100	24
	Poor	%	3	3	13	11	3	4
3.2	Increase in							
	Borderline poor	%	11	8	4	4	11	6
	Not-poor	%	50	25	31	29	20	29
4	Incremental income generation							
	Client HHs	Rs/yr	12752	9068	11316	11513	13042	11312
	Non-client HHs	Rs/yr	5165	4698	4483	5221	4558	4875

Table 15: Problems Encountered by Clients in Credit Financed Income Generating/Micro-enterprise Activities

S.N.	Particulars	Unit	MDB	GBB	SFCL-1	SFCL-2	SCCs	Average
1	Type of problems							
	Illness of HH members	%	42	45	90	50	53	52
	Cash crunch	%	43	52	40	63	40	48
	Seasonal marketing problems	%	35	32	40	30	23	32
	Loss/damage of assets	%	43	37	57	37	43	42
2	Sample size	No	148	154	72	68	68	510

Source: Field Survey 2004

Table 16: Risks and Their Effect on Vulnerable Households

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

Source: FGDs 2004

Table 17: Role of microfinance in risk management

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

Source: Field study 2004